FINANCIAL REPORTING (FR)

STUDY TEXT

THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF NIGERIA

FINANCIAL REPORTING (FR)

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Foreword

FOREWORD

As the global economy continues to evolve, the importance of accounting professionals with strong technical skills, professional competence and ethical awareness cannot be overstated. The swift transformation in the business world, driven by globalisation, technological advancements and sustainability considerations, have significantly impacted the finance function and the skills required by professional accountants.

To remain relevant, the Institute's syllabus and training curriculum are designed to equip students with the knowledge and competencies required to succeed in the dynamic fields of accounting and finance. These are regularly reviewed and updated to reflect current trends and future needs of users of accounting and related services.

The Institute of Chartered Accountants of Nigeria (ICAN) is committed to ensuring that its syllabus and training curriculum remain current and relevant. To achieve this, ICAN undertakes a comprehensive review of these documents every three years, supplemented by annual updates to reflect emerging trends and developments in the national and global accountancy profession.

Following a rigorous process, the Syllabus Review, Professional Examinations, and Students' Affairs Committees have developed a new 3-level, 15-subject syllabus. As approved by the Council, the new syllabus will be implemented starting with the November 2025 examination diet.

The publication of the Study Texts has consistently accompanied syllabus reviews, yielding notable improvements in the performance of professional examination candidates. To further enhance student success rates, the Council has approved the development of new learning materials (Study Texts) for all the subjects. This sixth edition, incorporates significant updates, including IT and soft skills, thereby enhancing the contents, innovation, and quality. This edition has taken into consideration all requirements of the International Panel on Accountancy Education (IPAE).

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The Institute engaged renowned writers and reviewers, comprising esteemed scholars and practitioners with extensive experience in their areas of specialisation, to develop high-quality learning materials. The 15 subjects include:

Foundation Level		
1.	Business Environment	A1
2.	Financial Accounting	A2
3.	Management Accounting	A3
4.	Corporate and Business Law	A4

Skills Level		
5.	Financial Reporting	B1
6.	Audit, Assurance and Forensics	B2
7.	Taxation	B3
8.	Performance Management	B4
9.	Financial Management	B5
10.	Public Sector Accounting and Finance	B6

Professional Level		
11.	Strategic Business Reporting	C1
12.	Advanced Audit, Assurance and Forensics	C2
13.	Strategic Financial Management	C3
14.	Advanced Taxation	C4
15.	Case Study	C5

A rigorous quality control process was implemented, featuring a detailed and comprehensive review of the materials developed by the writers and reviewers by the Study Texts Review Technical Subcommittee.
These Study Texts will be valuable resources, not only for our candidates but also for students of other professional bodies, tertiary institutions, and finance and management practitioners, providing valuable resources for their studies and practices.

Chibuzor Noel Anyanechi, (Chief) BSc, MBA, FCA
Chairman, Syllabus Review Committee

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Acknowledgement

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Syllabus

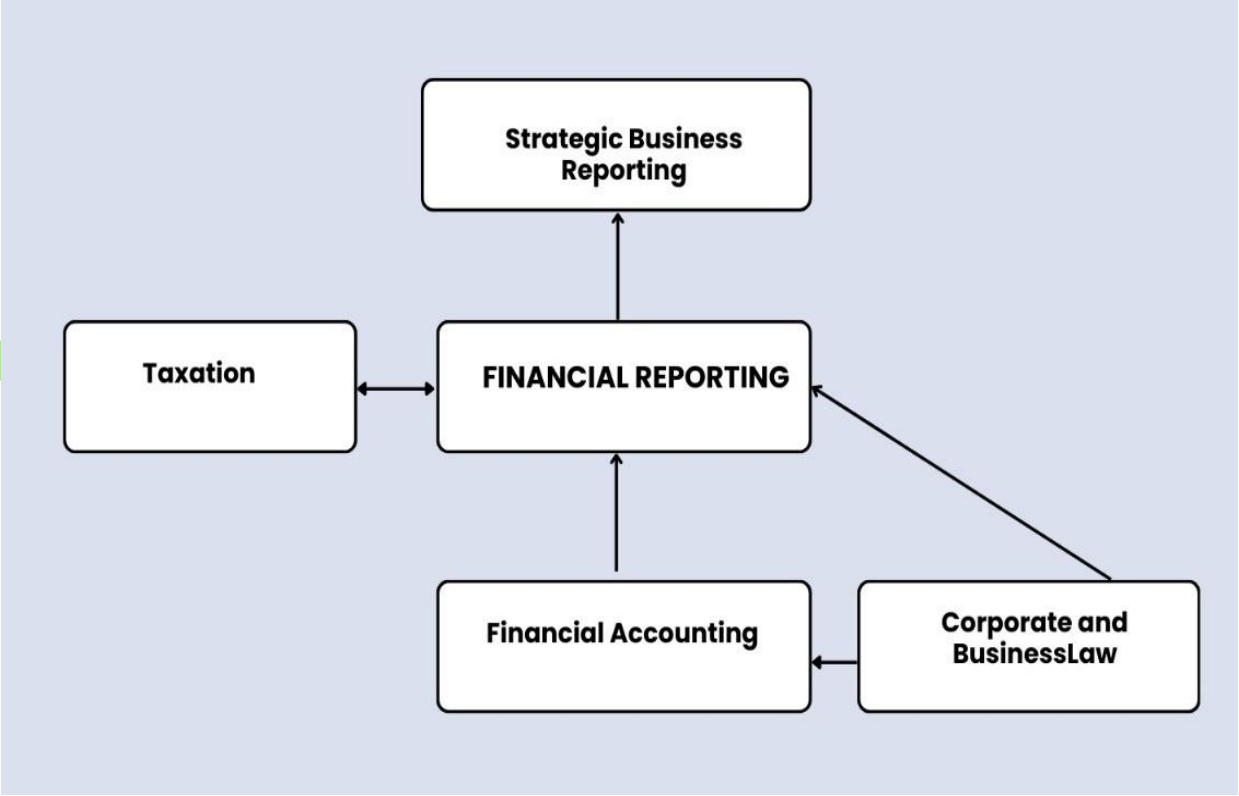
Aim

To enable candidates develop their knowledge of Financial Accounting to a higher level of skills and ability to prepare financial statements, including consolidated financial statements and sustainability disclosures, in accordance with International Financial Reporting Standards (IFRSs) and IFRS Sustainability Disclosure Standards (IFRS SDSs).

Candidates are also expected to demonstrate an understanding of and competence in financial statements analyses, interpretation and knowledge of sustainability reporting.

Linkage with other related subjects

This diagram depicts the relationship between this subject and other related subjects. Financial accounting is a pre-requisite to this subject.



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Main competencies

On successful completion of this paper, candidates are expected to be able to:

- explain the importance of regulatory frameworks for accounting and reporting;
- identify and state the circumstances in which private sector entities are required to prepare and present statutory financial statements in line with IFRS;
- identify and state the laws, regulations, accounting standards and other requirements that govern the preparation of financial statements by public and private sector entities;
- account for specific transactions in accordance with relevant international financial reporting standards;
- draft and present general purpose financial statements, or extract therefrom, of an entity and simple groups in accordance with relevant accounting policies and in line with international financial reporting standards (IFRS) and local laws;
- assess the circumstances in which the use of IFRS may not be required for companies;
- analyse and interpret financial statements of entities and simple groups;
- explain the basis of sustainability reporting standards; and
- explain recent developments and ethical issues in the area of financial reporting.

Specification grid

The grid below shows the relative weightings of the main sections within this syllabus and should guide the study time spent on each. Over time, the marks available in the assessment will be within the ranges of weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

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Syllabus Review		
Grid		Weighting %
A	Conceptual and regulatory frameworks for financial reporting	10
B	Accounting standards and policies relating to specific transactions in financial statements	15
C	Preparation and presentation of single entity general purpose financial statements	20
D	Preparing and presenting financial statements of simple group (parent, one subsidiary and an associate)	20
E	Analyses and interpretation of financial statements	15
F	Sustainability reporting framework	10
G	Ethics, current, and technological developments in financial reporting	10
	TOTAL	100

Detailed contents

A. CONCEPTUAL AND LEGAL FRAMEWORKS FOR FINANCIAL REPORTING 10%

1. Discuss the need for regulatory frameworks in financial reporting.
2. Conceptual framework
   - (a) Explain the meaning and purpose of conceptual framework of financial reporting.
   - (b) Explain the objectives, qualitative characteristics and limitations of financial statements.
   - (c) Discuss the underlying assumptions in preparing financial statements and how they are applied to financial reporting.
   - (d) Identify users of financial statements and their information needs.
   - (e) Identify and discuss the elements of financial statements.
   - (f) Discuss recognition and measure of element of financial statements.
   - (g) Explain the concept of capital maintenance.
   - (h) Differentiate between principle-based and rule-based financial reporting frameworks.
   - (i) Discuss accrual and cash bases of accounting.

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(j) Discuss financial statements in relation to reporting entities under the conceptual framework.

(k) Explain the standard setting process of International Accounting Standards Board (IASB) and the relationship with national standard setters.

(l) Discuss the process for revision of standards.

(m) Discuss the process of adoption of IFRSs and application of local standards.

(n) Explain the peculiar nature and relevant frameworks of specialised, not-for-profit and public sector entities including IFRS, national standards and International Public Sector Accounting Standards (IPSAS).

(o) Discuss the need and role of the International Sustainability Standards Board (ISSB).

2. Legal framework

(a) Identify and discuss laws and regulations that govern the preparation of financial statements.

(b) Identify and discuss relevant provisions of Companies and Allied Matters Act 2020 (as amended), and special pronouncements by regulatory authorities, including:

(i) Central Bank of Nigeria (CBN);
(ii) Nigeria Deposit Insurance Corporation (NDIC);
(iii) Financial Reporting Council of Nigeria (FRC);
(iv) National Insurance Commission (NAICOM);
(v) Nigerian Exchange Group (NGX);
(vi) Securities and Exchange Commission (SEC); and
(vii) Pension Commission (PENCOM) etc.

B. ACCOUNTING STANDARDS AND POLICIES RELATING TO SPECIFIC TRANSACTIONS IN FINANCIAL STATEMENTS 15%

1. Tangible non-current assets

Calculate, discuss and account for tangible non-current assets in accordance with the provisions of relevant accounting standards (IAS 16, IAS 20, IAS 23, IAS 40, IFRS 5, and IFRS 16).

2. Intangible non-current assets (IAS 38)

Calculate, discuss and account for intangible non-current assets in accordance with the provisions of IAS 38.

3. Impairment of tangible and non-intangible assets (IAS 36)

Calculate, discuss and account for impairment of tangible and intangible non-current assets (excluding financial assets and liabilities) in accordance with the

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provisions of IAS 36.

4. Financial instruments: financial assets and liabilities, and fair value measurement

   (a) Differentiate between debt and equity financial instruments.
   (b) Calculate, discuss and account for financial instruments using amortised cost or fair value measurement in accordance with the provisions of relevant accounting standards (IAS 32, IFRS 7, IFRS 9 and IFRS 13) with respect to measurement (including fair value and amortised cost), recognition, de-recognition and disclosures, excluding hedging but including simple impairment cases.

5. Inventories and revenue from contracts with customers (IAS 2, IFRS 15)

   Calculate, discuss and account for inventories and revenue from contracts with customers in accordance with the provisions of relevant accounting standards (IAS 2 and IFRS 15).

6. Provisions, contingent liabilities and assets, and events after the reporting period (IAS 10, IAS 37)

   Calculate, discuss and account for provisions, contingent liabilities and assets as well as events after the reporting period in accordance with the provisions of relevant accounting standards (IAS 10, IAS 37).

7. Income taxes (IAS 12)

   Calculate, discuss and account for income tax, including current and deferred tax in accordance with the provisions of IAS 12.

8. Earnings per share (IAS 33)

   Calculate, discuss and account for earnings per share (EPS) in accordance with provisions of IAS 33.

9. Effects of changes in foreign exchange rates (IAS 21)
   a. Account for foreign currency transactions
   b. Translate financial statements
   c. Report exchange rate changes

C. PREPARATION AND PRESENTATION OF SINGLE ENTITY GENERAL PURPOSE FINANCIAL STATEMENTS 20%

1. Preparation of financial statements

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(a) Discuss accounting policies in accordance with the provisions of IAS 8, in relation to:
   (i) Selection of accounting policies;
   (ii) Consistency in the application of accounting policies;
   (iii) Changes in accounting policies;
   (iv) Disclosure of accounting policies; and
   (v) Changes in accounting estimates and accounting for material errors in prior period.

(b) Prepare and present single entity general purpose financial statements including statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and relevant notes in accordance with IAS 1 and other relevant IFRSs.

(c) Prepare and present statement of cash flows for single entities in accordance with IAS 7, using direct and indirect methods.

(d) Discuss the objectives and limitations of general purpose financial reporting.

(e) Other national disclosures in accordance with Companies and Allied Matters Act 2020 (as amended):
   (i) Prepare value added statement; and
   (ii) Prepare five-year financial summary.

D. PREPARING AND PRESENTING FINANCIAL STATEMENTS OF SIMPLE GROUP (PARENT, A SUBSIDIARY AND AN ASSOCIATE) 20%

1. Understanding a simple group
   (a) Explain the concept of group and the objectives of preparing group financial statements.
   (b) Discuss the provisions of the relevant accounting standards for the preparation and presentation of financial statements of simple group – (IAS 27, IAS 28, IFRS 3 and IFRS 10), including the use of fair value for non-controlling interest.
   (c) Calculate non-controlling interest, using alternative methods and effect necessary adjustments required to prepare the financial statements of simple group.

2. Preparation and presentation of simple group financial statements
   (a) Prepare and present statement of financial position of a simple group (a subsidiary and an associate in accordance with its accounting policies and the provisions of relevant international financial reporting standards (IAS 1, IAS 27, IAS 28, IFRS 3 and IFRS 10).
   (b) Prepare and present statement of profit or loss and other comprehensive income of a simple group (a subsidiary and an associate), in accordance with its accounting policies and the provisions of relevant international financial reporting standards (IAS 1, IAS 27, IAS 28, IFRS 3 and IFRS 10).

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(c) Prepare and present statement of cash flows of a simple group (a subsidiary and an associate), in accordance with the provisions of IAS 7.

(d) Discuss management disclosures, analyses and commentaries on simple group financial statements.

(e) Explain the application of international financial reporting standards (IFRS) to specified simple group scenarios.

E. ANALYSES AND INTERPRETATION OF FINANCIAL STATEMENTS 15%

1. Analyses of financial statements

(a) Identify and discuss types of analysis and interpretation of financial statements.

(b) Discuss various aspects of financial position and performance that may be assessed (profitability, efficiency, liquidity, solvency, investors' returns) through the analyses and interpretation of financial statements.

(c) Define ratio, identify and calculate various types of ratio used in the assessment of financial position and performance of a business entity.

(d) Analyse and interpret computed ratios and assess the current period financial position and performance of a business entity in comparison with:

(i) Its prior period;

(ii) Another given entity for the same period; and

(iii) Industry average for the same period.

(e) Analyse and interpret computed ratios and assess the current period financial position and performance of a simple group (a subsidiary and an associate) in comparison with:

(i) Its prior period;

(ii) Another given simple group entity for the same period; and

(iii) Industry average for the same period.

(f) Discuss the use of statement of cash flows in assessing liquidity and compare its usefulness with that of a statement of profit or loss and other comprehensive income when assessing liquidity and going concern of a business entity.

(g) Identify and assess non-financial information relevant to the assessment of the performance and financial position of an entity.

(h) Explain the use of earnings per share (EPS) in assessing the performance of corporate entities in the capital market, especially capital market reaction to earnings announcement.

(i) Write reports as may be required when analysing and interpreting the financial position and performance of a business entity and simple group, drawing conclusions, making recommendations and giving advice from the perspectives of different stakeholders.

3. Limitations of analyses and interpretation of financial statements

(a) Discuss the limitations of historic financial information in the analyses and interpretation of financial statements.

(b) Explain how financial statements may be manipulated and discuss the impact of window dressing and creative accounting on calculated

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ratios and how they can distort analyses and interpretation of financial statements.

(c) Explain how analyses and interpretation of financial statements of specialised and not-for-profit organisations differ from those of profit-oriented organisations.

(d) Explain why earnings per share (EPS) trend may be a better indicator of performance, when compared with a company's profit trend and discuss the limitations of using EPS as a performance measure.

(e) Explain why and how the use of consolidated financial statements might limit analyses and the use of interpretation techniques.

(f) Discuss the use of other information, including non-financial information relevant to the assessment of an entity's performance.

F. SUSTAINABILITY REPORTING FRAMEWORK 10%

1. Discuss the movement from social and environmental accounting to sustainability reporting.
2. Discuss sustainability reporting and methods of reflecting its impacts in financial statements and narratives for investors.
3. Discuss factors responsible for the increasing demand for sustainability reporting – internationally and locally.
4. Evaluate the problems and limitations of sustainability reporting.
5. Discuss the principles and content elements of Global Reporting Initiative (GRI) and United States (US) Sustainability Accounting Standards Board (SASB) frameworks for sustainability reporting and Nigeria Exchange Group's guidelines on sustainability reporting.
6. Evaluate the impact of sustainability reporting on corporate performance measures.
7. Discuss the emergence of International Sustainability Standards Board (ISSB).
8. Discuss international sustainability standard issued by ISSB: IFRS S1 – General Requirements for Disclosure of Sustainability-related Financial Information.
9. Explain the roadmap for adopting IFRS S1 and S2 issued by the Financial Reporting Council (FRC) of Nigeria for the implementation of IFRS S1 and S2:
   a. early adopters for accounting periods ending on or before December 31, 2023;
   b. voluntary adopters for accounting periods ending on or before December 31, 2026;
   c. mandatory adopters for accounting periods beginning on or after January 1, 2027; and
   d. public sector entities – to be communicated later.
10. List and explain, including the timelines for submission, documents to be submitted by entities adopting IFRS S1 and S2 to Financial Reporting Council of Nigeria for readiness test assessments including:

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a. to be submitted at least three months before the beginning of the reporting date:
i. Board resolution approving the adoption of IFRS Sustainability disclosure standards.
ii. Gap analysis report;
iii. implementation plan.
b. to be submitted not more than three months after the beginning of the reporting date:
i. IFRS Sustainability disclosure policies;
ii. identification and application of transitional reliefs;
iii. enterprise risk management and sustainability framework;
iv. evidence of Board approval of the IFRS Sustainability disclosure policies;
v. evidence of Board approval of enterprise risk management and sustainability frameworks; and
vi. evidence of sustainability and ESG-specifics training for Board members, management, and preparers by reputable training providers acceptable to the FRC.
c. to be submitted not more than six (6) months after the beginning of the reporting date:
i. evidence of registration of the entity and professionals engaged in the sustainability reporting process with FRC;
ii. description of models used for scenario analysis;
iii. identification of sustainability and climate-related risks; and opportunities;
iv. evidence of the establishment of a governance structure for sustainability reporting;
v. targets and metrics set to manage and measure identified risks and opportunities,
vi. identification of aspects of financial reports requiring updates;
vii. identification of current and anticipated effect of sustainability-related risks and opportunities on the entities business model and value chain; and
viii. internal control over sustainability reporting.

G. ETHICS, CURRENT AND TECHNOLOGICAL DEVELOPMENTS IN FINANCIAL REPORTING 10%

1. Discuss and apply ethical and professional issues in financial reporting and identify appropriate actions.
2. Discuss new accounting standards in issue as may be specified from time to time.
3. Identify and explain current and emerging issues in financial reporting.
4. Identify and discuss the uses and application of cloud accounting, digital assets, blockchain, distributed ledger technologies, fintech, etc;
5. Discuss the effect of technological developments in financial reporting, relating to artificial intelligence, machine learning, etc.

Applicable Accounting Standards

- Preface to IFRS

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- Conceptual Framework for Financial Reporting
- IAS 1 - Presentation of Financial Statements
- IAS 2 - Inventories
- IAS 7 - Statement of Cash Flows
- IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 10 - Events after the Reporting Period
- IAS 12 - Income Taxes
- IAS 16 - Property, Plant and Equipment
- IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance
- IAS 21 - The Effects of Changes in Foreign Exchange Rates
- IAS 23 - Borrowing Costs
- IAS 27 - Separate Financial Statements
- IAS 28 - Investments in Associates
- IAS 32 - Financial Instruments: Presentation
- IAS 33 - Earnings Per Share
- IAS 36 - Impairment of Assets
- IAS 37 - Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 - Intangible Assets
- IAS 40 - Investment Property
- IFRS 3 - Business Combinations
- IFRS 5 - Non-current Assets Held for Sale and Discontinued Operations
- IFRS 7 - Financial Instruments: Disclosures
- IFRS 9 - Financial Instruments
- IFRS 10 - Consolidated Financial Statements
- IFRS 13 - Fair Value Measurement
- IFRS 15 - Revenue from Contracts with Customers
- IFRS 16 - Leases
- IFRS 18 - Presentation and Disclosure in Financial Statements
- IFRS S1 - General Requirements for Disclosure of Sustainability-related Financial Information

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CHAPTER 1

REGULATORY FRAMEWORK

Contents

1.0 Learning objective
1.1 Learning outcomes
1.2 The regulatory framework
1.3 The IFRS Foundation and the IASB
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1.5 Legal regulations for Accounting in Nigeria
1.6 Regulatory frameworks for public sector and not-for- profit organisations
1.7 Chapter review
1.8 End of chapter questions and suggested solutions

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1. Regulatory Framework

1.0 Learning objective

This chapter discusses the regulatory framework of financial reporting.

1.1 Learning outcomes

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

a) explain the sources of accounting regulation in Nigeria;

b) outline the roadmap for conversion to IFRS in Nigeria;

c) understand the rules on financial statements set out in companies and allied matters act 2020 and IFRS;

d) explain the standard setting process for IFRS; and

e) explain how financial statements of public sector entities and not-for-profit entities might differ from those of private sector, profit making entities.

1.2 The regulatory framework

1.2.1 The need for regulation

The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

There are several reasons why financial reporting should be regulated. The most obvious one is that without it, an entity would be free to adopt any accounting treatment that it chooses.

Other reasons

a) People external to businesses are normally dependent on the published financial statements for information about the entity's activities. Regulation ensures that external users of financial statements are provided with information that is relevant and reliable to their decisions making.

b) Accounting standards and other forms of regulation help to ensure that entities adopt similar accounting treatments for similar items and account for similar transactions in the same way. This makes it possible to compare the financial statements of different entities and to compare an entity's performance for the current year with its performance in previous years.

c) Without regulation, management would adopt whichever accounting treatment that presents its results and position in the best possible light. Sometimes, management might deliberately mislead users of the financial statements using creative accounting and window dressing.

1.2.2 Sources of regulation

The main sources of regulation are:

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a) accounting standards.

b) company law.

c) sectoral regulations; and

d) the listing rules of the relevant stock exchange, for listed companies.

i. **Accounting standards** are authoritative statements of how particular types of transactions and events are reflected in the financial statements. It can also be described as the rules and regulation that guide the preparation of financial statements. International Financial Reporting Standards are used in Nigeria.

ii. **Company law** varies from country to country, but typically also it sets out rules for determining profits available for distribution, issuing and redeeming share capital, the reserves that a company must have and the uses to which they can be put. These matters are not covered in accounting standards. The main company law statute in Nigeria is the Companies and Allied Matters Act 2020 as amended to date.

iii. **Sectoral regulation** may apply to certain industries, for example, the banking sector is regulated by Central Bank of Nigeria, insurance sector by National Insurance Commission and pension by National Pension Commission. Such regulations may specify peculiar financial reporting requirements of the sectors. For example, in Nigeria, the Central Bank prudential guidelines override impairment provision of IFRS 9.

iv. **Listing rules** set out the information which entities must supply when their shares are traded on a major stock market. They must comply with these rules in order to maintain their listing. These rules include requirements relating to information, including financial reports that entities must prepare and provide to the stock market while they are listed.

1.2.3 Principles and rules

Company law consists of detailed rules. Accounting standards may be rules- based or principles-based. IASs and IFRSs are mainly principles based, though some would argue that in practice they are a mixture of rules and principles.

It is possible for rules and principles to complement each other. Many countries (including Nigeria, the UK, Canada, and Australia) have a regulatory system in which company law deals only with a few specific matters. Detailed financial reporting practice is developed by the accounting profession through accounting standards. Accounting standards are generally (though not always) principles- based. This allows reporting practice to develop over time in response to the needs of users and changes in the business environment. Accounting standards usually allow preparers to exercise judgement in developing accounting policies that are appropriate to the circumstances of a particular entity.

In other countries, the content of financial statements and accounting practice may be prescribed in great detail by company law, with little scope for individual judgement. Because the existing framework is based on detailed rules, users of the financial statements tend to view principles-based accounting as insufficiently rigorous.

1.2.4 Conceptual framework

A conceptual framework for financial reporting is a statement of generally accepted theoretical

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principles, which form the frame of reference for financial reporting.

Its theoretical principles provide the basis for:

a) the development of accounting standards; and

b) the understanding and interpretation of accounting standards.

Therefore, a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to users of financial statements.

1.2.5 Advantages of a conceptual framework

a) Accounting standards are developed on the same theoretical principles – which avoids a haphazard approach to setting standards and should lead to standardised accounting practices.

b) The development of accounting standards is less subject to political pressure – pressure on standard setters to adopt a certain approach would only prevail if it was acceptable under the conceptual framework.

c) Accounting standards use a consistent approach – e.g. without a conceptual framework, some standards may concentrate on profit or loss whereas some may concentrate on the valuation of net assets.

d) A principles-based approach avoids the need for large volumes of 'rules' to address every scenario. Instead, the same underlying principles can be applied to any scenario.

1.2.6 Disadvantages of a conceptual framework

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

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

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

1.2.7 The IASB's Conceptual Framework

Purpose

IFRS Standards are based on the Conceptual Framework for Financial Reporting (the 'Conceptual

Framework') which addresses the concepts underlying the information presented in general purpose financial statements.

Purpose of the conceptual framework

a) Assist the IASB to develop IFRS that are based on consistent concepts.

b) Assist preparers of accounts to develop accounting policies in cases where there is no IFRS applicable to a particular transaction, or where a choice of accounting policy exists.

c) Assist all parties to understand and interpret IFRSs. (Conceptual Framework: para. SP1.1).

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Status
The Conceptual Framework is not an IFRS Standard. It does not override any IFRS Standard but instead forms the conceptual basis for the development and application of IFRS Standards.

Contents
The Conceptual Framework is divided into eight chapters. You do not need to know all the contents of the Conceptual Framework for the Financial Reporting exam. In the rest of this chapter, we will cover the key parts of the Conceptual Framework that are included in the Financial Reporting syllabus.

The objective of general-purpose financial reporting
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' (Conceptual Framework: para. 1.2).

Existing and potential investors, lenders and other creditors are referred to as the 'primary users of financial statements (Conceptual Framework: para. 1.5).

Primary users may make decisions about buying, selling or holding shares or debt instruments or providing or settling loans (Conceptual Framework: para. 1.2).

To make decisions, primary users need information about:

a) The economic resources of the entity, claims against the entity and changes in those resources and claims; and

b) Management's stewardship: how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources.

Accrual accounting

The Conceptual Framework requires financial statements to be prepared using accrual accounting. That is, the effects of transactions and events are reported in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

This is also referred to as the 'matching' concept.

Cash accounting

Cash Basis of Accounting is an accounting method where revenues and expenses are recorded only when cash is received or paid, rather than when they are earned or incurred. This method is simple and commonly used by small businesses, as it focuses on actual cash flow. However, it does not provide a complete picture of financial performance since it ignores accounts receivable and payable.

In line with the Conceptual Framework for Financial Reporting, the Cash Basis of Accounting does not fully comply with the accrual basis of accounting, which is recommended by standard-setting bodies like the International Financial Reporting Standards (IFRS) and **Generally Accepted Accounting Principles (GAAP).**

The Conceptual Framework emphasises faithful representation and relevance, which the cash basis may not fully achieve because it does not recognise financial events when they occur but only when cash transactions take place. This can lead to misstatements of an entity's financial position and performance, as it does not account for outstanding receivables, payables, or accrued expenses.

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Thus, while cash-based accounting is simple and useful for small businesses, it lacks the completeness and comparability that the conceptual framework promotes for high-quality financial reporting.

Underlying assumption: Going concern

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

This means that it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

However, if such an intention or need exists, the financial statements may have to be prepared on a different basis such as the 'break-up basis'.

Qualitative characteristics of useful financial information

The Conceptual Framework identifies the characteristics of information that make that information useful to users of financial statements.

There are fundamental qualitative characteristics and enhancing qualitative characteristics.

Fundamental qualitative characteristics

There are two fundamental qualitative characteristics: relevance and faithful representation.

Information is useful if it is relevant and faithfully represents what it purports to represent

(Conceptual Framework, para. 2.4).

Enhancing qualitative characteristics

The enhancing qualitative characteristics are:

a) comparability;

b) verifiability;

c) timeliness; and

d) understandability.

(Conceptual Framework: paras. 2.23–2.38)

The usefulness of information is enhanced if these characteristics are maximised. Enhancing qualitative characteristics cannot make information useful if the information is irrelevant or if it is not a faithful representation.

The benefits of reporting information should justify the costs incurred in reporting it. This is known as the 'cost constraint'.

Comparability

Comparability: The qualitative characteristic that enables users to identify and understand similarities in, and differences among, items (Conceptual Framework: para. 2.25).

For example:

a) Consider the disclosure of accounting policies. Users must be able to distinguish between different accounting policies in order to be able to compare similar items in the accounts of different entities.

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

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c) Comparability is not the same as uniformity. Accounting policies should be changed if the change will result in information that is reliable and more relevant, or where the change is required by an IFRS.

Verifiability

Verifiability: This helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation (Conceptual Framework: para. 2.30). Information can be verified as a model or formula or by direct observation, such as undertaking an inventory count. Independent verification can be carried out, e.g. a valuation by a specialist.

Timeliness

Timeliness: This means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older information is the less useful it is (Conceptual Framework: para. 2.33).

There is a balance between timeliness and the provision of reliable information.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error. Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

Understandability

Understandability: Classifying, characterising and presenting information clearly and concisely makes it understandable (Conceptual Framework: para. 2.34). Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently (Conceptual Framework: para. 2.36).

The elements of the financial statements

The Conceptual Framework defines the elements of the financial statements.

The five elements of financial statements are assets, liabilities, equity, income and expenses.

Asset: A present economic resource controlled by the entity as a result of past events

(Conceptual Framework: para. 4.2).

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

Framework: para. 4.14).

Economic benefits include:

a) Cash flows, such as returns on investment sources

b) Exchange of goods, such as by trading, selling goods, provision of services

c) Reduction or avoidance of liabilities, such as paying loans

(Conceptual Framework: para. 4.16)

Liability:

A present obligation of the entity to transfer an economic resource as a result of past events (Conceptual Framework: para. 4.2).

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An essential characteristic of a liability is that the entity has an obligation. An obligation is 'a duty or responsibility that the entity has no practical ability to avoid' (Conceptual Framework: para.4.29).

Equity:

The residual interest in the assets of an entity after deducting all its liabilities

(Conceptual Framework: para. 4.2).

Remember that EQUITY = NET ASSETS = SHARE CAPITAL + RESERVES.

Income:

Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from equity participants (Conceptual Framework: para.4.2).

Expenses:

Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to equity participants (Conceptual Framework: para.4.2).

The Conceptual Framework describes financial reporting as providing information about financial position and changes in financial position: assets and liabilities are defined first, and income and expenses are defined as changes in assets and liabilities, rather than the other way around.

1.3 The IFRS Foundation and the IASB

1.3.1 Background

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.

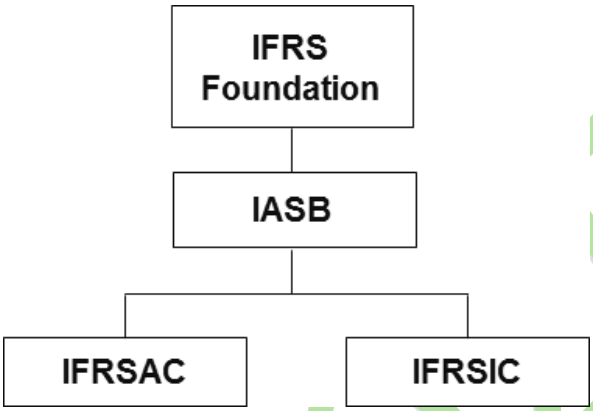
In 2001 a new standard setting structure was introduced headed up by the IASC Foundation ("the foundation"). The foundation is now called the IFRS Foundation.

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1.3.2 The standard setting structure

The current structure of the organisations responsible for publishing international accounting standards is as follows:

Illustration: IFRS Accounting Standard setting structure



1.3.3 The IFRS Foundation

The foundation, a not-for-profit organisation is run by 22 trustees who are responsible for:

a) the governance of the Foundation and the bodies within it; and

b) fundraising.

The constitution of the Foundation includes a requirement that, in order to achieve a broad international basis, there must be:

a) 6 trustees from the Asia/Oceania region.

b) 6 trustees from Europe.

c) 6 trustees from the Americas.

d) 1 trustee from Africa; and

e) 3 trustees who may be appointed from any area.

1.3.4 The International Accounting Standards Board (IASB)

The **International Accounting Standards Board** (IASB) is the standard-setting body of the IFRS Foundation.

The IASB is responsible for developing international accounting standards. It has full responsibility for all IASB technical matters, including the issue of IFRSs and revised IASs, and has full discretion over the technical agenda of the IASB.

The objectives of the IASB are to:

a) develop, in the public interest, a single set of high-quality global accounting standards.

b) promote the use and rigorous application of those standards.

c) to take account of the special needs of small and medium sized entities and emerging economies; and

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d) to promote and facilitate the adoption of IFRS through the convergence of national accounting standards and international accounting standards.

The IASB consists of 14 members, all with a very high level of technical expertise in accounting, who are appointed by the trustees of the IFRS Foundation. Each IASB member is appointed for a five-year term, which might be renewed once for a further five years.

Each IASB member has one vote, and approval of nine members is required for the publication of:

a) an exposure draft

b) a revised International Accounting Standard (IAS)

c) an International Financial Reporting Standard (IFRS)

d) a final Interpretation of the IFRS Interpretations Committee (IFRSIC).

1.3.5 The IFRS Interpretations Committee (IFRSIC)

The role of IFRSIC is to issue rapid guidance where there are differing possible interpretations of an international accounting standard. Its role is therefore to:

a) interpret international accounting standards (IASs and IFRSs).

b) issue timely guidance on issues not covered by an IAS or IFRS, within the context of the IASB Conceptual Framework; and

c) publish draft Interpretations for public comment. After studying responses to the draft Interpretation, it will obtain IASB approval for a final (published) Interpretation (an IFRIC)

1.3.6 The IFRS Advisory Council (IFRSAC)

The IFRS Advisory Council (IFRSAC) provides a forum through which the IASB is able to gather opinions and advice from different countries and industries. The IFRSAC consists of experts from different countries and different business sectors, who offer advice to the IASB.

1.3.7 IFRSs and IASs

Following the establishment of the IFRS Foundation in 2001, the IASB became the body responsible for:

a) developing and publishing accounting standards as IFRSs; and

b) approving and publishing Interpretations of IFRSs.

Previously, standards had been published as International Accounting Standards (IASs) and Interpretations were published as SIC Interpretations.

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).

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	Published by the IASC (up to 2001)	Published by the IASB (from 2001)

Thus, IFRS is made up as follows:

Accounting standards	IASs	IFRSs
Interpretations	SICs	IFRICs

Note that many IASs and SICs have been replaced or amended by the IASB since 2001.

Note that interpretations are not examinable at this level.

The following pages set out a list of standards so that the breadth of the GAAP can be appreciated. Not all of these standards are examinable at this level. Those that are examinable are indicated on the list. Please note that many of the standards examined at this level will also be examined in more detail in Corporate Reporting.

Standard	Applicable in	Examinable at Nigeria?	This level?
IAS 1	– Presentation of Financial Statements	Yes	Yes
IAS 2	– Inventories	Yes	Yes
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	Yes
IAS12	– Income Taxes	Yes	**Yes**

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Standard		Applicable in Nigeria?	Examinable at this level?
IAS16	– Property, Plant and Equipment	Yes	**Yes**
IAS 19	– Employee Benefits	Yes	Yes
IAS 20	– Accounting for Government Grants and Disclosure of Government Assistance	Yes	**Yes**
IAS 21	– The Effects of Changes in Foreign Exchange Rates	Yes	No
IAS 23	– Borrowing Costs	Yes	**Yes**
IAS 24	– Related Party Disclosures	Yes	**Yes**
IAS 26	– Accounting and Reporting by Retirement Benefit Plans	Yes	No
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	No
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	No
IFRS 1	– First-time Adoption of IFRS	Yes (subject to specific guidance issued by FRCN)	No
IFRS 2	– Share-based Payment	Yes	No
IFRS 3	– Business Combinations	Yes	**Yes**

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IFRS 5	– Non-current Assets Held for Sale and Discontinued Operations	Yes	**Yes**

Standard		Applicable in Nigeria?	Examinable at this level?
IFRS 7	– Financial Instrument Disclosures	Yes	**Yes**
IFRS 8	– Operating Segments	Yes	No
IFRS 9	– Financial Instruments	Yes	**Yes**
IFRS 10	– Consolidated Financial Statements	Yes	**Yes**
IFRS 11	– Joint Arrangements	Yes	No
IFRS 12	– Disclosure of Interests in Other Entities	Yes	No
IFRS 13	– Fair Value Measurement	Yes	**Yes**
IFRS 14	– Regulatory Deferral Accounts	Yes	No
IFRS 15	– Revenue from Contracts with Customers	Yes	**Yes**
IFRS 16	– Leases	Yes	**Yes**
IFRS 17	– Insurance Contracts	Yes	No
IFRS 18	– Presentation and Disclosure in Financial Statements	Yes	Yes
IFRS for SMEs		Yes	No
IFRS S1	– General Requirements for Disclosure of Sustainability-related Financial Information	Yes	Yes

1.3.8 Developing a new standard

IFRSs are developed through international due process. Due process normally (but not necessarily) involves the following steps.

a) A subject is identified as being appropriate for a new or revised standard.

b) National accounting rules and practice are studied and there is an exchange of views with national standards setters (e.g. The Financial Reporting Council of Nigeria the role of which is covered in more detail later in this chapter).

c) An advisory group is established to give advice to the IASB.

d) A discussion document is issued by the IASB for public comment.

e) After receiving comments on the discussion document, the IASB issues an Exposure Draft (subject to the appropriate level of IASB approval). The Exposure Draft also includes the opinions of any dissenting IASB members, and the basis for the IASB's conclusions.

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All comments on the Exposure Draft and discussion documents are considered. Includes consideration of:

a) whether it is desirable to hold a public hearing.

b) whether it is desirable to hold field tests

c) whether it is necessary to issue a revised ED (when the deliberations following the original ED indicate that there is a need for substantial changes from what was originally envisaged).

d) An approved IFRS is published (subject to the appropriate level of IASB approval). This will also include the opinions of any dissenting IASB members, and the basis for the IASB's conclusions. Each new or revised standard is published with a date for implementation and guidance on how an entity should account for the transition to the new accounting rules.

e) The development of a new or revised accounting standard involves widespread consultation and discussion.

f) Any new standard published by the IASB is automatically applicable in Nigeria.

1.4 Accounting Standards in Nigeria

1.4.1 Background to accounting standards in Nigeria

The Nigerian Accounting Standards Board (NASB) which came into being in 1982 was an independent body which was previously responsible for the development and issuance of Nigerian accounting standards. The NASB was formed by ICAN. These were called ***Statements of Accounting Standards (SAS)***.

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 ....."*

The Nigerian Accounting Standards Board was formally established as a parastatal in 1992 under the Ministry of Industry, Trade and Investment.

Definition: Parastatal

Noun: A company or agency owned or controlled wholly or partly by the government

Adjective: Of an organization or industry, having some political authority and serving the state indirectly (e.g., a parastatal organisation).

The Nigerian Accounting Standards Board Act No. 22, 2003 clarified the status, authority and responsibilities of the board.

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1.4.2 Financial Reporting Council (FRC) of Nigeria

In June 2011, Financial Reporting Council of Nigeria Act, No. 6, 2011, as amended to date, repealed the Nigerian Accounting Standards Board Act No. 22, 2003. This Act resulted in the Nigerian Accounting Standards Board being replaced by the Financial Reporting Council (FRC) of Nigeria.

The Financial Reporting Council of Nigeria is a Federal Government parastatal under the supervision of the Federal Ministry of Industry, Trade and Investment.

The FRC's main objects, as defined in the FRC Act, are to:

a) protect investors and other stakeholders' interest;

b) give guidance on issues relating to financial reporting and corporate governance to professional, institutional and regulatory bodies in Nigeria;

c) ensure good corporate governance practices in the public and private sectors of the Nigerian economy;

d) ensure accuracy and reliability of financial reports and corporate disclosures, pursuant to the various laws and regulations currently in existence in Nigeria;

e) harmonise activities of relevant professional and regulatory bodies relating to corporate governance and financial reporting;

f) promote the highest standards among auditors and other professionals engaged in the financial reporting process;

g) enhance the credibility of financial reporting; and

h) improve the quality of accountancy and audit services, actuarial, valuation and corporate governance standards.

The FRC is structured into a series of directorates to allow it to fulfil its many responsibilities. The directorates are:

a) Directorate of Accounting Standards – Private Sector;

b) Directorate of Accounting Standards – Public Sector;

c) Directorate of Auditing Practices Standards;

d) Directorate of Actuarial Standards;

e) Directorate of Valuation Standards;

f) Directorate of Inspection and Monitoring; and

g) Directorate of Corporate Governance.

1.4.3 Directorate of Accounting Standards – Private Sector

The FRC is responsible for, among other things, developing and publishing accounting and financial reporting standards to be applied in the preparation of financial statements of public entities in Nigeria, and for related matters.

To this end the ***Directorate of Accounting Standards*** has the following responsibilities:

a) To develop accounting and financial reporting standards to be observed in the preparation of financial statements in the private sector and small and medium scale enterprises;

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b) To promote the general acceptance and adoption of such standards by preparers and users of financial statements;

c) To promote compliance with the accounting standards developed or reviewed by the Directorate;

d) To review from time to time the accounting standards developed in line with the prevalent social, economic and political environment;

e) To promote compliance with the accounting and financial reporting standards adopted by the Council;

f) To promote, in the public interest, accounting and financial reporting standards to be observed in the preparation of financial statements of public interest entities; and

g) To perform such other duties which in the opinion of the Board are necessary or expedient to ensure the efficient performance of the functions of the Council.

1.4.4 Adoption of IFRS in Nigeria

IFRS 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. In Nigeria, however, the FRCN has not published any formal procedure for adoption of IFRS but appears to follow IASB prescription on when a new standard comes into force. The implication is that a new IFRS becomes applicable in Nigeria on the effective date prescribed by IASB. As such, it does not permit early adoption.

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.

Phase 1: Significant public interest entities and publicly listed entities

Entities in this category include:

a) Government business entities

b) Entities that have equity or debt instruments listed and traded in domestic markets, foreign markets or in over-the-counter trades.

c) All other organisations which are required by law to file returns with regulatory authorities (this excludes private companies that routinely file returns only with the Corporate Affairs Commission and Federal Inland Revenue Service). This category will include private entities involved in financial services.

d) All entities in this category adopted IFRS in 2012.

Phase 2: All other public interest entities

These are unquoted private companies which are of significant public interest because of the nature of their business, size, number of employees, etc.

All entities in this category adopted IFRS in 2013.

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Phase 3: Small and medium - sized entities (SMEs)

The following are the characteristics of SMEs:

a) They are not public interest entities: They are required to apply the IFRS for SMEs'; SMEs are entities that may not have public accountability.

b) Their equity and debt instruments are not traded or in the process of becoming traded.

c) They do not hold assets in a fiduciary capacity for a broad group of outsiders as one of their primary businesses.

d) 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.

e) Their total assets value is not more than ₦60 million or such an amount as might be fixed by the Corporate Affairs Commission.

f) They do not have foreign board members.

g) No member of the entity is a government, government agency, government corporation or a nominee of any such body.

h) The directors hold not less than 51% of its equity share capital; and

i) 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.

1.4.5 Advantages and disadvantages of convergence with IFRS

Advantages

a) 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.

b) 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.

c) If all entities are using the same framework for financial reporting, management should find it easier to monitor performance within their group.

d) 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.

e) 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.

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Disadvantages

a) 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.

b) 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.

c) Some countries may believe that their framework is satisfactory or even superior to IFRSs. This has been a problem with the US who have not adopted IFRS.

1.4.6 National standard setters and the IASB

National standard setters (like FRC), traditionally produced accounting standards for application in their own jurisdiction. However, the acceptance of the benefits of a global set of accounting standards has caused their role to change in many jurisdictions.

The IASB works with national standard-setters to promote and facilitate adoption of IFRSs through convergence of national accounting standards and IFRSs.

The IASB encourages the collaboration of national standard setters in research programme and standard-setting activities. Specifically, national standard setters are encouraged to respond to due process documents by providing comment letters and to undertake research to better understand the effects of proposed new standards in their jurisdictions.

In addition, national standard setters are well placed to support implementation by organising local events on the rules.

There are various national and regional forums that national standard setters can get involved in, some of which are organised by IASB, and others organised independently.

The IFRS Foundation encourages national standard setters to participate in standard-setting communities organised on a regional basis. One such regional community is the Pan African Federation of Accountants (PAFA).

1.4.7 Role of national standard setters

National standard setters have a key role to play in the development of standards and their implementation in the jurisdictions they serve.

The IASB sees the national standard setters as important partners in their work to produce global accounting standards.

a) Their knowledge of local financial reporting and legal requirements, experience in standard-setting and technical accounting capabilities allow them to make invaluable contributions to the development of global accounting standards; and

b) Their relationships with key stakeholders in their jurisdictions are important as they are able to represent them in the international debate on the development of new rules.

1.5 Legal Regulations for Accounting in Nigeria

1.5.1 Companies and Allied Matters Act, (CAMA) 2020

CAMA is the primary source of company law in Nigeria. Amongst other things, it establishes

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the requirements for financial reporting by all companies in Nigeria.

The rules are set out in Chapter 14 of the Act which includes sections 374 to 400.

1.5.2 Requirement to keep accounting records

Section 374 states that every company shall cause accounting records to be kept.

The accounting records shall be sufficient to show and explain the transactions of the company and shall be such as to:

a) disclose with reasonable accuracy, at any time, the financial position of the company; and

b) enable the directors to ensure that financial statements prepared comply with the requirements of the Act, with regard to form and content.

The accounting records must contain:

a) entries from day-to-day of all sums of money received and expended by the company, and the matters in respect of which the receipts and expenditure take place; and

b) a record of assets and liabilities of the company.

If the business of the company involves dealing in goods, the accounting records shall contain:

a) Statements of stock held by the company at the end of each accounting year of the company.

c) all statements of stock takings from which any such statement of stock has been or is to be prepared; and

d) except in the case of goods sold by way of ordinary retail trade, statement of all goods sold and purchased, showing the goods and the buyers and sellers in sufficient detail to enable all these to be identified.

1.5.3 Section 375: Place and duration of records

The accounting records must be kept at the company's registered office or such other place in Nigeria as the directors think fit.

They must be open to inspection by the officers of the company at all times.

Accounting records must usually be kept for a period of six years from the date on which they were made.

1.5.4 Section 377: Directors' duty to prepare annual accounts

In the case of every company, the directors shall, in respect of each year, of the company, prepare financial statements for the year.

At their first meeting after the incorporation of the company, the directors must determine the accounting year end for the company.

Form and content of individual financial statements

1.5.5 Section378: Form and content of individual financial statements

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Directors have a duty to prepare annual financial statements each year. These statements must include:

a) a statement of accounting policies;
b) a balance sheet (statement of financial position);
c) a profit and loss account (statement of comprehensive income);
d) notes on the accounts;
e) the auditors' report;
f) the directors' report;
g) a value-added statement for the year;
h) a five-year financial summary; and
i) in the case of a holding company, the group financial statements.

1.5.6 Section 378 states that financial statements must comply with the requirements of the first Schedule to the Act, with respect to their form and content.

However, the section further states that financial statements must also comply with accounting standards laid down in the Statements of Accounting Standards issued by the Financial Reporting Council of Nigeria.

Paragraph 59 of the Financial Reporting Council Act of 2011 gives precedence to the accounting rules in the standards adopted (IFRS) and other rules in the legal framework if they are inconsistent.

True and fair view

The balance sheet must give a true and fair view of the state of affairs of the company as at the year end and the profit and 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 balance sheet or profit and 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:

   i. particulars of the departure.
   ii. the reasons for it; and
   iii. its effects.

1.5.7 Disclosure of loans to directors and officers

Section 383: Disclosure of loans in favour of directors and connected persons

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Section 296: Sets out a general prohibition on a company from making a loan or guaranteeing a loan to a director.

CAMA allows the following exceptions to this:

a) A loan may be made to a director for the purpose of enabling him to properly perform his duties as an officer of the company, but this is subject to approval at a general meeting; or

b) A loan may be made or a guarantee given by a company whose ordinary business includes the lending of money or the giving of guarantees in connection with loans made by other persons.

If a loan has been made, the following must be disclosed:

i. the amount of the liability of the person to whom the loan was or was agreed to be made, in respect of principal and interest, at the beginning and at the end of the year.

ii. the maximum amount of that liability during that year.

iii. the amount of any interest which, having fallen due, has not been paid; and

iv. the amount of any provision for any failure or anticipated failure by the borrower to repay the whole or part of the loan or interest.

If a guarantee has been given the following must be disclosed:

a) the amount for which the company was liable under the guarantee or in respect of the security both at the beginning and at the end of the year.

b) the maximum amount for which the company may become liable; and

c) any amount paid and any liability incurred by the company for the purpose of fulfilling the guarantee or discharging the security.

1.5.8 Section 384: Disclosure of loans, etc., to officers

If a company has made a loan or guaranteed a loan to an officer of the company, it must make the following disclosures:

a) the aggregate amounts outstanding at the end of the financial year.

b) the number of officers for whom the transactions, arrangements and agreements falling within each of those subparagraphs, were made.

c) The disclosure does not apply if the aggregate amounts outstanding at the end of the year in respect of any officer do not exceed ₦5,000 nor to loans made by a recognised bank to any of its officers.

Procedure on completion of financial statements

1.5.9 Section 386: Signing of balance sheet and documents to be annexed there to

A company's balance sheet and every copy of it which is laid before the company in a general meeting or delivered to the Commission shall be signed on behalf of the board by two of the directors of the company.

1.5.10 Section 387: Persons entitled to receive financial statements as of right

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A company must send a copy of its financial statements for the year to all the following not less than 21 days before the date of the meeting at which they are to be laid:

a) every member of the company (whether or not entitled to receive notice of general meetings).

b) every holder of the company's debentures, (whether or not so entitled); and

c) all persons other than members and debenture holders, being persons so entitled.

1.5.11 Section 388: Directors' duty to lay and deliver financial statements

The directors must lay the financial statements before the company in a general meeting not later than 18 months after incorporation.

The directors must lay the financial statements before the company in a general meeting subsequently at least once a year not exceeding nine months after the year-end.

The directors must deliver with the annual return to the Commission a copy of the balance sheet, the profit and loss account and the notes on the statements which were laid before the general meeting for each year.

1.5.12 Section 390: Shareholders' right to obtain copies of financial statements

Any member of a company or any debenture holder is entitled on demand to a copy of the company's last financial statements.

1.5.13 Section: 385. Directors' report

Every company must prepare a director's 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; and

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 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.

h) particulars of any important events affecting the company which have occurred since the end of the year.

i) an indication of likely future developments in the business.

j) an indication of the activities (if any) of the company in the field of research and development.

k) names of distributors of the company's products; and

l) particulars of donations and gifts made for any purpose.

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1.6 Regulatory Frameworks for Public Sector, Not-for-Profit Organisations and International Sustainability Standards BOARD (ISSB)

1.6.1 Introduction

This section provides information about the "peculiar nature and relevant frameworks of specialized, not-for-profit and public sector entities including IFRS, national standards and IPSAS" as referred to in the syllabus.

There are many different ways in which organisations might be classified. For example, entities might be classified based on:

a) Whether they operate in the private sector or the public sector.

b) Whether they exist to make a profit or are not-for-profit organisations.

Most public sector organisations would also be not-for-profit. However, sometimes a government might own "for profit" trading entity that for all practical purposes is just like a private company. For example, a government might own the electricity supply companies who sell electricity to the public. These are known as ***government business enterprises (GBEs)***. GBEs would normally prepare financial statements according to IFRS and will not be considered further.

Most private sector organisations would exist to make a profit. However, there are many who do not, for example, charities.

Another way of putting it is that most profit-making entities exist in the private sector (but there are some in the public sector) and most not-for-profit entities are in the public sector but there are some in the private sector.

1.6.2 Private sector and public sector organisations

The private sector is the part of a nation's economy which is owned and controlled by private individuals or organisations. Private sector organisations include limited companies, partnerships and sole traders.

The public sector is the part of a nation's economy which is under the control of government. Public sector entities include national governments, regional governments (for example, state, provincial, territorial), local governments (for example, city, town) and their component entities (for example, departments, agencies).

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Key differences between a private sector company and a public sector organisation are as follows:

Private sector (Limited company)		Public sector organisation
Ownership	Shareholders	The people (through the government)
Management	The owners or managers appointed by the owners	Government appointees
Objective	To make a profit	To provide a service
Funding	From shareholders or borrowing from financial institutions	By grant from the government

In total, the public sector comprises a large number of organisations which provide a multiplicity of services. Often a single public sector organisation might have multiple objectives. For example, a government ministry for health might have objectives in the areas of disease prevention, disease treatment, health initiatives, health education etc.

In this text the term public sector entity will be used to mean a body that exists to provide a service to the public at large (government business enterprises will not be considered further).

All organisations have to be managed to achieve their objectives and to do this management need information. This information is gathered and processed by management information systems. The accounting system is a very important part of any entity's management information systems.

1.6.3 Not-for-profit entities

Not-for-profit entities are entities that usually have no transferable ownership interests, set up and operated exclusively for social, educational, professional, religious, or charitable purposes for the benefits of the public or its members.

Some such entities (e.g., charities) might operate under a specific statutory framework that might specify financial reporting rules.

Not-for-profit organization differ from profit making entities in key respects and the financial reporting rules whether imposed by regulation or otherwise should reflect these differences.

Key differences that need to be reflected in financial reports include the following:

a) Not-for-profit organisation would seek to operate at a surplus. However, any surplus arising from their activities are not generally distributed to owners but are used to pursue the goals and objectives.

b) Revenue is earned when an organisation supplies goods and services to customers. Not-for-profit organisation do not have revenue as such but are financed by donations, contributions from members, cash raised from the public etc. Sometimes, donations are made for a restricted purpose and this must be reflected in the financial statements.

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The financial statements of not-for-profit organisation might deal with these issues as follows:

a) Financial statements identify the different types of "revenue" received and the costs of generating this revenue.

b) Financial statements should refer to surplus rather than profit or deficit rather than loss and

c) There is no accumulated profit but there may be an accumulated surplus.

d) The statement of financial position of not-for-profit organisation might represent several groups of net assets each held for a specific purpose and each represented by its own capital balance. These are known as funds.

Illustration: Funds (capital balances)

Net assets	10,000
Represented by: General fund	7,000
Restricted fund 1 (Educational purposes)	1,000
Restricted fund 2 (Disaster relief)	2,000
	10,000

The net assets represented by the general fund can be used for any of the organisations purposes.

The net assets represented by Restricted fund1can be used only in pursuit of the organisation's educational objectives.

The net assets represented by Restricted fund can be used only for disaster relief.

Restrictions on assets held generally arise because:

- they were donated for a specific purpose – e.g., money given to the organization 50 where the donor specifies how it is to be used; or
- the money was raised for a specific purpose – e.g., money raised in an appeal in response to a natural disaster.

The Nigerian Accounting Standards Board issued ***SAS 32: On accounting by not-for-profit organisation*** in 2011. This is not an examinable standard at this level.

Note that the IASB Foundation is a not-for-profit 50 organisation that applies IFRS in its financial statements.

1.6.4 Conceptual Framework for Public Sector Entities

The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities was developed by the International Public Sector Accounting Standards Board (IPSASB) to guide the preparation and presentation of financial reports in the public sector International Public Sector

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Accounting Standards Board (2013). Public sector entities, unlike private businesses, primarily aim to deliver public services rather than generate profits. This unique nature necessitates a financial reporting framework that ensures transparency, accountability, and comparability.

The IPSASB Conceptual Framework establishes fundamental principles for financial reporting, assisting public entities in enhancing the credibility and consistency of their financial statements. Given Nigeria's evolving governance and economic landscape, aligning financial reporting practices with IPSAS can significantly improve public sector management and fiscal accountability.

Key Definitions of Terms

To understand the conceptual framework, the following key terms are essential:

a) **Public Sector Entities** – Governmental organizations including **national, regional, state, and local governments**, along with agencies responsible for delivering public services.
b) **General Purpose Financial Reports (GPFRs)** – Financial statements and additional reports used by stakeholders, such as citizens, donors, and creditors, to assess a government's financial position and performance.
c) **IPSAS (International Public Sector Accounting Standards)** – A set of accounting standards developed to enhance **financial reporting transparency** in the public sector.
d) **Non-Exchange Transactions** – Transactions where one party receives a benefit without directly giving approximately equal value in return, such as **taxes, grants, and social benefits**.
e) **Accrual Basis Accounting** – A method where **revenues and expenses** are recorded when they are earned or incurred, rather than when cash is received or paid.
f) **Accountability** – The obligation of public sector entities to report on the **use of resources** and their impact on service delivery.
g) **Sovereign Power –** The authority of a government to enforce laws, levy taxes, and manage public resources for the common good.

1.6.6 Nature of Public Sector Entities

Difference between public sector entities and private businesses

a) **Service-Oriented Mission**: Governments focus on **service delivery** rather than profit-making.
b) **Non-Exchange Transactions**: Revenue mainly comes from **taxation, grants, and transfers**, not direct sales.
c) **Budgetary Control**: Government financial management is tied to legally approved **budgets**, ensuring fiscal discipline, while the budgets of private businesses are limited to the organisations.
d) **Long-Term Sustainability**: Many government projects and liabilities, such as infrastructure, pensions, and social benefits, extend over long periods.
e) **Regulatory Role**: Governments regulate markets, enforce laws, and provide essential public goods and services, while private businesses do not.

Relevance of the Conceptual Framework to Public Entities

The IPSASB Conceptual Framework enhances **financial reporting, accountability, and governance** in the public sector by:

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a) **improving financial transparency** – ensuring comprehensive financial reporting that promotes **public trust**;
b) **enhancing decision-making** – providing relevant information for **policy formulation, budget planning, and resource allocation**;
c) **facilitating international comparability** – allowing stakeholders to compare **financial performance across jurisdictions**;
d) **strengthening public accountability** – ensuring that governments report on the **use of public funds** effectively;
e) **promoting efficient resource management** – aiding in **asset and liability management**, reducing financial mismanagement; and
f) **ensuring compliance with budgetary provisions** – governments can assess financial outcomes against **approved budgets**.

1.6.8 Nigerian context and adoption of IPSAS

In Nigeria, the adoption of **IPSAS** is driven by the need to improve **public sector financial management** and align it with global best practices. The Nigerian government, through the **Financial Reporting Council (FRC) and the Federation Account Allocation Committee (FAAC)**, has implemented IPSAS to enhance **transparency and accountability** in public finance.

1.6.9 Key impacts of IPSAS adoption in Nigeria

a) **Improved Public Sector Governance** – Strengthening oversight of government finances and reducing corruption.
b) **Enhanced Financial Reporting** – Standardising financial statements across **federal, state, and local governments**.
c) **Increased Investor Confidence** – Making Nigeria's financial reports **more reliable** for investors and international donors.
d) **Better Budget Implementation** – Aligning financial reporting with **budgetary controls**, reducing fiscal leakages.
e) **Strengthened Fiscal Sustainability** – Providing clearer insights into **long-term financial obligations and public debt**.

1.6.10 Challenges in Nigeria's IPSAS implementation

a) **Capacity Building Issues** – Limited technical expertise in **public sector accounting**.
b) **Resistance to Change** – Bureaucratic hurdles and **institutional reluctance**.
c) **Infrastructure Deficiencies** – Limited adoption of **financial management information systems (FMIS)**.
d) **Funding Constraints** – Need for investment in **training and IT infrastructure**.

Despite these challenges, IPSAS adoption remains a **critical step** toward enhancing Nigeria's **public sector financial accountability** and ensuring prudent management of resources.

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1.6.11 Conclusion

The **IPSASB Conceptual Framework** is an essential tool for guiding financial reporting in **public sector entities**, ensuring they operate with **accountability, transparency, and efficiency**. In Nigeria, adopting **IPSAS** fosters better governance, financial discipline, and international credibility.

By aligning **public sector financial reporting** with IPSAS principles, Nigeria can achieve **greater fiscal responsibility**, improve decision-making, and enhance **service delivery for citizens**.

1.6.12 International Sustainability Standards Board (ISSB)

The International Sustainability Standards Board (ISSB) was established in November 2021 by the International Financial Reporting Standards (IFRS) Foundation to develop a global baseline for sustainability disclosure standards. The ISSB was created in response to the increasing demand for consistent, reliable, and comparable sustainability reporting, particularly concerning environmental, social, and governance (ESG) factors.
In 2021 the IFRS Foundation created the International Sustainability Standards Board (ISSB), to deliver a comprehensive global baseline of sustainability-related disclosure standards (IFRS Sustainability Disclosure Standards).
International investors called for corporate reporting on climate and other environmental, social and governance matters that is high quality, transparent, reliable and comparable.
The first standards were issued for public consultation in 2022 and aim to provide users with reliable, comparable, sustainability-related information to help them make informed decisions concerning sustainability-related risks and opportunities relevant to individual entities.

The ISSB builds upon existing sustainability frameworks such as the Task Force on Climate-related Financial Disclosures (TCFD), Sustainability Accounting Standards Board (SASB), and Global Reporting Initiative (GRI) to create a unified standard for corporate sustainability reporting.

1.6.13 Need for ISSB

The ISSB was established to address several critical gaps in sustainability reporting, including:

a) **Lack of consistency** – Various voluntary sustainability frameworks exist, leading to inconsistent and non-comparable corporate ESG disclosures;
b) **Investor demand for ESG transparency** – Investors require standardized sustainability information to assess risks and make informed investment decisions;
c) **Regulatory pressures** – Governments and regulatory bodies worldwide are introducing sustainability disclosure requirements, necessitating a global standard;
d) **Integration with financial reporting** – Sustainability issues, such as climate risks, directly affect financial performance, requiring their alignment with financial reporting standards; and
e) **Corporate accountability** – Companies need to provide transparent sustainability reports to meet stakeholder expectations and improve corporate governance.

1.6.14 Roles of ISSB

Role of ISSB in global sustainability reporting

a) **Developing global sustainability standards** – The ISSB issues International Sustainability Disclosure Standards (ISDS) to establish a common framework for sustainability reporting.

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b) **Enhancing comparability and transparency** – ISSB standards ensure that sustainability disclosures are consistent across industries and countries, making it easier for investors and stakeholders to assess corporate performance.
c) **Aligning with IFRS financial reporting** – The ISSB works alongside the International Accounting Standards Board (IASB) to ensure sustainability disclosures complement financial reporting.
d) **Facilitating decision-making for investors** – ISSB standards provide decision-useful ESG information, enabling investors to evaluate sustainability risks and opportunities.
e) **Supporting regulatory alignment** – The ISSB collaborates with governments, regulators, and global standard-setting bodies to harmonize sustainability reporting requirements across jurisdictions.
f) **Promoting corporate sustainability accountability** – Standardized ESG disclosures encourage companies to adopt responsible business practices and improve sustainability performance.

1.6.14 Key ISSB Standards

a) IFRS S1 (General Sustainability-Related Disclosures) – Provides a comprehensive framework for reporting sustainability-related risks and opportunities.
b) IFRS S2 (Climate-Related Disclosures) – Focuses specifically on climate risks, aligned with the TCFD recommendations.

These standards aim to enhance corporate transparency, investor confidence, and sustainable business practices globally.

1.6.15 Conclusion

The ISSB is a significant step towards standardised, transparent, and globally accepted sustainability reporting. By addressing inconsistencies in ESG disclosures and aligning with financial reporting, the ISSB helps investors, regulators, and businesses navigate the complexities of sustainability risks and opportunities effectively.

In summary, the ISSB addresses the need for clear, consistent, and comparable sustainability reporting to enhance corporate transparency, investor confidence, and global sustainability efforts.

1.6.16 Laws and Regulations Governing the Preparation of Financial Statements in Nigeria

The preparation of financial statements in Nigeria is subject to various laws and regulatory frameworks designed to ensure accuracy, transparency, and accountability. These regulations apply to all entities, with sector-specific guidelines governing financial institutions such as banks, insurance companies, and pension administrators. This paper examines the general legal framework and the role of key financial regulatory bodies in enforcing compliance.

1.6.17 General laws and regulations governing financial statements in Nigeria

a) Companies and Allied Matters Act (CAMA), 2020

CAMA 2020 serves as the primary legislation for corporate governance and financial reporting in Nigeria. Key provisions include:

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i. **Financial record-keeping (Section 331):** Requires companies to maintain proper accounting records.
ii. **Preparation of financial statements (Section 376):** Mandates that companies prepare annual financial statements.
iii. **Audit and compliance (Section 404):** Requires public companies to have their financial statements audited.
iv. **International Financial Reporting Standards (IFRS) compliance:** Public and large private companies must align their financial reporting with IFRS.

b) Financial Reporting Council of Nigeria (FRCN) Act 2011

The FRCN Act establishes the Financial Reporting Council of Nigeria (FRCN) as the regulatory body overseeing financial reporting. Key provisions include:

i. **Standard-setting (Section 8):** Empowers the FRCN to issue accounting and financial reporting standards.
ii. **Compliance and oversight (Section 11):** Mandates adherence to IFRS and Generally Accepted Accounting Principles (GAAP).
iii. **Regulation of auditors and accountants:** Ensures that financial statements meet global standards.

c) Securities and Exchange Commission (SEC) Regulations

SEC oversees financial disclosures for publicly listed companies to protect investors. Key regulations include:

i. **Periodic reporting (Section 60, Investment and Securities Act 2007):** Requires companies to submit quarterly, semi-annual, and annual financial reports.
ii. **Financial transparency:** Enforces compliance with accounting standards and disclosure requirements.

d) Federal Inland Revenue Service (FIRS) Act and Tax Laws

Financial statements must comply with tax regulations outlined in:

i. **Companies Income Tax Act (CITA):** Governs corporate tax reporting.
ii. **Value Added Tax (VAT) Act:** Ensures proper tax computation and remittance.
iii. **Financial Records Access (Section 56, FIRS Act 2007):** Grants FIRS the authority to review company financial statements for tax compliance.

1.6.18 Sector-Specific Financial Statement Regulations

a) Central Bank of Nigeria (CBN) Regulations

CBN regulates banks' financial reporting under the Central Bank of Nigeria Act 2007. Key provisions include:

i. **Regulatory oversight (Section 33):** Grants CBN the authority to issue guidelines for financial institutions.

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ii. **Prudential guidelines:** Requires banks to submit financial statements reflecting liquidity, risk exposure, and capital adequacy.

b) Nigeria Deposit Insurance Corporation (NDIC) Regulations

The NDIC Act 2006 governs financial reporting in the banking sector to protect depositors. Key provisions include:

a. **Deposit insurance reporting (Section 3):** Requires NDIC to maintain financial records of insured deposits.
b. **Bank examination and supervision (Section 16):** Mandates periodic financial reporting by banks.
c. **Resolution of distressed banks:** Ensures accurate financial reporting for failed banks.

C. National Insurance Commission (NAICOM) Regulations

NAICOM oversees financial reporting in the insurance industry under the Insurance Act 2003. Key provisions include:

i. **Financial reporting requirements:** Insurance companies must submit annual financial statements.
ii. **IFRS 17 compliance:** Ensures transparency in insurance contract valuation.
iii. **Solvency and capital adequacy:** Mandates financial reporting on assets, liabilities, and policyholder funds.

d) National Pension Commission (PenCom) Regulations

PenCom regulates pension financial reporting under the Pension Reform Act 2014. Key provisions include:

a. **Periodic Reporting (Section 89):** Requires pension fund administrators (PFAs) to submit audited financial statements.
b. **Pension Asset Valuation:** Ensures accurate reporting of pension investments.
c. **Protection of Pension Funds:** Mandates strict compliance with investment guidelines.

e) Nigerian Exchange Group (NGX) Regulations

NGX, operating under CAMA 2020, regulates the financial reporting of publicly traded companies. Key provisions include:

i. **Market Transparency:** Enforces compliance with IFRS and SEC rules.
ii. **Financial Statement Submission:** Requires timely publication of audited reports.

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1.6.19 Legal Provisions Governing Key Financial Regulatory Institutions

Regulatory Authority	Key Legal Provisions	Financial Reporting Role
Central Bank of Nigeria (CBN)	Central Bank of Nigeria Act, 2007	Regulates and supervises banks, ensuring financial stability and compliance with reporting guidelines.
Nigeria Deposit Insurance Corporation (NDIC)	Nigeria Deposit Insurance Corporation Act, 2006	Insures deposit liabilities and supervises financial reporting of banks.
Financial Reporting Council of Nigeria (FRCN)	Financial Reporting Council Act, 2011	Sets accounting standards and enforces compliance.
National Insurance Commission (NAICOM)	National Insurance Commission Act, 1997	Regulates financial reporting of insurance companies.
Nigerian Stock Exchange (NGX)	Companies and Allied Matters Act (CAMA) 2020	Oversees financial disclosures of publicly traded companies.
Securities and Exchange Commission (SEC)	Investment and Securities Act, 2007	Supervises financial reporting in capital markets.
National Pension Commission (PenCom)	Pension Reform Act, 2014	Ensures financial transparency in pension fund management.
Federal Inland Revenue Service (FIRS)	FIRS (Establishment) Act, 2007	Ensures compliance with tax reporting and audits financial records.

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1.6.20 Conclusion

The regulatory framework for financial statements in Nigeria ensures transparency, accountability, and compliance with international standards. CAMA 2020, IFRS, and the FRCN Act provide the foundation for financial reporting, while sector-specific regulations by CBN, NDIC, NAICOM, and PenCom address industry-specific concerns. Adherence to these laws enhances investor confidence, promotes financial stability, and ensures the integrity of Nigeria's financial system.

1.7 Chapter review

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

a) Explain the sources of accounting regulation in Nigeria

b) Outline the roadmap for conversion to IFRS in Nigeria

c) Understand the rules on financial statements set out in Companies and Allied Matters Act 2020

d) Explain the standard setting process for IFRS

e) Explain how financial statements of public sector entities and not-for-profit entities might differ from those of private sector, profit making entities.

1.8 End of chapter questions and suggested solutions

1.8.1 Questions

Question 1

International Financial Reporting Standards (IFRS) through the International Accounting Standard Board (IASB) sets out the definition and essential characteristics of assets and liabilities in the presentation of financial statements which users of the statements are likely to rely on when making major economic decisions.

Required:

Identify the essential characteristics of assets and comment on the features of liabilities in accordance with provisions of IAS1 on Presentation of Financial Statements.

QUESTION 2

A conceptual framework for reporting emphasises the importance that transactions should be recorded on the basis of their substance over their form.

Required:

Explain the importance of substance over form and why financial statements should show the substance of the underlying transaction different from its legal form.

1.8.2 Suggested solutions

Solution 1

Essential characteristics of assets

IASB defines asset as a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The characteristics of this definition are as follows:

a. emphasis on control rather than ownership of asset. it means ability to restrict other entity from using the asset;

b. also, it places emphasis on substance of the transactions rather than their legal form;

c. when there is control of an asset, it is recognised in the statement of financial position e.g. finance lease, contractual rights; and

d. the definition makes reference to past events, thereby excluding asset that may occur in future.

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Essential characteristics of liabilities:

IASB defines liability as a present obligation of the entity arising from past events, the statement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

From this definition, the characteristics of a liability are as follows:

a) it is opposite or mirror image of asset;

b) it is a present obligation;

c) the obligations are legally enforceable; and

d) such obligations may also arise on provisions, contingent liabilities, contingent assets e.g. replacing faulty assets, warranty.

Solution 2

Importance of substance over form

Users desire information in general purpose financial statements for making economic decisions. Therefore, financial statements are expected to be of value to their users and as such they must possess certain important characteristics like reliability and faithful representation.

For financial statements to be reliable, they must faithfully represent an entity's underlying transactions and other events. To achieve faithful representation, transactions must be accounted for and presented in accordance with their substance and economic reality where this differs from their legal form. For example, where an entity sells an asset to a third party but continued to enjoy the future benefits embodied in that asset, then this transaction would not be represented faithfully by recording it as a sale. In all probability this would be a financing transaction.

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CHAPTER 2

ACCOUNTING AND REPORTING CONCEPTS, FRAMEWORKS AND PRACTICES

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2. Accounting and Reporting Concepts, Frameworks and Practices

2.0 Learning objective

This chapter discusses accounting and reporting concepts, frameworks and practices.

2.1 Learning outcomes

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

i. Explain the objectives of financial statements;

ii. List and explain the components of the conceptual framework;

iii. Explain the difference between the accruals, cash and break up basis of accounting;

iv. Prepare simple cash and break-up financial statements;

v. Explain the measurement bases available under IFRS;

vi. Explain and illustrate the capital maintenance concepts described in the conceptual framework; and

vii. Explain the meaning of true and fair or fairly presented.

2.2 A conceptual framework for financial reporting

2.2.1 The meaning of GAAP

The preparation and presentation of financial statements is based on a large number of concepts, principles and detailed rules. Some of these are contained in law, and others are in financial reporting standards. Many of the most fundamental concepts are not contained in any law or regulation or standard but are simply accepted accounting principles and conventions.

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.

'Generally accepted accounting principles' vary from country to country, because each country has its own legal and regulatory system. The way in which businesses operate also differs from country to country. (For example, there is US GAAP, UK GAAP and Nigerian GAAP).

Many countries have now adopted International Financial Reporting Standards or IFRSs, sometimes called international accounting standards. It is now fairly common to refer to the totality of the rules as IFRS or IAS.

2.2.2 The meaning of a conceptual framework

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 International Accounting Standards Committee (the predecessor of the IASB) issued a conceptual framework document in 1989. This was called the *Framework for the Preparation and Presentation of Financial Statements* and was adopted by the IASB.

The IASB has been working closely with FASB (the US standard setter) on a wide range

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of projects with the aim of converging IFRS and US GAAP. One of the projects has had the aim of producing a conceptual framework common to each GAAP.

The new conceptual framework was developed on a chapter-by-chapter basis. The complete new conceptual framework was published in March 2018 and is 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:

a) **Chapter 1** – The objective of general-purpose financial reporting.

b) **Chapter 2** – Qualitative characteristics of useful financial information.

c) **Chapter 3** – Financial statements and the reporting entity.

d) **Chapter 4** – The elements of financial statements.

e) **Chapter 5** – Recognition and derecognition.

f) **Chapter 6** –Measurement.

g) **Chapter 7** – Presentation and disclosure.

h) **Chapter 8** – Concepts of capital and capital maintenance.

2.2.3 The purpose of a conceptual framework

Most preparers and users of financial statements recognise that there is a need for a formal conceptual framework and that this can be useful in a number of ways.

Where there is a formal conceptual framework for accounting, accounting practice and accounting standards are based on this framework.

Lack of a formal framework often means that standards are developed randomly or only to deal with particular problems. The result is that standards are inconsistent with each other or with legislation.

Lack of a conceptual framework may also mean that accounting standards fail to address important issues. For example, until the IASB developed its Framework, there was no proper definition of terms such as 'asset', liability', income' and 'expenses'.

The business environment is becoming increasingly complex. It is unlikely that accounting standards can cover all possible transactions. Where an entity enters into an unusual transaction and there is no relevant accounting standard, it can refer to the framework and apply the principles in it.

It can also be argued that a conceptual framework strengthens the credibility of financial reporting and the accounting profession in general.

2.2.4 The alternative to a conceptual framework

The alternative to a system based on a conceptual framework is a system based on detailed rules.

Accounting standards based on detailed rules are open to abuse. 'Creative accounting' is the name given to techniques which enable management to give a biased impression (usually favourable) of the company's performance while still complying with accounting standards and other regulations. During the 1980s there were a number of scandals in which investors

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were misled by the financial statements of apparently healthy companies which then collapsed. This was one of the original reasons why the IASB and other standard setters developed their conceptual frameworks. Principles are normally much harder to evade than rules.

Another disadvantage of a rule-based system is that standard setters are more likely to be influenced by 'vested interests' such as large companies or a particular business sector. The existence of a conceptual framework is an important safeguard against this kind of political pressure.

Despite these problems, some preparers and regulators still appear to favour rule-based standards. Standards based on principles may require management to use its judgement (and to risk making a mistake), while rules simply need to be followed. This can be important where management can face legal action if an investor makes a poor decision based on the financial statements.

The use of a conceptual framework can lead to standards that are theoretical and complex. They may give the 'right answer' but be very difficult for the ordinary preparer to understand and apply. However, a system of extremely detailed rules can also be very difficult to apply.

2.3 The IASB Conceptual Framework

2.3.1 Introduction

Financial reports are based on estimates, judgements and models rather than exact depictions. The Conceptual Framework establishes the concepts that underline those estimates, judgements and models.

The Conceptual Framework deals with:

a) The objective of financial reporting.

b) the qualitative characteristics of useful financial information.

c) the definition, recognition and measurement of the elements from which financial statements are constructed; and

d) concepts of capital and capital maintenance.

The Conceptual Framework sets out the concepts that underline the preparation and presentation of financial statements for external users. Its purpose is to:

a) assist the IASB to develop IFRS Standards (Standards) that are based on consistent concepts.

b) assist preparers to develop consistent accounting policies when no standard applies to a particular transaction or other event, or when IFRS allows a choice of accounting policy; and

c) assist all parties to understand and interpret IFRS.

This Conceptual Framework is not an IFRS and nothing in the Conceptual Framework overrides any specific IFRS.

On very rare occasions there may be a conflict between the Conceptual Framework and an IFRS. In those cases, the requirements of the IFRS prevail over those of the Conceptual Framework.

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2.3.2 Users and their information needs

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need.

These are the primary users to whom general purpose financial reports are directed.

a) General purpose financial reports cannot provide all the information needed and users also need to consider pertinent information from other sources.

b) General purpose financial reports do not show the value of a reporting entity; but they provide information to help users estimate value.

c) Individual primary users have different information needs. The aim of IFRSs is to provide information that will meet the needs of the maximum number of primary users.

Other users

a) Regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful but these reports are not primarily directed to these groups.

b) A company's management is often interested in financial information but the management do not need to rely on general purpose financial reports.

2.3.3 Chapter1: Objective of general-purpose financial statements

The objective of general-purpose financial reporting forms the foundation of the Conceptual Framework. Other aspects of the Conceptual Framework flow logically from the objective.

The objective

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.

a) In order to make these decisions the users need information to help them assess the prospects for future net cash inflows to anentity.

b) In order to assess an entity's prospects for future net cash inflows, users need information about:

i. the resources of the entity.

ii. claims against the entity; and

iii. 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).

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Information provided

General purpose financial statements provide information about:

a) the financial position of the entity – information about economic resources and the claims against them; and

b) changes in its financial position which could be due to:

   1. financial performance; and/or
   2. other events or transactions (e.g share issues).

2.3.4 Economic resources and claims

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

a) identify the financial strengths and weaknesses of a reporting entity.
b) 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.

2.3.5 Changes in economic resources and claims – Financial performance

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

This is important because such information provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period

Importance of information about a reporting entity's financial performance:

a) It helps users to understand the return generated from its economic resources. This in turn provides an indication of how well management has discharged its responsibilities to make efficient and effective use of these resources.

b) It shows the capacity of a reporting entity to generate net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors.

c) It gives an indication of the extent to which events such as changes in market prices or interest rates affect its ability to generate net cash inflows.

d) Information about the variability and components of return is also important, especially in assessing the uncertainty of future cashflows.

e) Information about past financial performance is helpful in predicting the entity's future returns on its economic resources.

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Another aspect of performance is management of cash flow. Information about a reporting entity's cash flows during a period helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

2.3.6 Changes in economic resources and claims – Other events and transactions

Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims have changed and the implications of those changes for its future financial performance.

2.3.7 Objectives of financial statements: summary

The objectives of financial statements are met by:

a) 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

b) supporting notes to the accounts, which provide additional details.

2.3.8 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:

a) in the statement of financial position, by recognising assets, liabilities and equity.

b) in the statement(s) of financial performance, by recognising income and expenses; and

c) in other statements and notes, by presenting and disclosing information about:

   i. recognised and unrecognised assets and liabilities, equity, income and expenses.

   ii. cashflows.

   iii. contributions from holders of equity claims and distributions to them; and

   iv. the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements.

2.3.9 Reporting period

Financial statements are prepared for a specified period of time (reporting period) and provide information about:

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a) assets and liabilities (including unrecognised assets and liabilities) and equity that existed at the end of the reporting period, or during the reporting period; and

b) income and expenses for the reporting period.

Perspective

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.

It is assumed that the entity does not intend or need to enter liquidation or to cease trading. If that is not the case, the financial statements may have to be prepared on a different basis and the basis used must be described.

The reporting entity

A reporting entity is one that prepares 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.

It can be difficult to determine the boundary of a reporting entity that is not a legal entity. In this case the boundary is determined by taking into account the information needs of the primary users.

2.4 Qualitative characteristics of useful financial information

2.4.1 Introduction

This is covered by chapter 2 of ***The IASB Conceptual Framework***.

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

a) fundamental qualitative characteristics; and

b) enhancing qualitative characteristics.

2.4.2 Fundamental qualitative characteristics:

a) relevance; and

b) faithful representation.

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

a) comparability;

b) verifiability;

c) timeliness; and

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d) understandability.

"If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable".

Emphasis

Information must be both relevant and faithfully represented if it is to be useful.

The enhancing qualitative characteristics cannot make information useful if that information is irrelevant or not faithfully represented.

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.

a) It has **predictive value** if it helps users to predict what might happen in the future.

b) 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 it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

a) 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.

b) 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:

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

b) neutral – the depiction is without bias in the selection or presentation of financial information; and

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c) free from error – whe re 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.

Comparability

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

Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Consistency is related to comparability but is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Consistency helps to achieve the goal of comparability.

Verifiability

This quality helps us assure users that information faithfully represents the economic phenomena it purports to represent.

a) Verifiability means that different knowledgeable and independent observers could reach a consensus that a particular depiction is a faithful representation.

b) Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

Timeliness

This means having information available to decision-makers in time to be capable of influencing their decisions.

Understandability

Information is made understandable by classifying, characterising and presenting it in a clear and concise manner.

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

Cost constraint on useful information

Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender or other creditor also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.

The benefits obtained from financial information should exceed the cost of obtaining and providing it. Information should not be provided if the cost is not worth the benefit.

Since it is difficult to measure the benefits of financial information, the setters of accounting standards must use their judgement in deciding whether certain items of information should be provided in the financial statements (and if so, in how much detail).

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2.5 The elements of financial statements

2.5.1 Introduction

This is covered by chapter 4 of ***The IASB Conceptual Framework***.

The IASB Framework discusses the five elements of financial statements:

a) for reporting financial position: assets, liabilities and equity; and

b) for reporting on financial performance: income and expenses.

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.

Rights

Rights can take many forms including the right to receive cash, exchange resources on favourable terms, rights over physical objects and rights to use intellectual property.

Many rights are established by contract, legislation or similar means.

However, rights might be obtained in other ways (e.g., developing know-how that is not in the public domain).

Some goods or services are received and immediately consumed (e.g., employee services). The right to obtain the economic benefits produced by such goods or services exists momentarily until the entity consumes the goods or services.

In order to be an asset, rights must both have the potential to produce economic benefits for the entity beyond those available to all other parties and be controlled by the entity. Therefore, not all rights are assets (e.g., the right to use public infrastructure is not an asset).

2.5.2 Potential to produce economic benefits

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

A right can be an asset, even if the probability that it will produce economic benefits is low. However, low probability might affect decisions about what information to provide about the asset and how to provide that information, including decisions about whether the asset is recognised and how it is measured.

Control

Control links an economic resource to an entity.

Control is the ability to obtain economic benefits from the assets, and to restrict the ability of others to obtain the same benefits from the same item.

Liabilities

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

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

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a) The entity has an obligation;

b) The obligation is to transfer an economic resource; and

c) The obligation is a present obligation that exists as a result of past events.

Obligation

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

An obligation is always owed to another party (or parties) but it is not necessary to know the identity of the party (or parties) to whom the obligation is owed.

Obligations might be established by contract or other action of law, or they might be constructive. A constructive obligation arises from an entity's customary practices, published policies or specific statements when the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements.

Transfer of economic resources

An obligation must have the potential to require the entity to transfer an economic resource to another party (or parties).

An obligation can meet the definition of a liability even if the probability of a transfer of an economic resource is low. However, low probability might affect decisions about what information to provide about the liability and how to provide that information, including decisions about whether the liability is recognised and how it is measured.

Present obligation as a result of past events

A liability is an obligation that already exists. An obligation may be legally enforceable as a result of a binding contract or a statutory requirement, such as a legal obligation to pay a supplier for goods purchased.

Obligations may also arise from normal business practice, or a desire to maintain good customer relations or the desire to act in a fair way. For example, an entity might undertake to rectify faulty goods for customers, even if these are now outside their warranty period. This undertaking creates an obligation, even though it is not legally enforceable by the customers of the entity.

Past transactions or events

A liability arises out of a past transaction or event.

A present obligation exists as a result of past events only if:

a) the entity has already obtained economic benefits or taken an action; and

b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

For example, a trade payable arises out of the past purchase of goods or services, and an obligation to repay a bank loan arises out of past borrowing.

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Other definitions

Equity

Equity is the residual interest in an entity after the value of all its liabilities has been deducted from the value of all its assets.

Income

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

The concept of income includes both revenue and gains.

a) **Revenue** is income arising in the course of the ordinary activities of the entity. It includes sales revenue, fee income, royalties' income, income and income from investments (interest and dividends). Revenue is recognised in the statement of profit or loss.

b) **Gains** represent other items that meet the definition of income. Gains may be recognised in the statements of profit or loss or in the statement of other comprehensive income. For example:

   i. Income includes gains on the disposal of non-current assets. These are recognised in the statement of profit or loss.

   ii. Income also includes unrealised gains which occur whenever an asset is revalued upwards but is not disposed of. For example, an unrealised gain occurs when a property owned by the entity is revalued upwards. Unrealised gains might be recognised in the statement of profit or loss (e.g. revaluation gains on property accounted for under IAS 16) or in the statement of other comprehensive income (e.g. revaluation gains on property accounted for under the IAS 40 fair value model).

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.

Expenses include:

a) **Expenses** arising in the normal course of activities, such as the cost of sales and other operating costs, including depreciation of non-current assets. Expenses result in the outflow of assets (such as cash or finished goods inventory) or the depletion of assets (for example, the depreciation of non-current assets).

b) **Losses** include, for example, the loss on disposal of a non-current asset, and losses arising from damage due to fire or flooding. Losses are usually reported as a net of related income.

Financial performance is measured by profit or loss and gains or losses recognised in other comprehensive income. Profits are measured as income less expenses.

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2.6 Recognition and derecognition

2.6.1 Recognition

This is covered by chapter 5 of ***The IASB Conceptual Framework***.

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 definition of one of the elements of financial statements.

Recognition involves depicting the item in words and by a monetary amount.

The amount at which an asset, a liability or equity is recognised in the statement of financial position is referred to as its *carrying amount*.

Recognition links the elements as the recognition of one item (or a change in its carrying amount) requires the recognition or derecognition of another item. For example, revenue is recognised at the same time as the corresponding receivable.

2.6.2 Recognition criteria

Only items that:

a) meet the definition of an asset, a liability or equity are recognised in the statement of financial position; or

b) meet the definition of income or expenses are recognised in the statement(s) of financial performance.

However, not all items that meet the definition of one of those elements are recognised.

An asset or liability is recognised only if recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful, i.e. with:

a) relevant information about the asset or liability and about any resulting income, expenses or changes in equity; and

b) a faithful representation of the asset or liability and of any resulting income, expenses or changes in equity.

Information about an asset or liability may not be relevant when there is uncertainty about its existence or when there is only a low probability of an inflow or outflow of economic benefits in respect of that asset or liability.

Whether a faithful representation can be provided may be affected by the level of measurement uncertainty associated with the asset or liability or by other factors.

2.6.3 Commentary on the new recognition criteria

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

a) it meets the definition of an element: and

b) satisfies the following two criteria:

   i. it must be **probable** that the future economic benefit associated with the item will flow either into or out of the entity; and

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ii. The item should have a cost or value that can be measured reliably.

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 it is believed to provide a stronger conceptual foundation to the recognition process.

2.6.4 Derecognition

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

This normally occurs when that item no longer meets the definition of an asset or of a liability:

a) for an asset, derecognition normally occurs when the entity loses control of all or part of the recognised asset; and

b) for a liability, derecognition normally occurs when the entity no longer has a present obligation for all or part of the recognised liability.

2.7 Accounting concepts

In addition to the accounting concepts in the IASB Framework, some other accounting concepts are used in financial reporting. These concepts, together with the underlying assumptions of going concern and accruals, are explained in IAS 1 *Presentation of financial statements*.

2.7.1 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. There are just two exceptions to the requirement for consistency:

a) Consistency is not required when it is apparent, following a significant change in the entity's operations or a review of its financial statements, that a different presentation or classification would be more appropriate.

b) Consistency is not appropriate if a new accounting standard (or the interpretation of a Standard by IFRIC) requires a change in the presentation of information.

2.7.2 Materiality and aggregation

IAS 1 also states that each **material** class of similar items should be presented separately in the financial statements.

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.

2.7.3 Offsetting

IAS 1 states that:

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a) Assets and liabilities should not be offset against each other.

b) 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 astandard 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.

2.8 Presentation, disclosures and bases of accounting

2.8.1. Introduction

There are three bases of accounting which go to the heart of how transactions are recognised and measured:

a) Accruals basis.

b) cash basis; and

c) break-up basis

The accruals basis is by far the most important and popularly applied of these three in practice.

2.8.2 Accruals basis of accounting (matching concept)

Accruals basis accounting (accruals accounting, the accruals concept) recognises transactions and other events and circumstances in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

a) Revenue from sales and other income should be reported in the period when the income arises (which might not be the same as the period when the cash is received).

b) The cost of sales in the statement of comprehensive income must be matched with the sales. Income and 'matching' expenses must be reported in the same financial period.

c) Other expenses should be charged in the period to which they relate, not the period in which they are paid.

2.8.3 Cash basis of accounting

Cash basis accounting recognises transactions in the periods in which cash receipts and payments occur.

a) Revenue from sales and other income will be reported in the period when the cash is received (which might be in a later period than when the income arises).

b) Expenses are charged in the period to which they are paid, not the period in which they are incurred.

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Over time the accruals-based accounting and cash-based accounting result in recognising the same amounts. However, transactions might be recognised in different periods under each system.

Example: Accruals vs cash basis

A company prepares its financial statements to the 31 December each year.

It sells goods for ₦50,000 to a customer on 6 December Year 2 but does not receive a cash payment from the customer until 15 January Year 3.

Accruals basis

The sale is recognised as income in the year to 31 December Year 2, even though the cash is not received until after the end of this financial year.

Cash basis

The sale is recognized as income in Year 3, even though sale was made in year 2.

₦50,000 is recognised as revenue under each basis but in different periods.

Example: Accruals vs cash basis

A company starts in business on 1 September Year 1. It acquires an office for which it pays one year's rent in advance, to 31 August Year 2.

The cost of the annual rental is ₦120,000. The company prepares its financial statements for a financial.

Accruals basis

The office rental cost in the period to 31 December Year 1 is the cost of just four months' rent.

The expense is therefore ₦40,000 (₦120,000u$^{4}/_{12}$) in Year 1, and there has been a prepayment for ₦80,000 that relates to the next financial period, the year to 31 December Year 2.

Cash basis

The entire cost is recognised in the year to 31 December Year 1.

2.8.4 Break-up basis of accounting

Both the accruals basis and the cash basis assume that a business is a going concern. This means that the business is expected to continue into the future. This may not always be the case.

A business might be brought to an end (wound up) either due to financial difficulty or, less likely, the owners decide that the business has run its course.

The break-up basis of accounting is used when the business is no longer a going concern. This basis results in all assets and liabilities being measured at the amount of cash that they can be sold (assets) or settled (liabilities).

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Example: Break-up basis

A company prepares its financial statements to the 31 December each year.

The company is in severe financial difficulty and is not expected to survive. It has a building in its accounts carried at ₦1,500,000.

Real estate professionals have advised that this building could be sold for only ₦1,200,000 in the current market conditions.

Break-up basis

The building should be re-measured at ₦1,200,000 in the financial statements.

2.8.5 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.

2.8.6 Presentation and disclosure objectives and principles

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

a) giving an entity the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses; and

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

2.8.7 Classification

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 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.

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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.

2.8.8 Classification of assets and liabilities

Classification is applied to the unit of accounts selected for an asset or liability. However, it may sometimes be appropriate to separate an asset or liability into components that have different characteristics and to classify those components separately. That would be appropriate when classifying those components separately would enhance the usefulness of the resulting financial information. For example, it could be appropriate to separate an asset or liability into current and non-current components and to classify those components separately.

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 presentations or disclosure of those reserves may provide useful information.

2.8.9 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.

The statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period. That statement contains a total for profit or loss that provides a highly summarised depiction of the entity's financial performance for the period. Many users of financial statements incorporate that total in their analysis either as a starting

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point for
that analysis or as the main indicator of the entity's financial performance for the period. Nevertheless, understanding an entity's financial performance for the period requires an analysis of all recognised income and expenses - including income and expenses included in other comprehensive income - as well as an analysis of other information included in the financial statements.

Because the statement of profit or loss is the primary source of information about an entity's financial performance for the period, all income and expenses are, in principle, included in that statement. However, in developing Standards, the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the statement of profit or loss providing more relevant information or providing a more faithful representation of the entity's financial performance for that period.

2.9 Measurement and capital maintenance

2.9.1 Measurements of elements of financial statements

The Conceptual Framework allows two principal measurement bases that are used for the elements of financial statements. These include:

Historical cost. Historical cost provides monetary information about assets, liabilities and related income and expenses, using information derived from the price of the transaction or other events that gave rise to them. It does not reflect changes in values, except to the extent that those changes relate to the impairment of an asset or a liability becoming onerous.

The historical cost of an asset when it is acquired or created is the value of the costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs. The historical cost of liability when it is incurred or taken on is the value of the consideration received to incur or take on the liability minus transaction costs.

Current value of the asset or liability is used as a deemed cost on initial recognition when an asset is acquired or created, or a liability is incurred or taken on, as a result of an event that is not a transaction on market terms, and that deemed cost is then used as a starting point for subsequent measurement at historical cost. This is because it may not be possible to identify a cost, or the cost may not provide relevant information about the asset or liability.

Current value

Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Because of the updating, current values of assets and liabilities reflect changes, since the previous measurement date, in estimates of cash flows and other factors reflected in those current values. The current value of an asset or liability is not derived, even in part, from the price of the transaction or other events that gave rise to the asset or liability.

Current value measurement bases include:

(a) fair value;
(b) value in use for assets and fulfilment value for liabilities; and
(c) current cost.

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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.

Fair value reflects the perspective of market participants - participants in a market to which the entity has access. The asset or liability is measured using the same assumptions that market participants would use when pricing the asset or liability, if those market participants act in their economic best interest.

In some cases, fair value can be determined directly by observing prices in an active market. In other cases, it is determined indirectly using measurement techniques, for example, cash flow-based measurement techniques, reflecting all the following factors:

a) estimates of future cash flows.
possible variations in the estimated amount or timing of future cash flows for the assets or liability being measured, caused by the uncertainty inherent in the cash flows.

b) the time value of money.
the price for bearing the uncertainty inherent in the cash flows (a risk premium or risk discount). The price for bearing that uncertainty depends on the extent of that uncertainty. It also reflects the fact that investors would generally pay less for an asset (and generally require more for taking on a liability) that has uncertain cash flows than for an asset (or liability) whose cash flows are certain; and

c) other factors, for example, liquidity, if market participants would take those factors into account in the circumstances.

Value in use and fulfilment value

Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability. Those amounts of cash or other economic resources include not only the amounts to be transferred to the liability counterparty, but also the amounts that the entity expects to be obliged to transfer to other parties, to enable it to fulfil the liability.

Value in use and fulfilment value are based on future cash flows, they do not include transaction costs incurred in acquiring an asset or taking on a liability. However, value in use and fulfilment value include the present value of any transaction costs an entity expects to incur on the ultimate disposal of the asset or on fulfilling the liability.

Current cost

The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date. Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire the

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asset or would incur the liability. Hence, it is different from fair value, value in use and fulfilment value, which are exit values. However, unlike historical cost, current cost reflects conditions at the measurement date.

In some cases, current cost cannot be determined directly by observing prices in an active market and must be determined indirectly by other means

Historical cost is the most commonly used measurement basis. However, the other bases of measurement are often used to modify historical cost. For example, inventories are measured at the lower of cost and net realisable value. Deferred income is measured at present value. Some non-current assets may be valued at current value.

The Framework does not favour one measurement base over the others; however fair value may be favoured over historical costs for financial instrument and investment property.

Problems with the use of fair value

Fair value is easy to understand and less complicated to apply than value to the business/current value. Arguably, it is also more reliable to the business, because market value is more easily verified than (for example) economic value. However, it has some serious disadvantages:

a) There may not be an active market for some kinds of asset. Where there is no active market, estimates have to be used and these may not be reliable.

b) It anticipates sales and profits which may never happen (the entity may have no plans to sell th easset).

c) Market values can move up and down quite rapidly. This may distort trends in the financial statements and make it difficult for users to assess an entity's performance over time.

A notable example of this problem occurred during 2007 and 2008 with the collapse of the market for certain types of asset-backed securities (mortgage- related securities known as CDOs). Many banks, particularly in the US and Europe, announced huge losses, due largely to the requirement to write down their investments in these financial instruments to fair value, even though fair value was difficult to assess.

Despite these problems, it looks increasingly likely that the IASB will require greater use of fair value in future.

2.9.2 Capital maintenance concepts

The Conceptual Framework states that there are two concepts of capital:

a) A financial concept of capital; and

b) A physical concept of capital.

Different systems of accounts used different capital maintenance concepts. The choice of capital maintenance has a profound effect on the measurement of profit.

Consider the basic accounting equation.

Formula: Accounting equation

Assets	=	Liabilities	+	Equity	or	Assets	–	Liabilities	=	Equity
A	=	L	+	E	or	A	–	L	=	E
						Net assets				

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The accounting equation is an equation. Therefore, changes in one side are matched by changes in the other side.

Profit or loss for a period can be calculated from the difference between the opening and closing net assets after adjusting for any distributions during the period.

Formula: Profit

Change in equity = Closing equity – Opening equity

Increase in equity = Profit + capital introduced – distributions

Profit = Increase in equity – capital introduced + distributions

This shows that the value ascribed to opening equity is crucial in the measurement of profit.

2.9.4 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).

Historical cost accounting is based on the concept of **money financial capital maintenance**. Under this concept, an entity makes a profit when its closing equity exceeds its opening equity measured as the number of units of currency at the start of the period. Note that this is a separate issue from asset valuation.
Assets could be revalued during the period, but this would have no effect on the opening capital position.

An alternative view of financial capital maintenance is used in constant purchasing power accounting. This system is based on the concept of **real financial capital maintenance**. Under this concept, an entity makes a profit when its closing equity exceeds opening equity remeasured to maintain its purchasing power.

This requires the opening equity to be uplifted by the general inflation rate. This is achieved by a simple double entry.

Illustration: Adjustment to maintain opening equity

	Debit	Credit
Statement of profit or loss	X	
Inflation reserve		X

2.9.5 Physical capital maintenance

A **physical concept of capital** is that the capital of an entity is represented by its productive capacity or operating capability. Where a physical concept of capital is used, the main concern of users of the financial statements is with the maintenance of the operating capability of the entity.

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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.

This requires the opening equity to be uplifted by the specific rates of inflation that apply to the individual components of the net assets of the company. Again, this is achieved by the same simple double entry.

The following example should help you to understand this:

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Example: Capital maintenance concepts

X Limited commenced business on 1 January with a single item of inventory which cost ₦10,000.

During the year it sold the item for ₦14,000 (cash).

During the year genera inflation was 5% but the inflation specific to the item was 10%.

Profit is calculated under each concept in the following ways.

	financial Capital maintenance concept		
	(money terms)	Financial (real terms)	Physical
	₦	₦	₦
Statement of profit or loss			
Revenue	14,000	14,000	14,000
Cost of sale	(10,000)	(10,000)	(10,000)
Inflation adjustment (inflation rate applied to opening equity):			
5% x ₦10,000		(500)	
10% x ₦10,000			(1,000)
	4,000	3,500	3,000
Statement of financial position	₦	₦	₦
Net assets	14,000	14,000	14,000
Equity:			
Opening equity			
	10,000	10,500	11,000
year)	4,000	3,500	3,000
	14,000	14,000	14,000

Before adjustment

Inflation reserve (see above)

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Commentary on the example

Under historical cost accounting, the profit is ₦4,000. If the business paid this out as a dividend it would have ₦10,000 left.

₦10,000 is the opening equity expressed as a number of units of currency. This means that the company would have maintained its equity expressed as a number of units of currency. However, inflation in the period has caused the purchasing power of the currency to decline. This means that ₦10,000 no longer has the same purchasing power that it had a year ago. The company has not maintained its capital in real terms.

To maintain its opening equity in real terms the company would have to ensure that it had the same purchasing power at the year-end as it had at the start.
Inflation was 5% so the company would need ₦10,500 at the year-end in order to have the same purchasing power as it had at the start of the year. The company can achieve this by transferring ₦500 from profit and loss into an inflation reserve. Profit would then be reported as ₦3,500.

If the business paid out ₦3,500 as a dividend it would have ₦10,500 left. This is not enough to buy the same as set that it had at the start of the year. The asset has been subject to specific inflation of 10% therefore the company would need ₦11,000 at the year-end in order to buy the same asset.

This means that the company would not have the same capacity to operate as it had a year ago.

To maintain its opening equity in physical terms the company would have to ensure that it had the same ability to operate at the year-end as it had at the start. In other words it would need to have ₦11,000. The company can achieve this by transferring ₦1,000 from profit and loss into an inflation reserve. Profit would then be reported as ₦3,000.
Comparing the two concepts

Neither the IASB Conceptual Framework nor accounting standards require the use of a specific capital maintenance concept. In practice, almost all entities use money financial capital maintenance, but both concepts can provide useful information.

Financial capital maintenance is likely to be the most relevant to investors as they are interested in maximising the return on their investment and therefore its purchasing power.

Physical capital maintenance is likely to be most relevant to management and employees as they are interested in assessing an entity's ability to maintain its operating capacity. This is particularly true for manufacturing businesses, where management may need information about the ability of the business to continue to produce the same or a greater volume of goods.

2.10 Fair Presentation

2.10.1 What is meant by fair presentation (or a true and fair view)?

Financial statements are often described as showing a 'true and fair view' or 'presenting fairly' the financial position and performance of an entity, and changes in its financial position. In some countries (for example, in Nigeria) this is the central requirement of financial reporting.

Under 'international GAAP' (specifically IAS 1) financial statements are required to present fairly the financial position, financial performance and cash flows of the entity.

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The Framework does not deal directly with this issue. However, it does state that if an entity complies with international accounting standards, and if its financial information has the desirable qualitative characteristics of information, then its financial statements 'should convey what is generally understood as a true and fair view of such information.

IAS 1 states that: '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 as set out in the IASB Framework.

The use of the term faithful representation means more than that the amounts in the financial statements should be materially correct. It implies that information should present clearly the transactions and other events that it is intended to represent. To provide a faithful representation, financial information must account for transactions and other events in a way that reflects their substance and economic reality (in other words, their true commercial impact) rather than their legal form. If there is a difference between economic substance and legal form, the financial information should represent the economic substance.

Faithful representation also implies that the amounts in the financial statements should be classified and presented, and disclosures made in such a way that important information is not obscured, and users are not misled.

2.10.2 Fair presentation and compliance with IFRSs

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:

a) When the financial statements of an entity comply fully with International Financial Reporting Standards, this fact should be disclosed.

b) An entity should not claim to comply with IFRSs unless it complies with **all** the requirements of **every** applicable standard.

IAS 1 appears to equate fair presentation with compliance with accounting standards.

In some situations, fair presentation may require more than this. It is important to apply the spirit (or general intention) behind an accounting standard as well as the strict letter (what the standard actually says).

The requirement to 'present fairly' also applies to transactions which are not covered by any specific accounting standard. It is worth noting that there is no IFRS that covers complex transactions and arrangements which have been deliberately structured so that their economic substance is different from their legal form.

IAS 1 states that a fair presentation requires an entity:

a) to select and apply accounting policies in accordance with IAS 8 Accounting policies, changes in accounting estimates and errors. IAS 8 explains how an entity should develop an appropriate accounting policy where there is no standard;

b) to present information in a manner that provides relevant, reliable, comparable and understandable information; and

c) to provide additional disclosures where these are necessary to enable users to

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understand the impact of particular transactions and other events on the entity's financial performance and financial position (even where these are not required by IFRSs).

2.9.3 Where fair presentation conflicts with an accounting 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.

An entity can then depart from the requirements of the standard or Interpretation. It must disclose:

a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cashflows;

b) that it has complied with applicable standards and Interpretations, except that it has departed from a particular requirement to achieve a fair presentation;

c) the title of the standard or Interpretation from which the entity has departed, the nature of the departure, including the treatment that the standard or Interpretation would require, the reason why that treatment would be misleading, and the treatment adopted; and

d) for each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.

2.11 Chapter review

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

a) explain the objectives of financial statements;

b) list and explain the components of the conceptual framework;

c) explain the difference between the accruals, cash and break up basis of accounting;

d) prepare simple cash and break up basis financial statements;

e) explain the measurement bases available under IFRS;

f) explain and illustrate the capital maintenance concepts described in the conceptual framework; and

g) explain the meaning of true and fair or fairly presented.

2.12 End of chapter questions and suggested solutions

2.12.1 Questions

Question 1

The conceptual framework states that there are two concepts of capital.

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Required:
Explain these two concepts.

Question 2
The International Accounting Standards Board's (The Board's) Conceptual Framework for Financial Reporting identifies two fundamental and four enhancing qualitative characteristics of financial information.

Required:
Identify and explain EACH of the TWO fundamental qualitative characteristics of financial information listed in the Board's Framework

Question 3
The Conceptual Framework for Financial Reporting has a number of purposes, including:

a) assisting the Board in the development of future IFRS Accounting Standards and in its review of existing IFRS Accounting Standards

b) assisting the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative treatments permitted by IFRS Accounting Standards

c) assisting preparers of financial statements in applying IFRS Accounting Standards and in dealing with topics that are yet to be covered in an IFRS Accounting Standard.

Required:
Discuss how The Conceptual Framework could help the Board achieve these objectives.

Question 4
The Conceptual Framework for Financial Reporting was first published in 1989 then updated in 2010 and 2018.
Required:
Explain the purposes of the Framework.

Question 5
You have been asked to show the effect of various asset measurement methods for the following asset:
An item of equipment that was purchased on 1 January 20X3 for ₦140,000. The equipment is depreciated as 25% per annum using the reducing balance method.
The equipment is still available and its list price at 31 December 20X4 is ₦180,000, although the current model is 20% more efficient than the model the entity purchased in 20X3.
It is estimated that the equipment could be sold secondhand for ₦44,000, although the company would have to spend about ₦500 in advertising costs to do so.
The asset is expected to generate net cash inflows of ₦20,000 for the next five years after which time it will be scrapped. The company's cost of borrowing is 6%.
The cumulative present value of ₦1 in five years' time is ₦4.212.

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Required:

a) What is carrying amount of the equipment in the statement of financial position as at December 31, 20X4 using historical cost?

b) What is the carrying amount of the equipment in the statement of financial position as at December 31, 20X4 using fair value?

c) What is the carrying amount of the equipment in the statement of financial position as at December 31, 20X4 using current cost?

d) What is the carrying amount of the equipment in the statement of financial position as at December 31, 20X4 using the value in use method?

2.12.2 Suggested solutions

Solution 1

Capital concepts

The financial concept of capital is that the capital of an entity is measured as its net assets, which is also its equity. Where a financial concept of capital is used, the main concern of users of the financial statements is with the maintenance of the nominal financial capital of the entity.

With the financial 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 financial value of equity (net assets) at the end of the period exceeds the financial value of equity at the beginning of the period.

The physical concept of capital is that the capital of an entity is represented by its productive capacity or operating capability. Where a physical concept of capital is used, the main concern of users of the financial statements is with the maintenance of the operating capability of the entity.

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.

Current value accounting reflects the concept of physical capital maintenance.

In a period of inflation, profits reported using a financial concept of capital will normally be higher than profits reported using a physical concept of capital, such as current value accounting.

Financial capital maintenance is likely to be the most relevant to investors as they are interested in maximising the return on their investment and therefore its purchasing power while Physical capital maintenance is likely to be most relevant to management and employees as they are interested in assessing an entity"s ability to maintain its operating

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capacity.

Solution 2
The two fundamental qualitative characteristics are:
Relevance – Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting their past evaluations.
The relevance of information can be affected by its nature and materiality. Some items may be relevant to users simply because of their nature whereas some items may only become relevant once they are material. Hence, materiality is a threshold quality of information rather than a primary characteristic.
According to the Framework, information is material if its omission or misstatement could influence the decisions of users.

Faithful representation – If information is to represent faithfully the transactions and other events that it purports to represent, they must be accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
To be a faithful representation of financial performance and position, the following characteristics should be evident.

Completeness - To be understandable information must contain all the necessary descriptions and explanations.

Neutrality - Information must be neutral, i.e. free from bias. Financial statements are not neutral if, by the selection or presentation of information, they deliberately influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Free from error - Information must be free from error within the bounds of materiality. A material error or an omission can cause the financial statements to be false or misleading and thus unreliable and deficient in terms of their relevance. Free from error does not mean perfectly accurate in all respects. For example, where an estimate has been used the amount must be described clearly and accurately as being an estimate.

Solution 3
A conceptual Framework provides guidance on the broad principles of financial reporting. It highlights how items should be recorded, measured and presented. The setting of broad principles could assist in the development of accounting standards, ensuring that the principles are followed consistently as standards and rules are developed.

A conceptual Framework can provide guidance on how similar items are treated. By providing definitions and criteria that can be used in deciding the recognition and measurement of items, conceptual

Frameworks can act as a point of reference for those setting standards, those preparing and those using financial information.
The existence of a conceptual Framework can remove the need to address the underlying issues over and over again. Where underlying principles have been established and the accounting standards are based on these principles, there is no need to deal with them fully in each of the standards. This will save the standard-setters time in developing standards

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and will again ensure consistent treatment of items.
Where a technical issue is raised but is not specifically addressed in an accounting standard, a conceptual Framework can help provide guidance on how such items should be treated. Where a short-term technical solution is provided by the standard-setters, the existence of a conceptual Framework will ensure that the treatment is consistent with the broad set of agreed principles.

Solution 4
According to the Framework, its purpose is to:
a) assist the International Accounting Standards Board to develop IFRS Accounting Standards that are based on consistent concepts
b) assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or other event, or when a Standard allows a choice of accounting policy
c) assist all parties to understand and interpret the Standards.

The Framework is not in itself an IFRS Accounting Standard and does not override any specific IFRS Accounting Standard. In any rare instances where there may be a conflict between the Framework and an IFRS Accounting Standard, the requirements of the IFRS. Accounting Standard prevail over the Framework.

Solution 5

Dates	Historical Cost (Using Reducing balance)	₦
1/1/20x3	Balance b/f	140,000
1/1/20x3 – 31/12/X3	Depreciation charge for the year @25%	(35,000)
31/12/20x3	Carrying amount	105,000
Year ended 20x4		
1/1/20x4 – 31/12/X4	Depreciation charge for the year @25%	(26,250)
31/12/20x4	Carrying amount	78,750

b.1 The price that will be received to sell an in an orderly transaction between market participants at measurement date. The value will be ₦44, 000 which is the fair value.

b.2

Dates		Current cost (restated)
		₦
1/1/20x3	b/d (180,000 * 100% / 120%)	150,000

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1/1/20x3 – 31/12/X3	Depreciation charge for the year @25%	(37,500)
31/12/20x3		112,500
Year ended 20x4		
1/1/20x4 – 31/12/X4	Depreciation charge for the year @25%	(28,125)
31/12/20x4		84,375

b.3

Date	Cash flow	Discount factor	Discount value	Transactional cost	Carrying amount
	₦	₦	₦(a)	₦ (b)	₦ (a-b)
31/12/ X4	20,000	4.212	84,240	500	83,740

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CHAPTER 3

PRESENTATION OF FINANCIAL STATEMENTS

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3 Presentation of Financial Statements

3.0 Learning objective

3.1 Learning outcomes

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

a) state the components of a set of financial statements according to IAS 1;

b) explain the general features of financial statements described in IAS 1;

c) define current and non-current assets;

d) define current and non-current liabilities;

e) explain the IAS 1 guidance on the structure of the statement of financial position, the statement of profit or loss and other comprehensive income and the statement of changes in equity;

f) describe the IAS 1 rules on notes to the financial statements; and

g) describe the IFRS 18 changes introduced to IAS 1.

3.2 The components of financial statements

3.2.1 Preparing financial statements

The basic approach to preparing a statement of financial position and a statement of profit or loss in practice can be summarised as follows.

a) The balances on all the accounts in the general ledger (nominal ledger or main) are extracted into a trial balance. (A list of balances on all ledger accounts for assets, liabilities, capital, income and expenses).

b) Adjustments are made for 'year-end' items, such as:

   i. depreciation charges for non-current assets.

   ii. accruals and prepayments for expense items.

   iii. adjusting the allowance for bad (irrecoverable) debts or Expected Credit Loss (ECL).

   iv. closing inventory; and

   v. other items and transactions not yet recorded or incorrectly recorded.

c) The adjusted income and expense balances are entered into a statement of profit or loss to establish the profit or loss for the period.

d) The adjusted assets, liability and capital balances, together with the retained profit for the year, are entered into a statement of financial position as at the end of the reporting period.

This process can be used to prepare the statement of profit or loss and statement of financial position of a sole proprietor, a partnership or a company.

It is likely that you will be given a trial balance with information about missing or incorrectly treated items. You will then be asked to construct a statement of financial position and a statement of profit or loss.

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3.2.1 The format of published accounts

Many entities must publish financial statements in accordance with International Financial Reporting Standards and International Accounting Standards. ***IAS 1: Presentation of Financial Statements*** sets out the rules on the form and content of financial statements which such entities must comply with.

> **Definition**
>
> **General purpose financial statements** (referred to as 'financial statements') are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

IAS 1 specifies what published 'general-purpose' financial statements should include, and provides formats for a statement of financial position, statement of profit or loss and other comprehensive income, and statement of changes in equity.

The objective of general-purpose financial statements is to provide information about the financial position of the company, and its financial performance and cash flows that is useful to a wide range of users in making economic decisions.

A complete set of financial statements consists of:

a) a statement of financial position as at the end of the period;

b) a statement of profit or loss and other comprehensive income for the period (made up of a statement of profit or loss and a statement of other comprehensive income);

c) a statement of changes in equity for the period;

d) a statement of cash flows (this is dealt with in a later chapter); and

e) notes to these statements, consisting of a summary of significant accounting policies used by the entity and other explanatory notes.

Further requirements include:

a. Financial statements should present fairly the financial position, financial performance and cash flows of the entity.

b. Comparative information for the immediate preceding accounting period should be disclosed.

c. Each component of the financial statements must be properly identified with the following information displayed prominently:

   i. the name of the reporting entity;

   ii. the date of the end of the reporting period or the period covered by the statement, whichever is appropriate;

   iii. Individual or Group of companies;

   iv. the currency in which the figures are reported; and

   v. the level of rounding used in the figures (for example, whether the figures are thousands of naira or millions of naira).

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Note: IAS 1 does not specify what the statements must be called and allows the use of other terminology. For example, a statement of financial position is often called a balance sheet, and a statement of profit or loss is often called an income statement.

3.3 General features of financial statements

3.3.1 Introduction

IAS 1 describes and provides guidance on the following general features of financial statements:

a) fair presentation and compliance with IFRSs;

b) going concern;

c) accrual basis of accounting;

d) materiality and aggregation;

e) offsetting;

f) frequency of reporting;

g) comparative information; and

h) consistency of presentation.

Fair presentation and compliance with IFRSs
Disclosure of compliance

An entity whose financial statements comply with IFRSs must make such disclosure in the notes to the accounts.

Financial statements shall not be described as complying with IFRS unless they comply with all the requirements of each applicable Standard and Interpretation.

3.3.2 Fair presentation

Financial statements must present fairly the financial position, financial performance and cash flows of an entity.

This means that they 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.

Fair presentation requires:

a) the selection and application of accounting policies in accordance with ***IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors***.

b) the presentation of information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and,

c) the provision of additional disclosures when the particular requirements in IFRSs are insufficient to enable users to understand the impact of particular transactions or other events on the entity's financial position and financial performance.

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3.3.3 True and fair override

In extremely rare circumstances, management might conclude that compliance with a requirement in IFRS would be so misleading that it would conflict with the objective of financial statements set out in IFRS.

In these cases, the requirement should not be followed as long as the relevant regulatory framework requires or otherwise does not prohibit this.

When an entity departs from a requirement in IFRS it must disclose:

a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cashflows.

b) that it has complied with applicable IFRS except that it has departed from a particular requirement to achieve a fair presentation; and

c) details of the departure:

d) the Standard (or Interpretation) from which the entity has departed and:

e) the nature of the departure (including the treatment that is required by IFRS).

f) the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the "Framework".

g) the treatment adopted; and,

h) for each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.

If the relevant regulatory framework prohibits departure from a requirement the entity must make the following disclosures to reduce the misleading aspects of compliance "to the maximum extent possible":

a) the Standard (or Interpretation) requiring the entity to report information concluded to be misleading and:

b) the nature of the requirement.

c) the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements; and,

d) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

3.3.4 Going concern

Financial statements must be prepared on a going-concern basis unless management either:

a) intends to liquidate the entity; or,

b) to cease trading; or

c) has no realistic alternative but to do so.

Management must assess an entity's ability to continue as a going concern, when

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preparing financial statements.

In making this assessment management must take into account all available information about the future. (This is for at least twelve months from the reporting date).

Disclosures

If management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties must be disclosed.

If the financial statements are not prepared on a going concern basis, that fact must be disclosed, together with:

a) the basis on which the financial statements are prepared; and,

b) the reason why the entity is not regarded as a going concern.

3.3.5 Accrual basis of accounting

Financial statements (except for cash flow information) must be prepared under the accrual basis of accounting.

Under the accrual basis of accounting, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements set out in the "Framework".

3.3.6 Materiality and aggregation

Each material class of similar items must be presented separately in the financial statements.

Items of a dissimilar nature or function must be presented separately unless they are immaterial.

An item that is not sufficiently material to warrant separate presentation on the face of the financial statements may nevertheless be sufficiently material for it to be presented separately in the notes.

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

Materiality depends on the size and nature of the item or aggregation of items judged in the particular circumstances of its omission.

3.3.7 Offsetting

Assets and liabilities must not be offset except when offsetting is required by another Standard.

The reporting of assets net of valuation allowances - for example, obsolescence allowances on inventories and doubtful debts allowances on receivables - is not offsetting.

Items of income and expense must be offset when, and only when IFRS requires or permits it. For example:

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a) gains and losses on the disposal of non-current assets are reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses; and,

b) expenditure that is reimbursed under a contractual arrangement with a third party (for example, a subletting agreement) is netted against the related reimbursement.

Also gains and losses arising from a group of similar transactions are reported on a net basis (for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading purposes).

Such gains and losses must be reported separately if their size, nature or incidence is such that separate disclosure is necessary for an understanding of financial performance.

3.3.8 Frequency of reporting

Financial statements must be presented at least annually.

When an entity's reporting date changes its financial statements are presented for a period longer or shorter than one year. In such cases an entity must disclose, in addition to the period covered by the financial statements:

a) the reason for using a period other than one year; and,

b) the fact that comparative amounts for the income statement, changes in equity, cash flows and related notes are not comparable.

3.3.9 Comparative information

Comparative information must be disclosed in respect of the previous period for all amounts reported in the financial statements unless IFRS permits or requires otherwise.

Comparative information must be included for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

When the presentation or classification of items in the financial statements is amended, comparative amounts must be reclassified (unless the reclassification is impracticable). When comparative amounts are reclassified, an entity must disclose:

a) the nature of their classification;

b) the amount of each item or class of items that is reclassified; and,

c) the reason for the reclassification.

The following must be disclosed when the reclassification of comparative amounts is impracticable:

a) the reason for not reclassifying the amounts; and,

b) the nature of the adjustments that would have been made if the amounts were reclassified.

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3.3.9 Consistency of presentation

The presentation and classification of items in the financial statements must be retained from one period to the next unless:
a significant change in the nature of the operations of the entity or a review of its financial statement presentation demonstrates that a change in presentation results in a more appropriate presentation of transactions or other events; or a change in presentation is required by an IFRS.

3.4 Structure and content of the statement of financial position

Introduction

IFRS uses terms which are incorporated into this study text. However, it does not forbid the use of other terms, and you might see other terms used in practice.

IAS 1 sets out the requirements for information that must be presented in the statement of financial position or in notes to the financial statements, and it also provides implementation guidance. This guidance includes an illustrative format for a statement of financial position. This format is not mandatory, but you should learn it and use it wherever possible.

Current and non-current assets and liabilities

Current and non-current items should normally be presented separately in the statement of financial position, so that:
current and non-current assets are divided into separate classifications; and current and non-current liabilities are also classified separately.

As a general rule, an amount is 'current' if it is expected to be recovered or settled no more than 12 months after the end of the reporting period.

Current assets

IAS 1 states that an asset should be classified as a current asset if it satisfies **any** of the following criteria:

a) The entity expects to realise the asset, or sell or consume it, in its normal operating cycle.

b) The asset is held for trading purposes.

c) The entity expects to realise the asset within 12 months after the reporting period.

d) It is cash or a cash equivalent unless the asset is restricted from being used for at least 12 months after the reporting date. (Note: An example of 'cash' is money in a current bank account. An example of a 'cash equivalent' is money held in a term deposit account with a bank.)

All other assets should be classified as non-current assets.

This definition allows inventory or trade receivables to qualify as current assets, even if they may not be realised into cash within 12 months, provided that they will be realised in the entity's normal operating cycle or trading cycle.

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The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. This is almost always the case.

Current liabilities

IAS 1 also states that liability should be classified as a current liability if it satisfies **any** of the following criteria:

a) The entity expects to settle the liability in its normal operating cycle.

b) The liability is held primarily for the purpose of trading. This means that all trade payables are current liabilities, even if settlement is not due for over 12 months after the end of the reporting period.

c) It is due to be settled within 12 months after the end of the reporting period.

d) The entity does **not** have the unconditional **right** to defer settlement of the liability for at least 12 months after the end of the reporting period.

All other liabilities should be classified as non-current liabilities.

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):

Assets

a) Property, plant and equipment

b) Investment property

c) Intangible assets

d) Long-term financial assets, such as long-term holdings of shares in other companies, with the exception of item (e) below

e) Investments accounted for using the equity method (this is explained in a later chapter on investments in associates)

f) Biological assets

g) Inventories

h) Trade and other receivables

i) Cash and cash equivalents.

j) The total of assets classified as held for sale in accordance with IFRS5

Liabilities

a) Trade and other payables

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b) Provisions

c) Financial liabilities, excluding any items in (k) and (l) above: (for example, bank loans)

d) Liabilities (but possibly assets) for current tax, as required by ***IAS12:***

Income Taxes

a) Deferred tax liabilities (but possibly assets). These are always non-current.
b) Liabilities included in disposal groups in accordance with IFRS5

Equity

a) Non-controlling interests presented within equity

b) Issued capital and reserves attributable to the **owners** of the entity. (The term 'owners', refers to the **equity holders**.)

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.

Information to be shown on the face of the statement of financial position Or in notes

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:

a) 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

b) in notes to the financial statements. For example:

i. Tangible non-current assets should be divided into sub-categories, as required by ***IAS 16: Property, Plant and Equipment***.

ii. Receivables should be sub-classified into trade receivables, receivables from related parties, prepayments and other amounts.

iii. Inventories are sub-classified in accordance with ***IAS 2: Inventories*** into categories such as merchandise, materials, work-in-progress and finished goods.

Example: Statement of financial position of an individual entity
IAS 1 does not specify what the format for statement of financial position should be. However, it includes an illustrative statement of financial position in Guidance to implementing the Standard (which is an appendix to the Standard)
The example below is based on that example. Illustrative figures are included.

Statement of financial position of ABCD Entity as at 31 December 20XX

Assets	₦'m	₦'m
Non-current assets		
Property, plant and equipment	205.1	
Intangible assets	10.7	

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investments	6.8	222.6
Current assets		
Inventories	17.8	
Trade and other receivables	13.3	
Other current assets	2.0	
Cash and cash equivalents	0.7	33.8
Total assets		256.4
Equity and liabilities	₦'m	₦'m
Share capital	50.0	
Retained earnings (accumulated profits)	60.6	
Other components of equity	31.9	
Total equity		142.5
Non-current liabilities		
Long-term borrowings	30.0	
Deferred tax	4.5	
Total non-current liabilities	34.5	
Current liabilities		
Trade and other payables	67.1	
Short-term borrowings (bank overdraft)	3.2	
Current portion of long-term borrowing	5.0	
Current tax payable	4.1	
Total current liabilities	79.4	
Total liabilities		113.9
Total equity and liabilities		256.4

3.5 Structure and Content of the Statement of Profit or Loss and Other Comprehensive Income

3.5.1 A single statement or two statements

The statement of profit or loss and other comprehensive income provides information about the performance of an entity in a period. It consists of two parts:

a) a statement of profit or loss – a list of income and expenses which result in a profit or loss for the period; and

b) 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. If two separate statements are used, they should include all the information that would otherwise be included in the single statement of profit or loss and other comprehensive income.

The statement of profit or loss shows the components of profit or loss, beginning with 'Revenue' and ending with 'Profit (or Loss)' for the period after tax.

Examples of other comprehensive income

In this syllabus the only gains and losses that are recognised in the statement of other

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comprehensive income are those arising on the revaluation of property. plant and equipment under the rules in IAS 16. This is covered in more detail in chapter 7 of this text.

There are many other transactions which must be recognised in the statement of other comprehensive income, but these are not in the scope of this syllabus. You will study them in papers at a higher level.

Definition of total comprehensive income

Total comprehensive income during a period is the sum of:

a) the profit or loss for the period; and

b) other comprehensive income.

Information to be presented on the face of the statement of profit or loss and other comprehensive income

As a **minimum**, IAS 1 requires that the statement of profit or loss and other comprehensive income should include line items showing the following amounts for the financial period:

a) revenue;

b) finance costs (for example, interest costs);

c) share of profit of associates;

d) tax expense;

e) an amount related to the profit or loss from discontinued operations (IFRS5);

f) profit or loss;

g) each component of 'other comprehensive income; and

h) total comprehensive income.

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

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Example: Statement of profit or loss and other comprehensive income of an individual entity

IAS 1 does not specify formats.

The example below is based on a suggested presentation included in the implementation guidance to IAS 1.

XYZ Entity: Statement of profit or loss and other comprehensive for the year ended 31 December 20XX

	₦'000
Revenue	678
Cost of sales	(250)
Gross profit	428
Other income	44
Distribution costs	(98)
Administrative expenses	(61)
Other expenses	(18)
Finance costs	(24)
Profit before tax	271
Taxation	(50)
PROFIT FOR THE YEAR	221
Other comprehensive income	
Gains on property revaluation	46
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	267

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Information to be shown on the face of the statement of profit or loss and other 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 profit or loss or in a note to the financial statements:

a) **material items** of income and expense

b) an **analysis of expenses**, providing either:

   i. expenses analysed by their nature, or

   ii. expenses analysed by the function that has incurred them.

IAS 1 encourages entities to show this analysis of expenses on the face of the statement of profit or loss, rather than in a note to the accounts.

Material items that might be disclosed separately include:

a) a write-down of inventories from cost to net realisable value, or a write- down of items of property, plant and equipment to recoverable amount;

b) the cost of a restructuring of activities;

c) disposals of items of property, plant and equipment;

d) discontinued operations;

e) litigation settlements; and

f) a reversal of a provision.

Analysis of expenses by their function

When expenses are analysed according to their function, the functions are commonly cost of sales, distribution costs, administrative expenses and other expenses. This method of analysis is also called the cost of sales method.

In practice, most entities use this method.

An example of a statement of profit or loss, showing expenses by function (cost of sales, distribution costs, and administrative expenses) is as follows.

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Example: Analysis of expenses by function

The following is an extract from the accounts of Entity Red for the year to 30 June 20X5, after the year-end adjustments had been made:

	Debit	Credit
	₦000	₦000
Cost of sales	6,214	
Distribution costs	3,693	
Revenue		14,823
Other expenses	248	
Administrative expenses	3,901	
Other income		22

Required

Show the first part of Entity Red's statement of profit or loss using the 'cost of sales' analysis method.

Entity Red: Statement of profit or loss for the year ended 30 June 20X5

	₦ 000
Revenue	
Cost of sales	6,214
Gross profit	8,609
Other income	22
Distribution costs	(3,693)
Administrative expenses	(3,901)
Other expenses	(248)
Profit before tax	789

The basis for separating these costs between the functions would be given in the question.

Analysis of expenses by their nature

When expenses are analysed according to their nature, the categories of expenses will vary according to the nature of the business.

In a manufacturing business, expenses would probably be classified as:

a) raw materials and consumables used;

b) staff costs ('employee benefits costs'); and

c) depreciation.

Items of expense that on their own are immaterial are presented as 'other expenses'.

There will also be an adjustment for the increase or decrease in inventories of finished goods and work-in-progress during the period.

Other entities (non-manufacturing entities) may present other expenses that are material to their business.

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An example of a statement of profit or loss, showing expenses by their nature, is shown below, with illustrative figures included.

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Example: Analysis of expenses by nature

The following is an alternative method of presenting the accounts of Entity Red.

	₦ 000
Increase in inventories of finished goods and work-in-progress	86
Revenue	14,823
Raw materials and consumables	5,565
Depreciation	1,533
Other income	22
Staff costs	4,926
Other operating expenses	2,118

Required

Show the first part of Entity Red's statement of profit or loss using the 'nature of expenditure' method, down to the operating profit level.

Entity Red: Statement of profit or loss for the year ended 30 June 20X5

	₦ 000	₦ 000
Revenue	14,823	
Other income	22	
	14,845	
Changes in inventories of finished goods and work-in- progress (reduction=expense, increase=negative expense)	(86)	
Raw materials and consumables used	5,565	
Staff costs (employee benefits costs)	4,926	
Depreciation and amortisation expense	1,533	
Other operating expenses	2,118	
		14,056
Profit before tax	789	

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3.6 Statement of changes in equity (SOCIE)

3.6.1 The contents of a statement of changes in equity

A set of financial statements must include a statement of changes in equity (SOCIE).

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

Components of equity include:

a) Share capital.

b) Share premium.

c) Retained earnings.

d) Revaluation surplus.

In a SOCIE for a group of companies, the amounts attributable to owners of the parent entity and the amounts attributable to the non-controlling interest should be shown separately. (Non-controlling interest is a concept used in group accounts. This is covered in a later chapter).

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

a) profit or loss for the period.

b) each item of other comprehensive income.

c) transactions with owners in their capacity as owners.

Transactions with owners in their capacity as owners

These include:

a) new issues of shares.

b) payments of dividends.

c) repurchases and cancellation of its own shares by the company.

These transactions are not gains or losses, so are not shown in the statement of comprehensive income but they do affect equity. The SOCIE highlights such transactions.

Retrospective adjustments

IAS 8 Accounting policies, changes in accounting estimates and errors require that when an entity changes an accounting policy or restates amounts in the financial statements to correct errors, the adjustments should be made retrospectively (to the extent that this is practicable).

Retrospective adjustments result in changes in the reported amount of an equity component, usually retained earnings. Retrospective adjustments and re- statements are not changes in equity, but they are adjustments to the opening balance of retained earnings (or other components of equity).

Where retrospective adjustments are made, the SOCIE must show for each component

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of equity (usually retained earnings) the effect of the retrospective adjustment. This is shown first, as an adjustment to the opening balance, before the changes in equity are reported. (This is covered in more detail in chapter 4).

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Illustration: statement of changes in equity

PQR Entity:

Statement of changes in equity for the year ended 31 December 20X9

	Share capital	Share premium	General reserve	Accumulated profits	Total
	₦ m	₦m	₦m	₦m	₦m
Balance at 31 December 20X8	200	70	80	510	860
Change in accounting policy	-	-	-	(60)	(60)
Restated balance	200	70	80	450	800
Changes in equity for 20X9					
Issue of share capital	80	100			180
Dividend payments				(90)	(90)
Profit for the year				155	155
Other comprehensive income for the year			12		12
Balance at 31 December 20X9	280	170	92	515	1,057

The statement reconciles the balance at the beginning of the period to that at the end of the period for each component of equity.

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3.7 Notes to the Financial Statements

3.7.1 Introduction

Notes contain information in addition to that presented in the statement of financial position, statement of profit or loss and other 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.

Structure

The notes to the financial statements of an entity must:

a) present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied for significant transactions and other significant events.

b) disclose the information required by IFRSs that is not presented elsewhere in the financial statements; and

c) provide additional information that is not presented on the face of the financial statements but is relevant to an understanding of them.

Notes to the financial statements must be presented in a systematic manner. Each item on the face of the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cashflows must be cross-referenced to any related information in the notes.

Notes are normally presented in the following order:

a) a statement of compliance with IFRS.

b) A summary of significant accounting policies applied.

c) supporting information for items presented on the face of each financial statement in the order in which each financial statement and each line item is presented; and

d) other disclosures, including:

i. contingencies.

ii. un-contracted commitments; and

iii. non-financial disclosures.

3.7.2 Disclosure of accounting policies

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

a) the measurement basis (or bases) used in preparing the financial statements; and

b) the other accounting policies used that are relevant to an understanding of the financial statements.

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c) 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:

   i. whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and

   ii. 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. (See chapter 4).

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:

a) their nature; and

b) their carrying amount as at the reporting date.

Examples of key assumptions disclosed are:

a) future interest rates;

b) future changes in salaries;

c) future changes in prices affecting other costs; and,

d) useful lives.

Examples of the types of disclosures made are:

the nature of the assumption or other measurement uncertainty;

a) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;

b) 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

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c) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

Other disclosures

An entity must disclose in the notes:

a) the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the related amount per share;

b) the amount of any cumulative preference dividends not recognised;

c) An entity must disclose the following, if not disclosed elsewhere in information published with the financial statements;

d) the domicile and legal form of the entity;

e) a description of the nature of the entity's operations and its principal activities; and

f) the name of the parent and the ultimate parent of the group.

3.8 Financial Statement – Specimen Formats

IAS 1 does not specify formats for financial statements. However, it includes illustrative statements in an appendix to the Standard).

The illustrations below are based on illustrative examples.
Statement of comprehensive income (analysis of expenses by function)

Illustration: Statement of comprehensive income (analysis of expenses by function)

Statement of comprehensive income for the year ended 31 December 20 X 9

Revenue	X
Cost of sales	(X)
Gross profit	X
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Finance costs	(X)
Share of profit of associates	
Profit before tax	X
Taxation	(X)
PROFIT FOR THE YEAR	X
Other comprehensive income	
Gains on property revaluation	X
OTHER COMPREHENSIVE INCOME FOR THE YEAR	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X

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Illustration: Statement of financial position format

Statement of financial position as at December 31, 20 X 9

	₦ m	₦m
Assets		
Non-current assets		
Property, plant and equipment	X	
Goodwill	X	
Intangible assets	X	
Investments in associates	X	
Available for sale financial assets	X	
Total non-current assets		X
Current assets Inventories	X	
Trade receivables	X	
Other current assets	X	
Cash and cash equivalents	X	
Total current assets		X
Total assets		X
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital		X
Share premium (not mentioned in IAS1but included for completeness)		
Retained earnings		X
Other components of equity		X
		X
Non-controlling interest		X
Total equity		X
Non-current liabilities		
Long-term borrowings	X	
Deferred tax	X	
Long term provisions	X	
Total non-current liabilities	X	
Current liabilities		
Trade and other payables	X	
Short-term borrowings	X	
Current portion of long-term borrowing	X	
Current tax payable	X	
Short term provisions	X	
Total current liabilities	X	
Total liabilities		X
Total equity and liabilities		X

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3.9 Technique of Preparing Financial Statements

3.9.1 Introduction

In this exam you will be expected to prepare a statement of financial position and statement of profit or loss and other comprehensive income from a trial balance. These questions are usually quite time pressured, so you need to develop a good technique in order to complete such tasks in an effective way.

The rest of this chapter use the following example to illustrate how such questions might be approached. You will need to choose an approach and practice it.

The example includes several straightforward year-end adjustments for illustrative purposes. In the exam you will face more complicated adjustments than these.

Example:

ABC – Trial balance as at 31 December 20X9

	₦	₦
Revenue		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Lighting and cooling	5,000	
Inventory as at 1 January 20X9	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000
Non-current assets	146,000	
Accumulated depreciation:		32,000
Trade receivables	51,000	
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 20X9		121,600
	627,600	627,600

Further information:.

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3.9.2 The journals

The business needs to process the following double entries to take account of the "further information" given above.

Example: Closing journals

		Debit	Credit
a)	**Accrual**		
	Lighting and cooling expenses	400	
	Accrual		400
	Being: Accrual for lighting and cooling expenses		
b)	**Rent prepayment**		
	Pre-payment	700	
	Rent expense		700
	Being: Adjustment to account for rent prepayment		
c)	**Bad and doubtful debt**		
	Bad and doubtful debt expense	1,200	
	Receivables		1,200
	Being: Write off of bad debt		
	Bad and doubtful debt expense	500	
	Allowance for doubtful debts		500
	Being: Increase in the allowance for doubtful debts		
d)	**Depreciation**		
	Depreciation expense	14,600	
	Accumulated depreciation		14,600
	Being: Depreciation for the year (10% of 146,000)		
e)	**Closing inventory**		
	Inventory (asset)	16,500	
	Inventory (cost of sales)		16,500
	Being: Recognition of inventory at the year-end		

These journals are only given to explain the double entry required. You should never write something like this in preparation of financial statements question. It uses up too much time. You want to do double entry rather than write journals.

The chapter continues to show two possible approaches that you might follow. You do not have to do either. If you decide on a way that suits, you then use it.

If you attend courses your lecture will show you how to do this. They are very experienced. Do as they advise.

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3.9.3 Preparation of financial statements: Approach 1

Step 1: Perform double entry on the face of the question and open up new accounts as you need them in any space that you have. (DO NOT COPY OUT THE TRIAL BALANCE).

After this your question paper should look something like the following (with the double entries are shown in bold italics):

Example: ABC – Trial balance as at 31 December 20X9

	₦	₦
Revenue		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	***700[b]***
Lighting and cooling	5,000 + ***400[a]***	
Inventory as at 1 January 20X9	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000+ ***500[c]***
Non-current assets	146,000	
Accumulated depreciation:		32,000+ ***14,600[d]***
Trade receivables	51,000	***1,200[c]***
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 20X9		121,600
	627,600	627,600
Accruals		***400[a]***
Prepayments	***700[b]***	
Bad and doubtful debt expense	***1200[c] + 500[c]***	
Depreciation expense	***14,600[d]***	
Closing inventory (asset)	***16,500[e]***	
Closing inventory (cost of sales)		***16,500[e]***

Step 2: Draft pro-forma financial statements including all of the accounts that you have identified. (A pro-forma is a skeleton document into which you can copy numbers later)

Step 3: Copy the numbers from the trial balance into the pro-forma statements. Note that if a number copied onto the financial statements is made up of a number provided in the

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original trial balance that has been adjusted, you must show the marker what you have done. This may involve adding in an additional explanation below the main answer or may be shown on the face of the statements.

Step 4: Calculate profit for the year.

Step 5: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:

Example: ABC – Statement of financial position

	₦	₦
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

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Example: ABC–Statement of comprehensive income (statement of profit or loss)

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory	(16,500)	
		(302,900)
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation **(W1)**	14,600	
Rent (14,000 – 700)	13,300	
Lighting and cooling (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
		(99,000)
		26,100

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

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3.9.4 Preparation of financial statements: Approach 2

Step 1: Draft pro-forma financial statements including all of the accounts that you have identified from reading the question. Leave space in case you have missed an account that you might need to insert later.

Step 2: Copy the numbers from the trial balance into the pro-forma statements. If you know that a number is not to be adjusted, then you can copy it straight to its destination. Otherwise set up bracketed workings next to the narrative in the pro-forma.

After step 2 your answer might look like this:

Example: ABC – Statement of financial position

		₦	₦
Assets			
Non-current assets			
Cost		146,000	
Accumulated depreciation	(32,000		
Current assets			
Inventories			
Trade receivables (51,000			
Allowance for doubtful debts (4,000			
Prepayments			
Cash		6,200	
Total assets			
Equity and liabilities			
Capital			
At start of year		121,600	
Profit for the year			
Drawings		(22,000)	
Current liabilities			
Trade payables		42,000	
Accruals (and prepaid income)			
Total equity and liabilities			

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Example: ABC – Statement of comprehensive income (statement of profit or loss)

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory		
Gross profit		
Expenses:		
Wages and salaries	64,000	
Depreciation		
Rent (14,000		
Lighting and cooling (5,000		
Bad and doubtful debts		

Step 3: Perform double entry on the face of your answer.

Step 4: Complete the bracketed workings and copy totals into their final destinations.

Step 5: Calculate profit for the year.

Step 6: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

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The final answer might look like this:

Example: ABC – Statement of financial position

	₦	₦
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

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Example: ABC–Statement of comprehensive income (statement of profit or loss)

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory	(16,500)	
		(302,900)
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation **(W1)**	14,600	
Rent (14,000 – 700)	13,300	
Lighting and cooling (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
		(99,000)
		26,100

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

3.10 IFRS 18 Presentation and Disclosure in Financial Statements

3.10.1 Overview of changes introduced by IFRS 18

IFRS 18 Presentation and Disclosure in Financial Statements was issued by the International Accounting Standards Board (IASB) in April 2024. IFRS 18 supersedes IAS 1 Presentation of Financial Statements and has resulted in numerous consequential amendments to IFRS® Accounting Standards including IAS 8 Basis of Preparation of Financial Statements (renamed from Accounting Policies, Changes in Accounting Estimates and Errors).

IFRS 18 introduces significant changes to numerous requirements, primarily how an entity:

a) Presents its statement of profit or loss, including the classification of income and expenses and new mandatory subtotals.

b) Aggregates and disaggregates information disclosed in financial statements; and

c) Disclosed information about management-defined performance measures.

While IFRS 18 does not change any of the recognition and measurement requirements in IFRS Accounting Standards, the effect of the new standard should not be underestimated

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by entities. The IASB has given preparers approximately 3 years to prepare for the adoption of the standard, which is a similar implementation timeframe similar to that given for the implementation of IFRS 9, 15 and 16.
Before exploring the requirements of IFRS 18 relating to the statement of profit or loss, it is useful to understand the history that led to the development and issuance of IFRS 18.

3.10.2 Background on primary financial statements project

IFRS 18 was developed as part of the primary financial statements project. This project was undertaken by the IASB because the board received feedback from stakeholders that IFRS Accounting Standards did not have detailed requirements on:

a) classification of income and expenses in the statement of profit or loss.
b) presentation of subtotals above 'profit or loss' (e.g. operating profit) in the statement of profit or loss; or
c) aggregation and disaggregation of information presented in the primary financial statements or disclosed in the notes.

This lack of detailed requirements led to diversity in practice, such as many entities presenting an 'operating profit' subtotal, with entities defining this subtotal differently. This lack of consistency made comparison of entities' financial performance difficult.
From 2015 to 2019, the IASB undertook research activities to determine how they may improve IFRS Accounting
Standards to address the above noted concerns. The IASB decided to introduce a basis for classifying items of income and expense in the statement of profit or loss into categories, which would result in mandatory subtotals in the statement of profit or loss and increased comparability between entities The IASB also decided to require entities to disclose information about management-defined performance measures, which are subtotals of income and expenses that an entity uses in public communication that communicate management's view of an aspect of financial performance (e.g. 'adjusted profit'). IFRS 18 contains certain exclusions for specified subtotals, which do not trigger disclosures.
After performing research, the IASB issued an exposure draft General Presentation and Disclosures in December 2019.
The IASB deliberated on feedback received in response to the exposure draft and issued IFRS 18 in April 2024 with effective date of 1st January 2027.

3.10.3 Scope

Applies in presenting and disclosing information in financial statements prepared in accordance with IFRS
Accounting Standards

General requirements

a) Objective of Financial Statements
b) To provide financial information
c) To provide financial information about a reporting entity's asset, liabilities, equity, income and expenses that is useful to users of financial statements in assessing:
   i. the prospects for future net cash inflows to the entity; and
   ii. management's stewardship of the entity's economic entity resources.

d) Roles of Primary Financial Statements and Notes

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i. To provide structured summaries i.e. more aggregated information in the primary financial statements than in the notes.

ii. The notes will provide more detailed information, including disaggregation of information presented in the primary financial statements.

d) Frequency of reporting provide a complete set of financial statements at least annually.

e) Presentation consistency.

Retain presentation and classification from one period to the next unless criteria in IAS 8 Basis of Preparation of Financial Statements is met to change presentation or an IFRS Accounting Standard requires a change.

f) Comparative information

Provide comparative information from the preceding reporting period for all amounts reported in the current period unless an IFRS Accounting Standard permits or requires otherwise.

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Changes in accounting policy, retrospective restatement or reclassification

a) Any changes in presentation, disclosure or classification of items in the financial statements, reclassify comparative amounts unless reclassification is impracticable.
b) When an entity reclassifies comparative amounts, it shall disclose nature, amount of each item and reason for reclassification.
c) When it is impracticable to reclassify, an entity shall disclose the reason for not reclassifying and adjustments that would have been made if amounts had been reclassified.

Components of financial statements

A complete set of financial statements comprises:
Primary financial statements

a) Statement of financial position
b) Statement(s) of financial performance
c) Statement of changes in equity
d) Statement of cash flows
e) Notes for the reporting period

The statement of financial performance is presented either as (1) a single statement of profit or loss and other comprehensive income; or (2) separate statements of profit or loss and other comprehensive income.
All statements are required to be presented with equal prominence.

3.10.4 Aggregation and Disaggregation

Principles of aggregation and disaggregation

An entity is required to present line items by aggregating on shared characteristics and disaggregate items based on characteristics that are not shared.
An entity shall disaggregate items with dissimilar characteristics when the resulting information is material.
Additional presentation criteria
An entity is required to present additional line items or sub-totals which shall:

a) Comprise amounts recognised and measured in accordance with IFRS Accounting Standards
b) Be compatible with statement structure created by the requirements listed in IFRS 18.22
c) Be consistent from period to period
d) Be displayed no more prominently than the totals and subtotals required by IFRS Accounting Standards.

3.10.5 Offsetting

Offsetting of assets and liabilities or income and expenses are not permitted unless required by other IFRS Accounting Standards.

Structure and Content

Statement of financial position

a) Present current and non-current items separately; or
b) Present items in order of liquidity.

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Current assets

a) Expected to be realised in, or is intended for sale or consumption in the entity's normal operating cycle
b) Held primarily for trading
c) Expected to be realized within 12 months
d) Cash or cash equivalents.

All other assets are required to be classified as non-current.

Current liabilities

a) Expected to be settled in the entity's normal operating cycle
b) Held primarily for trading
c) Due to be settled within 12 months
d) The entity does not have the right at the end of the reporting period to defer settlement of the liability for at least 12 months.

All other liabilities are required to be classified as non-current.
Information required to be presented on the face of the statement of financial position is detailed in IFRS 18.103-104.
Further information required to be presented on the face or in the notes to the financial statements.

3.10.6 Statement of profit or loss

An entity presents all items of income and expense recognised in a period, either:

a) In a single statement of profit or loss and other comprehensive income
b) In two statements: a statement of profit or loss and a separate statement presenting comprehensive income.

Information required to be presented in the:

a) Statement of profit or loss as required in IFRS 18.46-85
b) Statement presenting comprehensive income as defined in IFRS
c) Further information required is to be presented on the face or in the notes to the financial statements.

i. Present operating expenses either by nature, by function or on a "mixed basis' which reflects the most useful structured summary of operating expenses.
ii. Mandatory presentation of the following totals and subtotals: (1) operating profit; (2) profit or loss before financing and income taxes; (3) profit or loss.
iii. Line items within other comprehensive income are required to be categorised into two categories:
   - Those that could subsequently be reclassified to profit or loss
   - Those that cannot be re-classified to profit or loss.
iv. Classification of foreign exchange differences
   An entity shall classify foreign exchange differences included in the statement of profit or loss applying IAS 21 in the same category as the income and expenses from the items that gave rise to the foreign exchange differences, unless doing so would involve undue cost or effort.

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3.10.6 Classification of Income and Expenses

Classify income and expenses in one of five categories:

a) Investing
b) Financing
c) Income Tax
d) Discontinued operations
e) Operating

3.10.7 Investing Category

Income and expenses from investments in associate, joint ventures and unconsolidated subsidiaries, cash and cash equivalents and other assets, if they generate a return individually and largely independently of the entity's other resources.

Examples of items generally classified in the investing category for entities without specified main business activities:

a) Fair value gains/losses on financial assets measured at fair value
b) Interest income on financial assets
c) Equity method income/loss from joint ventures and associates
d) Dividend income
e) Rental income

3.10.8 Financing Category

Most income and expenses related to:

a) Liabilities arising from transactions that involve only raising of finance such as debt instruments settled in cash (e.g. debentures, loans, etc.)
b) Other liabilities such as payables for goods or services and contract liabilities, lease liabilities, defined benefit pension liabilities, certain provisions (decommissioning / asset restoration).
c) Examples of items generally classified in the financing category for entities without specified main business activities:
d) Interest expense on a debt instrument issued
e) Interest expenses on lease liabilities
f) Net interest expense (income) on a net defined benefit liability (asset)

3.10.9 Operating category

All income and expenses that are not classified in the investing, financing, income taxes or discontinued operations categories.

a) The operating category is a residual or default category that:

   i. Comprises all income and expenses arising from an entity's operations, regardless of whether they are volatile or non-recurring; and
   ii. Includes, but is not limited to income and expenses from other business activities, such as income and expenses from additional activities, if those income and expenses do not meet the requirements to be classified in any of the other categories.

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Entities with specified main business activities**
Exceptions to the requirements for entities that have one or more "specified" main business activities, that is, a main business activity of:

a) Investing in particular types of assets; or

b) Providing financing to customers.

Certain income and expenses will be classified in other categories for entities with specified main business activities.

Income taxes category
Comprises:

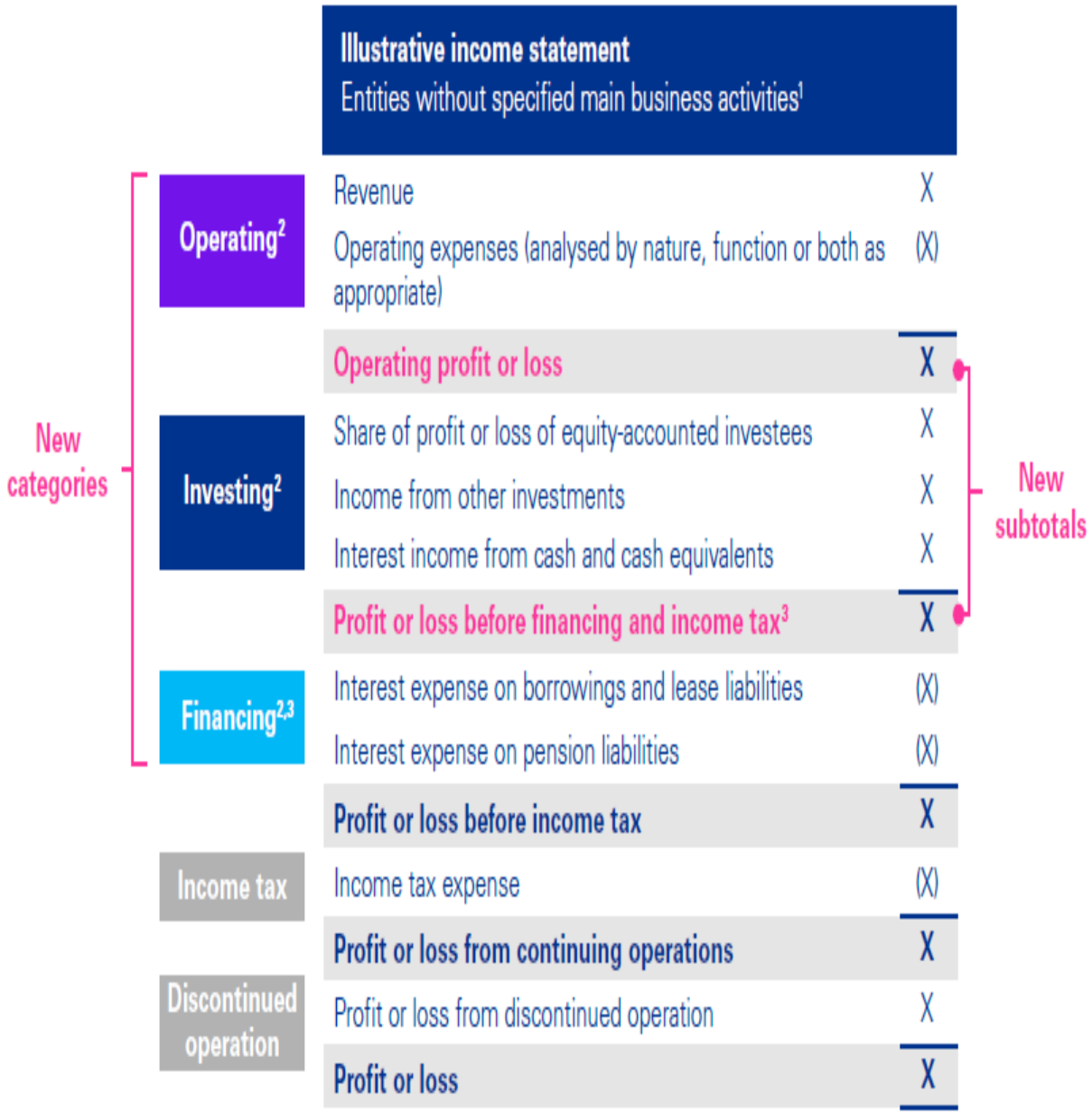
a) Tax expense or tax income included in the statement of profit or loss applying IAS 12 Income Taxes.

b) Any related foreign exchange differences from the associated income taxes.

Discontinued operations category
Comprises income and expenses from discontinued operations as required by IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
Illustrative example – entity without specified main business activities

Line item	₦	Classification
Revenue	XXX	Operating category
Cost of sales	XXX	
Gross profit	XXX	
Other operating income	XXX	
Selling expenses	XXX	
Research and development	XXX	
General and administrative	XXX	
Operating profit	XXX	Mandatory specified sub-total
Share of profit from joint venture	XXX	**Investing category**
Profit before financing and income taxes	XXX	Mandatory specified sub-total
Interest expenses on borrowings and lease liabilities	XXX	**Financing category**
Profit before income taxes	XXX	Additional sub-total
Income tax expense	XXX	**Income taxes category**

Profit from continuing operations	XXX	Additional sub-total
Loss from discontinued operations	XXX	**Discontinued operating category**
Profit	XXX	Mandatory total
Adapted from BDO (2025)		



Statement of changes in equity
Information required to be presented:

a) Total comprehensive income for the period, showing separately attributable to owners or the parent and non-controlling interest
b) For each component of equity, the effects of retrospective application/restatement recognised in accordance with IAS 8 Basis of Preparation of Financial Statements
c) The amounts of transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners
d) For each component in equity a reconciliation between the carrying amount at the beginning and end of the period, separately disclosing each change
e) Amount of dividends recognised as distributions to owners during the period (can alternatively be disclosed in the notes)
f) Analysis of each item of OCI (alternatively to be disclosed in the notes).

Statement of cash flows
Provides users of financial statements with cash flow information refer to IAS 7 Statement of Cash Flows

Notes to the financial statements
Statement of compliance with IFRS Accounting Standards
a) Material accounting policy information, estimates, assumptions, and judgements must be disclosed
b) Additional information useful to users understanding/ decision making to be presented
c) Information that enables users to evaluate the entity's objectives, policies and processes for managing capital.
d) Note disclosing the management-defined performance measures used by the entity.

Management-defined performance measures (MPM)
MPMs are a subtotal of income and expenses that an entity uses in public communications outside the financial statement to communicate to the management's view of an aspect of financial performance (e.g. adjusted profit).
An entity is required to disclose all MPMs in a single note to the financial statements, including a description, how the MPM was calculated, a reconciliation to the most directly comparable IFRS. Accounting Standard subtotal and the income tax/NCI effects.

Third Statement of Financial Position
A third statement of financial position required when an entity applies an accounting policy retrospectively, or makes retrospective restatements or reclassifications:
a) opening statement is only required if impact is material;
b) opening statement is presented as at the beginning of the immediately preceding comparative period required by IFRS 18 (e.g. if an entity has a reporting date of 31 december 20x2 statement of financial position, this will be as at January 1, 20x1); and
c) only include notes for the third period relating to the change.

Identification of the financial statements
Financial statements must be clearly identified and distinguished from other information in the same published document, and must identify:
a) the level of rounding name of the reporting entity;
b) whether the financial statements cover the individual entity or a group of entities;

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c) the statement of financial position date (or the period covered); and
d) the presentation currency used.

Reporting period

a) Accounts presented at least annually.
b) If longer or shorter, entity must disclose that fact.

Effective date and transition requirements

Required transition approach

IFRS 18 is effective for annual reporting periods beginning on or after 1 January 2027 (IFRS 18.C1). Earlier application is permitted, however, early application in many jurisdictions may be subject to endorsement of IFRS 18 (e.g. endorsement by the European Union for entities that comply with IFRS as endorsed by the European Union).
For example, entities with the following annual reporting period ends would be required to apply IFRS 18 in annual financial statements as follows:

Annual reporting period ending	IFRS 18 mandatorily effective for the first time in annual reporting period ending:
April 30	April 30, 2028
May 31	May 31, 2028
December 31	December 31, 2028

When an entity applies IFRS 18, it must do so retrospectively. Retrospective application means that an entity must restate all comparative periods presented to comply with the requirements of IFRS 18. Adopting IFRS 18 for the first time will primarily affect the statement of profit or loss, however, it is possible that the application of IFRS 18 may also affect other primary financial statements along with notes to the financial statements if, for example, entities change the level of aggregation in financial statements.
However, an entity is not required to present the quantitative information specified in IAS 8.28(f) (amount of the adjustment for each line item affected and if IAS 33 is applicable, the amount of the adjustment for basic and diluted earnings per share) (IFRS 18.C2). Instead, an entity applies the 'IFRS 18-specific' transition disclosures.

Disclosures required upon transition

When IFRS 18 is applied for the first time, entities are required to disclose for the comparative period immediately preceding the period in which IFRS 18 is first applied (e.g. the 31 December 2026 comparative for 31 December 2027 financial statements), a reconciliation between (IFRS 18.C3):

a) The restated amounts presented applying IFRS 18; and
b) The amounts previously presented applying IAS 1.

For example, if an entity previously presented certain line items outside of how the entity defined 'operating profit' under IAS 1, but those amounts are required to be classified in the operating category in accordance with IFRS 18, the entity would need to reconcile the line items affected.

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The reconciliation required by IFRS 18.C3 is permitted, but not required, to be provided for the current period or earlier comparative periods (IFRS 18.C6).

Key changes introduced by IFRS 18

Note that this section is not an exhaustive summary of all the effects of IFRS 18 and consequential amendments.
The most significant effects of IFRS 18 (and consequential amendments to IFRS Accounting Standards other than IFRS 18) relate to the following topics:

Key change
Classification of income and expenses in the statement of profit or loss

Summary
All income and expenses are classified into one of five categories:
a) The investing category
b) The financing category
c) The operating category
d) The income taxes category
e) The discontinued operations category

Income and expenses are generally classified based on the characteristic of the expense (i.e. the type of asset or liability to which the income or expense relates); however, certain exceptions exist for entities with specified main business activities, resulting in certain income and expenses being classified in the operating category that would otherwise be classified in the investing and/or financing categories.

Key change
Principles of aggregation and disaggregation

Summary
A new set of principles has been introduced for how assets, liabilities, equity, reserves, income, expenses and cash flows are aggregated and disaggregated. Applying these requirements results in aggregations and disaggregations of items being presented in the primary financial statements and disclosed in the notes.

Key change
Totals and subtotals presented in the statement of profit and loss

Summary
Once an entity has classified individual items of income and expense into the appropriate categories and it has aggregated those items into appropriate levels of aggregation for presentation in the statement of profit or loss, mandatory and additional subtotals are presented as a result of the previous steps. For example, all entities are required to present 'operating profit' in the statement of profit or loss, which is the total of all income and expenses classified in the operating category.

Key change
Disclosure of management-defined performance measures

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Summary
IFRS 18 requires entities to disclose information about management-defined performance measures (MPMs), which are a subtotal of income and expense that:

a) an entity uses in public communications outside financial statements;

b) an entity uses to communicate to users of financial statements management's view of an aspect of the financial performance of the entity as a whole; and

c) is not listed in IFRS 18.118, or specifically required to be presented or disclosed by IFRS Accounting Standards.

A common example of an MPM could be an 'adjusted profit' measure, which excludes share-based payments expenses and impairment of goodwill. A separate IFRS Accounting Standards In Practice publication is being prepared for management-defined performance measures.

Key change
Consequential amendments to IAS 7 Statement of Cash Flows

Summary
For entities that use the indirect method to prepare their statement of cash flows, the starting point will be typically operating profit or loss. Prior to the adoption of IFRS 18, the starting point in the statement of cash flows was profit or loss. IFRS 18 also eliminates the classification options for interest and dividend cash flows, which will increase consistency.

Key change
Other changes

Summary
Statement of financial position
IFRS 18 requires goodwill to be presented as a separate line item in the statement of financial position, separate from other intangible assets. IAS 1 did not require this disaggregation (IAS 1.54(c)).
IAS 33 Earnings per Share

a) Prior to the effective date of IFRS 18, IAS 33 permitted entities to disclose additional earnings per share amounts using a reported component of the statement of comprehensive income as the numerator.

b) IFRS 18 amends IAS 33 and permits additional earnings per share amounts only when the numerator is:
   a. A total or subtotal specified by IFRS 18 in IFRS 18.69, 86 or 118; or
   b. A management-defined performance measure.

   a. Additional disclosure requirements in IAS 33 when an entity presents additional amounts per share other than basic and diluted earnings per share (e.g. adjusted operating profit per share). Disclosure requirements are more significant if the disclosed additional per share amount uses a management-defined performance measure as the numerator in the calculation.

Topics substantially unchanged from IAS 1
Many requirements in IAS 1 were brought forward into IFRS 18 (or other IFRS Accounting Standards) substantially unchanged. A significant number of requirements from IAS 1 have

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been relocated to IAS 8 Basis of Preparation of Financial Statements (renamed from Accounting Policies, Changes in Accounting Estimates and Errors). Certain other requirements were relocated from IAS 1 to other IFRS Accounting Standards, such as IFRS 7 Financial Instruments: Disclosures.

Topic
Most requirements applicable to the preparation of primary financial statements other than the statement
of profit or loss

Summary
IFRS 18 does not significantly affect how the other primary financial statements (e.g. statement of financial position, statement of cash flows, statement of changes in equity, etc.) are prepared other than the introduction of new aggregation and disaggregation requirements (see section 4), with some exceptions, such as those noted above applicable to:

a) The statement of financial position (separate presentation of goodwill); and
b) The statement of cash flows (operating profit or loss being the starting point for the indirect method and the reduction of classification options for interest and dividend cash flows).

Topic
Fair presentation and compliance with IFRS Accounting Standards
Summary
Relocated to IAS 8 substantially unchanged.

Topic
Going concern

Summary
Relocated to IAS 8 substantially unchanged.

Topic
Offsetting

Summary
Substantially unchanged from IAS 1.

Topic
Frequency of reporting

Summary
Substantially unchanged from IAS 1.

Topic
Comparative information

Summary
Substantially unchanged from IAS 1.

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Topic
Consistency of presentation

Summary
Substantially unchanged from IAS 1.

Topic
Current/non-current classification of assets and liabilities

Summary
Substantially unchanged from IAS 1, including amendments made to IAS 1 affecting the classification of loans as current vs. non-current, which became effective for annual reporting periods beginning on or after 1 January 2024. See BDO's IFRS Accounting Standards In Practice Classification of Loans as Current or Non-Current.

Topic
Structure of notes

Summary
Substantially unchanged from IAS 1.

Topic
Disclosure of accounting policy information

Summary
Relocated to IAS 8 substantially unchanged.

Topic
Disclosures about judgements and sources of significant estimation uncertainty

Summary
Relocated to IAS 8 substantially unchanged.

Topic
Capital disclosures

Summary
Substantially unchanged from IAS 1.

Topic
Disclosures about puttable financial instruments classified as equity

Summary
Relocated to IFRS 7 substantially unchanged.

Topic
Miscellaneous other disclosures (declared dividends, cumulative preference dividends not recognised, domicile and legal form, description of the nature of the entity's operations, etc.)

Summary

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Substantially unchanged from IAS 1.

3.11 Chapter review

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

a) State the components of a set of financial statements according to IAS1;

b) Explain the general features of financial statements described in IAS1;

c) Define current and non-current assets;

d) Define current and non-current liabilities;

e) Explain the IAS 1 guidance on the structure of the statement of financial position the statement of profit or loss and other comprehensive income and the statement of changes inequity;

f) Describe the IAS 1 rules on notes to the financial statements; and

g) Describe the introduction of IFRS 18 to IAS 1.

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3.12 End of chapter questions and suggested solutions

3.12.1 Questions

Question 1

In today's dynamic global economy, transparent and consistent financial reporting is essential for fostering investor confidence, enabling regulatory oversight, and supporting strategic decision-making. The International Financial Reporting Standards (IFRS) serve as a globally recognised framework that ensures comparability and reliability of financial statements across jurisdictions and industries. Understanding the foundational principles that govern IFRS presentation is not only crucial for accountants and auditors, but also for stakeholders who rely on financial data to assess performance and make informed choices.

Required:

Discuss the fundamental principles governing financial statement presentation under IFRS. In your response, explain the importance and application of the following key accounting concepts with example in the industry:

a) Fair presentation and compliance with IFRSs
b) Going concern
c) Accrual basis of accounting
d) Materiality and aggregation
e) Offsetting
f) Frequency of reporting
g) Comparative information
h) Consistency of presentation

Use relevant examples where necessary to support your discussion. *(20 Marks)*

Question 2

IAS 1, *Presentation of Financial Statements*, establishes the components of financial statements to ensure consistency and comparability in financial reporting.

Required:

a) Explain the **FIVE** main components of financial statements as required by IAS 1.

b) Discuss the importance of comparative information and consistency of presentation in financial reporting, providing relevant industry examples.

c) Explain the purpose and key elements of the statement of changes in equity (SOCIE), illustrating its significance with a practical industry example.

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3.12.2 Suggested solutions

Solution 1

Fair presentation and compliance with IFRSs

Financial statements must provide a true and fair view of an entity's financial position and performance, adhering to IFRS. Example: A multinational corporation like Unilever must comply with IFRS to ensure its financial statements are comparable globally. Misstating revenues or expenses (e.g., recognizing revenue before delivery of goods) would violate fair presentation.

Going concern

An entity prepares financial statements assuming it will continue operating in the foreseeable future unless evidence suggests otherwise. Example: Airlines like Peace Airline must assess their ability to continue operations post-pandemic, considering cash reserves and revenue forecasts. If financial difficulties arise, auditors may issue a "going concern" warning.

Accrual basis of accounting

Transactions are recorded when they occur, not when cash is received or paid. Example: A telecom company like MTN Nigeria recognizes subscription revenue over time rather than immediately upon cash receipt, ensuring expenses and revenues match the period in which they are incurred.

Materiality and aggregation

Only relevant financial information that influences decision-making should be reported separately, while immaterial amounts can be aggregated. Example: A large retailer like Just rite would separately disclose impairment of major assets but aggregate minor office expenses. Material misstatements, even if unintentional, can mislead investors.

Offsetting

Assets and liabilities should not be offset unless permitted by IFRS. Example: A bank like Zenith Bank Plc cannot offset customer deposits against loans in its financial statements, as these are separate transactions requiring full disclosure. However, IFRS allows netting in certain derivative contracts.

Frequency of reporting

Entities must prepare financial statements at least annually, with some requiring quarterly or interim reports. Example: Listed companies like Dangote Plc. publish quarterly financial reports to keep investors informed, ensuring timely disclosure. Private companies may only report annually.

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Comparative information

Financial statements must include figures from previous periods for trend analysis. Example: A company like Tesla presents financial results for 2022 alongside 2021 data, allowing stakeholders to compare performance. If a company changes accounting policies, past figures must be adjusted for consistency.

Consistency of presentation

The format and classification of financial statements should remain consistent unless a justified change occurs. Example: A manufacturing company like Toyota should maintain the same financial statement format over years unless a new IFRS standard requires reclassification (e.g., IFRS 15 on revenue recognition).

Solution 2

a) Components of Financial Statements

i. **Statement of Financial Position (Balance Sheet)**:
Presents an entity's financial position at a specific date, showing assets, liabilities, and equity. Example: A bank like First Bank Plc. reports total assets, liabilities, and shareholders' equity, reflecting its solvency

ii. **Statement of Profit or Loss and Other Comprehensive Income**
Shows financial performance over a period, including revenue, expenses, and net profit. Example: Coca-Cola discloses its revenue streams, cost of goods sold, and net income for stakeholders

iii. **Statement of Changes in Equity (SOCIE)**
Reflects movements in equity, including retained earnings, dividends, and share capital changes. Example: A tech company like PAYTRACK reports stock buybacks and retained earnings in SOCIE.

iv. **Statement of Cash Flows**:
Summarises cash inflows and outflows from operating, investing, and financing activities. Example: IVN presents cash generated from operations, capital investments, and debt repayments.

v. **Notes to the Financial Statements**:
Provide additional disclosures, accounting policies, and assumptions. Example: AP Plc explains assumptions behind asset valuations in its notes.

b) Comparative Information & Consistency

Comparative Information: Requires financial statements to include prior-period figures for trend analysis. Example: Unilever presents 2023 financials alongside 2022 to facilitate performance comparison

Consistency of Presentation: Ensures financial reports maintain uniformity across periods

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unless justified changes occur. Example: Toyota retains the same financial statement structure unless IFRS updates mandate reclassification

Statement of Changes in Equity (SOCIE)
Purpose of SOCIE: Explains equity movements, showing investor contributions, dividend payments, and retained earnings. Example: Jumia reports share-based compensation changes in SOCIE.

Key Elements and Practical Example: Includes share capital, retained earnings, revaluation surplus, and non-controlling interests. Example: Facebook (Meta) shows share buybacks and dividend payouts in SOCIE.

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CHAPTER 4

IAS 8: ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

Contents

4.0 Learning objective
4.1 Learning outcomes
4.2 Accounting policies
4.3 Accounting estimates
4.4 Errors
4.5 Chapter review
4.6 End chapter questions and suggested solutions

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4 IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

4.0 Learning objective

This chapter discusses the provisions of IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors.

4.1 Learning outcomes

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

a) Define accounting policy;

b) Explain the guidance on the selection of accounting policies;

c) Account for changes in accounting policy;

d) Distinguish between accounting policy and accounting estimate;

e) Account for changes in accounting estimates; and

f) Correct errors.

4.2 Accounting Policies

4.2.1 Introduction to IAS8

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:

a) the criteria for selecting accounting policies; and,

b) the accounting treatment and disclosure of:

i. changes in accounting policies.

ii. changes in accounting estimates; and

iii. errors.

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

4.2.2 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

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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 size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

a. 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:

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

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

a) the requirements and guidance in IFRS dealing with similar and related issues; and
b) 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.

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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.

4.2.4 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:

a) required by IFRS; or

b) results in the financial statements providing reliable and more relevant financial information.

A new or revised standard usually includes specific ***transitional provisions*** to explain how the changes 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.

4.2.5 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:

a) recognition (e.g., capitalising or writing off certain types of expenditure)

b) measurement (e.g., measuring non-current assets at cost or valuation)

c) 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.

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IAS 8 specifies that the application of a new accounting policy to transactions or

Illustration: Determining when there is a change in accounting policy

X Ltd has previously used the cost model to measure investment properties (IAS 40).

X Ltd decides to use the fair value model instead because it is believed that this will provide reliable and more relevant information.

This is a change in accounting policy affecting measurement.

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 with the guidance in those standards rather than in accordance with IAS 8.

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 20 X 9 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 20 X 9 and December 20 X 8 only.

However, because there is a change in policy the company must also present a statement of financial position as at 1 January 20 X 8 (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.

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

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:

- provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
- would have been available when the financial statements for that prior period were authorized 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.

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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.

4.2.5 Disclosure of a change in accounting policy

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.

When a change in accounting policy has an effect on the current period or any prior period (or would have an effect 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	9	
The nature of the change in accounting policy	9	9
A description of any transitional provisions	9	
The reason why the new accounting policy provides reliable and more relevant information		9
For the current and previous period(s), to the extent practicable, the amount of the adjustment to each item in the financial statements.	9	9
To the extent practicable, the adjustment relating to accounting periods before those presented in the financial statements	9	9
If retrospective application is impracticable, an explanation of how the accounting policy change has been applied	9	9

b. Accounting Estimates

4.3.1 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:

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a) Bad debts.

b) inventory obsolescence.

c) the fair value of financial assets or liabilities.

d) the useful lives of non-current assets.

e) the most appropriate depreciation pattern (depreciation method, for example straight line or reducing balance) for a category of non-current assets.

f) 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.

4.3.1 Accounting policy vs 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.

4.3.2 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.

Prospective application of a change in estimate

A change in accounting estimate is accounted for prospectively not retrospectively. This means that the effect of the change is recognised in the current period and the future periods affected by the change.

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The effect of a change in accounting estimates should be recognised prospectively, by including it:

a) in profit or loss for the period in which the change is made, if the change affects that period only, or

b) 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($₦^{200,000}/_{10years}$) 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 ($₦^{180,000}/_{5years}$).

a) Disclosures

The following information must be disclosed:

a) 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.

b) The fact that the effect in future periods is not disclosed because estimating it is impracticable (if this is the case).

b) Errors

4.4.1 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.

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A problem arises, however, when an error is discovered that relates to a prior accounting period or if after the financial statements have been published. 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:

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

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

4.4.2 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 20 X 9 Company a discovers an error affecting the 31 December 20 X 8 financial statements.

The error should be corrected in the 31 December 20 X 9 financial statements byre- stating the comparative figures for 31 December 20 X 8 at their correct amount.

If the error had occurred in 31 December 20 X 7, the comparative opening balances for the beginning of 31 December 20X8 should be re-stated at their correct amount.

The reported profit for 31 December 20 X9 is not affected.

Example: Correction of prior period errors
Kano Transport Company (KTC) is preparing its financial statements for 20 X 9.

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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/X7	500	50	90	640
Profit for the year	-	-	150	150
Balance at 31/12/X8 **20X9**	500	50	240	790
Dividends			(100)	(100)
Profit for the year			385	385
Balance at 31/12/X9	500	50	525	1,075

KTC has now discovered an error in its inventory valuation. Inventory was overstated by N70,000 at 31 December 20 X 9 and by N60,000 at 31 December 20 X 8. The rate of tax on profits was 30% in both 20 X 8 and 20 X 9.
The error in 20 X 9 is corrected against the current year profit.

The error in 20X8 is corrected against the prior year profit. (Note that the 20X8 closing inventory is the opening inventory in 20 X 9 so the 20 X 8 adjustment will impact both periods' statements comprehensive income.

Profit adjustments:	20X9 ₦000	20X8 ₦000
Profit (20X9 draft and 20X8 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 20 X 9 becomes:

Share capital	Share premium	Retained earnings	Total
	₦000	₦000	₦000	₦000
Balance at 31/12/X7	500	50	90	640
Profit for the year (**restated)**	-	-	**108**	108
Balance at 31/12/X8 **20X9**	500	50	198	748
Dividends			(100)	(100)
Profit for the year			378	378
Balance at 31/12/X9	500	50	476	1,026

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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.

4.4.3 Disclosure of prior period errors

The following information must be disclosed:

a) the nature of the prior period error;

b) 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;

c) the amount of the correction at the beginning of the earliest prior period in the statements (typically, at the start of the previous year); and

d) 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 31 December 20 X 9 to explain the adjustments made to figures previously published for the year 31 December 20x8.

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)

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4.5 Chapter review

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

a) Define accounting policy;

b) Explain the guidance on the selection of accounting policies;

c) Account for changes in accounting policy;

d) Distinguish between accounting policy and accounting estimate;

e) Account for changes in accounting estimates; and

f) Correct errors.

4.6 End of chapter questions and suggested solutions

4.6.1 Questions

Question 1

There are significant differences in the treatment of changes in accounting policy and changes in accounting estimates in the financial statements.

Required:

Which of the following transactions extracted from BEOZONE represents a change in accounting policy, rather than a change in accounting estimate?

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

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

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

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

Question 2

Fatima Plc acquired equipment on January 1, 20x4 costing ₦500,000. The initial estimate of the useful life of the equipment was 5 years with a nil residual value.

The estimate of residual value was revised to ₦90,000 at the start of 20x6.

Required:

Draft the disclosure note required in the financial statements for the year ended 31 December, 20x6.

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Question 3

Errors might happen when preparing financial statements. If such errors 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.

However, when an error is discovered that relates to a prior accounting period, a problem may arise.

Required:
Explain prior period errors giving examples and discuss how such errors are corrected in accordance with IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors.

Question 4
The aim of IAS 8- Accounting Policies, Changes in Accounting Estimates and Errors is to enhance compatibility of the entity's financial statements to previous periods and to the financial statements of other entities.

Required:
Explain the terms, "accounting policies and accounting estimates".

In an in-house training for newly recruited trainee accountants in your organisation, a disagreement arose on the distinction between change in accounting policies and change in accounting estimates. Consequent upon the above the finance director requested you as the head of accounting department to make a presentation on the subject matter.

Required:
Write a memo addressed to the finance director distinguishing changes in accounting policies and changes in accounting estimates, highlighting also the accounting treatment of the changes in accounting estimates.

Question 5
During year 2022, Owo Company Nig. Limited discovered that certain items had been erroneously included in inventory at December 31, 2021, the amount was valued at N16.8million which had been sold before the year-end.

The following figures for year 2021 (as reported) and 2022 (draft) are available as follows:

	2022 (Draft)	2021 (Published)
	₦'000	₦'000
Revenue	268,800	189,600
Cost of sales	(223,200)	(138,280)
Profit before tax	45,600	51,320
Income tax	(13,600)	(15,520)
Profit for the year	32,000	35,800

The retained earnings at January 1, 2021 were N52million. The cost of sales for year 2022 includes N16.8million error in the opening inventories. Company income tax rate is 30%.

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Required:
Prepare statement of profit or loss and other comprehensive income for the year ended December 31, 2022 and retained earnings extracts showing comparative figures.

4.6.2 Suggested solutions

Solution 1
For each of the items, ask whether this involves a change to:

- recognition
- presentation
- measurement basis

If the answer to any of these is yes, the change is a change in accounting policy.

- This is a change in recognition and presentation. Therefore, this is a change in accounting policy.
- The answer to all three questions is no. This is only a change in estimation technique.
- This is a change in presentation and therefore a change in accounting policy.
- This is a change in the measurement basis and therefore a change in accounting policy.

Solution 2
Disclosure: Profit after tax
Profit before tax is stated after taking the following into account:

	20x6	20x5
Depreciation	₦	₦
Original estimate (Annually)	100,000	100,000
Change in estimate	(30,000)	-
	70,000	100,000

Change in estimate
The estimate residual value of plant and machinery was changed from nil to ₦90,000.

The increase /(decrease) in profits caused by the change is as follows:

	20x6
	₦
Current year's profits:	30,000
Future profits (combined profit of year 4 and 5 = ₦30,000 * 2)	60,000

The total effect on profit is an increase in profit of ₦90,000 (₦30,000 in the current year and ₦60,000 in future years)
The reason for the net increase in profit owing to changes in estimate is that residual value was changed. The residual value increased from ₦0 to ₦90,000.
This means that instead of expensing the whole cost of ₦500,000 as depreciable over the

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life of the asset, only ₦410,000 will now be expensed as depreciation.

Working

	Change policy	Original Policy
	₦	₦
Cost as at Jan. 1, 20x4	500,000	500,000
Accumulated depreciation up to 31 Dec., 2015 (₦500,000/5 * 2years)	(200,000)	(200,000)
Carrying amount at 31 December 20X5	300,000	300,000
Introduction of residual value	(90,000)	None
Depreciable amount	210,000	300,000
Remaining useful life	3 years	3 years
Depreciation in the year ended 31 December, 20x6	70,000	100,000
Carrying amount at 31 December 20x6		
Change in policy will be (₦300,000 – ₦70,000)	**230,000**	
Original policy will be (₦300,000 - ₦100,000)		*200,000*

SOLUTION 3

Explanation of 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:

i. was available when financial statements for those periods were authorised for issue; and
ii. could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Correction of prior-period errors

i. According to the provision of IAS 8, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:
ii. Restating the comparative amounts for the prior period(s) presented in which the error occurred; or
iii. If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities, and equity for the earliest prior period presented.

b. The correction of a prior period is excluded from the statement of profit or loss in the period when the error was discovered.

Examples of prior-period errors:

i. The effects of mathematical mistakes

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ii. Mistakes in applying accounting policies.

iii. Oversights or misinterpretations of facts; and

iv. Fraud.

Solution 4

a. Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting its financial statements. These include any accounting methods, measurement systems and procedures for presenting disclosures. Accounting policies differ from accounting principles in that the principles are the accounting rules and the policies are a company's way of adhering to those rules. e.g. depreciation policies, inventory policies, etc.

Accounting estimates on the other hand are "approximation of the amount of a business transaction for which there are no precise means of measurement." Estimates are used in accrual basis accounting to make the financial statements more complete, usually to anticipate events that have not yet occurred but are considered probable. These estimates may be subsequently revised as more information becomes available.

Accounting estimates arise from inherent uncertainties in business activities which mean that many items in financial statements cannot be measured with precision but can only be estimated. Estimates are formed using judgements based on the latest available and reliable information. Common examples of estimates in the financial statements include:

a. Allowances for bad debts;
b. Allowances for inventory obsolescence;
c. The fair value of financial assets or financial liabilities;
d. The useful lives of, or the expected pattern of consumption of the future economic benefits embodied in depreciable assets; and
e. Warranty obligations.

Solution 5

Owo Company Nigeria Limited

Statement of profit or loss and other comprehensive income for the year ended December 31

	2022	2021
	₦'000	₦'000
Revenue	268,800	189,600
Cost of sales	(206,400)	(155,080)
Profit before tax	62,400	34,520
Income tax expenses (wk. 2)	(18,640)	(10,480)
Profit for the year	43,760	24,040

Statement of movement in retained earnings for the year ended December 31

	2022	2021
	₦'000	₦'000
Balance at January 1 (wk. 3)	76,000	52,000

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Profit for the year	43,760	24,040
Balance as at December 31, 2021	119,800	76,040

Working note

Wk. 1: Cost of sales

	2022	2021
	₦'000	₦'000
Balance b/f	223,200	138,280
Adjustment for inventory overcast	(16,800)	16,800
Balance to SOPL	206,400	155,080

Wk. 2: Income tax expenses

	2022	2021
	₦'000	₦'000
Balance b/f	13,600	15,520
Tax effect of inventory overcast at 30%	(5.040)	(5,040)
Balance to SOPL	18,640	10,480

Wk. 3: **Opening retained earnings**

	₦'000
January 1, 2021 (per question)	52, 000
Add: profit for the year 2021	35,000
	87,800
Less: Error in inventory 2021	(16,800)
Add: Related tax at 30%	5,040
	76,040

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Skills Level
Financial Reporting

CHAPTER 5

IFRS15: REVENUE FROM CONTRACTS WITH CUSTOMERS

Contents

5.0 Learning objective
5.1 Learning outcomes
5.2 Introduction to IFRS15
5.3 The five step model
5.4 Factors affecting the transaction price
5.5 Other aspects of IFRS15
5.6 Specific examples
5.7 Chapter review
5.8 End of chapter questions and suggested solutions

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5 Revenue from Contracts with Customers

5.0 Learning objective

This chapter covers IFRS 15: Revenue from Contracts with Customers.

5.1 Learning outcomes

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

a) Explain the core principle and the five-step approach to revenue recognition;

b) Apply the five-step approach to revenue recognition;

c) Explain and apply the rules on variable consideration;

d) Explain how the existence of significant financing components affects revenue recognition;

e) Account for contract costs; and

f) Explain the required accounting treatment in a series of specific areas.

5.2 Introduction to IFRS 15

5.2.1 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.

5.2.3 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:

a) in a manner that depicts the transfer of goods or services to customers;

b) at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

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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 license, 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

Step1	Whether the contract is within the scope of IFRS 15 and what to do if IFRS15 does not apply.
Step2	If IFRS 15 applies, whether the contract contains a single performance obligation or separate performance obligations (say for the license, installation and updates).
Step3	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.
Step4	How the transaction price should be allocated to the separate performance obligations.
Step5	Whether the performance obligation is satisfied (and thus revenue recognised) overtime 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.

5.3 The Five Step Model

5.3.1 Step1: 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.

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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:

a) the contracts are negotiated as a package with a single commercial objective;

b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or

c) 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:

a) the parties have approved the contract and are committed to perform their respective obligations:

b) the entity can identify each party's rights;

c) the entity can identify the payment terms for the goods and services to be transferred;

d) 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

e) 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 ₦1 m. 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 payout 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

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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.

a) the entity's performance is complete and substantially all of the consideration in the arrangement has been collected and is non-refundable.

b) the contract has been terminated and the consideration received is non-refundable.

Definition

A performance obligation is a promise in a contract with a customer to transfer to the customer either:

i. a good or service (or a bundle of goods or services) that is distinct; or

ii. a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

5.3.2 Step 2: Identify the separate performance obligations in the contract

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

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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 (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:

a) 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

b) 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 a service 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.

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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 o 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.

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Example: Distinct goods and services

X Ltd is a software developer.

X Ltd enters into a contract with a customer to transfer a software license, perform an installation service and provide unspecified software updates and technical support for a two-year period.

X Ltd sells the license, 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 good sand 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

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Conclusion: X Ltd should account for four separate performance obligations (the software licence, the installation service, software updates and technical support).

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).

5.3.3 Step 3: Determine the transaction price

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:

c) variable consideration (including the constraining estimates of variable consideration); and

d) time value of money;

These are covered in more detail later in this chapter.

5.3.4 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 s**tand-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

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obligations in the contract if all of the following criteria are met:

a) each distinct good or service (or each bundle of distinct goods or services) in the contract is sold regularly on a stand-alone basis;

b) 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

c) such discounts are substantially the same as the discount in the contract.

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Example: Allocation of discount

X Ltd sells three products at the following stand-alone selling prices:

Standalone selling price	
Product A	40
Product B	55
Product C	45

X Ltd sells each one of the products to Y Plc for ₦100 in total. Products B and C are sold regularly together or ₦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 Band 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 x (40/100)) =22	33
Product C	45	(45 x (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

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In other cases, the discount is allocated proportionately to all performance obligations in the contract.

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Example: Allocation of discount

X Ltd sells three products at the following stand-

	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 x 50/150) = 17	33
Product B	25	(25 x 50/150) = 8	17
Product C	75	(75 x 50/150) = 25	50
	150		100

5.3.5 Step 5: Recognise revenue when or as an entity obligation

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):

a) over time (in which case revenue would be recognised over time); or

b) 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.

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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:

a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

b) 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

c) 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.

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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

Does the customer simultaneously receive and consume the benefits provided?	Yes (criterion met)
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
Does X Ltd's performance create an asset with an alternative use and	No (this part of the criterion met)
Does X Ltd have an enforceable right to payment for performance completed to date	Yes probably (this part of the criterion met)

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Conclusion: The performance obligation is satisfied overtime. (All three criteria are actually met)

There would be no need to consider criteria or consecratory on 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) 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.

b) Progress must be remeasured at the end of each reporting period.

c) 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:

a) surveys of performance completed to date.

b) appraisals of results achieved.

c) milestones reached.

d) time elapsed and units produced; or

e) 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

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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

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 overtime 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:

a) labour hours expended relative to total expected labour hours to satisfy the performance obligation

b) 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.

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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 recognizes 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 x 100	60%
Revenue recognised	₦ 1,920,000

Note that ₦1,500,000 would also be recognized 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:

a) 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.

b) 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.

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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 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	1,400,000	1,400,000
Rectification costs		100,000
Other costs	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 x 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

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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:

	Year1	Year2
	₦	₦
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 x 100	60%	
2,000,000/2,500,000 x 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

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5.3.7 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

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 x (₦53,100/₦113,100))	56,340
Network contract (₦120,000 x (₦60,000/₦113,100))	63,660
	120,000

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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 ÷ 24months)		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 x 24months)		63,660
Receivable (₦2,347x 24months)		56,340

The above example does not take time value into account.

The stand-alone 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 would be taken into account.

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5.4 Factors affecting the transaction price

5.4.1 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:

i. 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.

ii. 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:

i. 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.

ii. 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 a 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.

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Example: Variable consideration

X Ltd sells100 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 30days 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 x ₦100)	10,000	
Revenue (97 x ₦100)		9,700
Refund liability (3 x ₦100)		300

In addition, X Ltd will recognize an asset of ₦180 (3 x ₦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:

a) the terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation; and

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b) the allocation is consistent with the IFRS 15 allocation objective.

Royalties

Regardless of the above, revenue for sales-based or usage-based royalties promised in exchange for a license of intellectual property is recognised only when (or as) the later of the following events occurs:

a) the subsequent sale or usage occurs; and

b) 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).

5.4.2 Financing components

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.

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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 20 X 6 (2 years later).

An appropriate discount rate is 6%.

1January 20 X 5 - Initial recognition

consideration $\frac{1}{(1+0.06)^2}$ = ₦4,449,982

	Debit	Credit
Receivables	₦4,449,982	
Revenue		4,449,982

31 December 20 X 5

Recognition of interest revenue

4,449,982 x 6% =266,999

	Debit	Credit
Receivables	266,999	
Revenue–interest		266,999

Balance on the receivable	₦
Balance brought forward	4,449,982
Interest revenue recognized in the period	266,999
Carried forward	4,716,981

31December 20X6

Recognition of interest revenue ₦4,716,981 x 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	–

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5.5 Other Aspects of IFRS 15

5.5.1 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.

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:

a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify.

b) 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

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c) the costs are expected to be recovered.

Costs that relate directly to a contract might include:

a) direct labour and direct materials;

b) allocations of costs that relate directly to the contract or to contract activities;

c) costs that are explicitly chargeable to the customer under the contract; and

d) 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:

a) general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract);

b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;

c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e., costs that relate to past performance).

5.5.2 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:

a) the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less

b) 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.

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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:

Example: Amortisation of contract costs	₦
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis

Cost must be recognised in the P&L on the same basis as that used to recognise revenue.

X Ltd recognizes revenue on a time basis, therefore 1/5 of the total expected cost should be recognised = ₦5,600per annum.

	₦
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.

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- **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 20 X 8

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 deliveredon31March.

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

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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.

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31 March	Dr(₦)	Cr(₦)
Receivable	1,000	
Contract asset		400
Revenue		600

Example: Double entry–Recognition of a contract asset 1 January 20 X 8

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 YPlc.

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 Bisal so recognised as receivable.

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

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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

5.6 Specific Examples

5.6.1 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

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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.

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Example: Agency

X Ltd distributes goods for Y plc under an agreement with the following terms.

a. X Ltd is given legal title to the goods by Y plc and sells them to the retailers.

b. Y plc sets the selling price and X Ltd is given a fixed margin on all sales.

c. Y plc retains all product liability and is responsible for any manufacturing defects.

d. X Ltd has the right to return inventory to Y plc without penalty.

e. X Ltd is not responsible for credit risk on sales made.

During the year ended 31 December 20 X 3 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 these 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% x (₦1,000,000 x 120%)	1,080,000	
Revenue (5% x 90% x (₦1,000,000 x 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:

a) another party is primarily responsible for fulfilling the contract.

b) the entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return.

c) the entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive

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from those goods or services is limited.

d) the entity's consideration is in the form of a commission; and

e) the entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

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) a full or partial refund of any consideration paid;

b) a credit that can be applied against amounts owed, or that will be owed, to the entity; and

c) another product in exchange.

All of the following must be recognised when a product is sold with a right of return:

a. 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);

b. a refund liability; and

c. an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

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.

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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:

	Dr	Cr
1 January		
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		

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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:

a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);

b) the product must be identified separately as belonging to the customer;

c) the product currently must be ready for physical transfer to the customer; and

d) 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.

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Example: Bill and hold arrangement

X Ltd enters into a contract with Y Plc for the sale of a machine and spw.are parts.

Y Plc pays for the machine and spare parts on 31 December 20 X 9, 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 20 X 9 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 20 X 9 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.

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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:

a) 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;

b) the entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and

c) 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.

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5.7 Chapter review

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

a) explain the core principle and the five step approach to revenue recognition;

b) apply the five-step approach to revenue recognition;

c) explain and apply the rules on variable consideration;

d) explain how the existence of a significant financing components affects revenue recognition;

e) account for contract costs; and

f) explain the required accounting treatment in a series of specific areas.

5.8 End of chapter questions and suggested solutions

5.8.1 Questions

Question 1

IFRS 15 - Revenue from Contract with Customers, defines contract as an agreement between two or more parties that create enforceable rights and obligations.

Required:

a. Compare with an example, where necessary:
i. Contract liabilities versus contract assets
ii. Stand-alone-selling price versus transaction price.
b. Under IFRS 15, highlight SIX criteria to assess a contract.
c. Explain what is meant by contract modification and state TWO ways in which it can be accounted for.

Question 2

IFRS 15-Revenue from Contracts with Customers; 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.

Required:

i. Explain the core principles upon which IFRS 15 is based.
ii. Briefly explain the FIVE steps-model involved in the application of the core principles

Question 3

IFRS 15 on revenue from contract with customers was issued for the purpose of ensuring that revenue are properly accounted for, better than what we have under IAS 18 and IAS 11.

Required:

i. Identify the FIVE step-model that needs to be followed by entities when recognising revenue from contract under IFRS 15.

ii. Explain how IFRS 15 is expected to improve the financial reporting of revenue.

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Question 4

Phonetell Nigeria Limited is a network service provider registered with the Nigeria Stock Exchange (NSE). The company has been operating in the country for the past 10 years.

On September 1, 20x8, the company entered into a service contract with its customers to provide a special model handset and one year service at a price of N250,000.

If the customers acquired the handset only, it would be sold at a price of N75,000 and if the network service is separately provided for one year duration, the customer will be made to pay the sum of N200,000 for the one year duration.

The financial year end of Phonetell Nigeria Limited is September 30.

Required:

Calculate the revenue from this contract for the accounting years ended 20x8 and 20x9 in accordance with the provisions of IFRS 15.

Question 5

On September 20, 20x9, Olafare Nigeria Limited sold 100 units of Android PT-Tablet to a major customer for N200,000 each. The PT-Tablet costs Olafare Nigeria Limited N160,000 each.

The terms of sales are that the customers have the right to return the tablets for a full refund within 3 months. On expiration of the 3-month period, the customer can no longer return the PT-Tablet and payment becomes immediately due. Olafare has entered into transactions of this type with these customers previously and can reliably estimate that 4% of the Android PT-Tablets are likely to be returned within the three-month period.

Required:

Explain how the above transactions would be reported in the financial statements of Olafare Nigeria Limited for the year ended September 30, 20x9.

5.8.2 Suggested solutions

Solution 1

a. Differentiate between:

i. **Contract liabilities versus contract assets**

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 due) from the customer. This situation normally occurs where the contract require payment in advance or allow the supplier a right to an amount of consideration that is unconditional before it transfers good and service to the customer.

A contract asset on the other hand 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. It usually occurs where a supplier transfer goods and services to a customer before the customer pays consideration or before payment is due.

ii) **Stand-alone selling price versus transaction price**

Stand-alone selling price is the price at which an entity would sell a promised goods and services separately to a customer. The stand-alone selling price which is determined at the inception of the contract is the basis upon which the transaction price will be allocated to each performance obligations in a contract. The objective of which is to depicts the amount of consideration to

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which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.
Transaction price on the other hand 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 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 transaction price is affected by the nature, timing and amount of consideration promised by a customer.

(b). Criteria for assessing a contract under IFRS 15 are:

a) The parties to the contract have approved the contract;

b) The parties to the contract are committed to perform the contract obligations;

c) The entity can identify each party's rights regarding the goods or services to be transferred;

d) The entity can identify the payment terms for the goods or services to be transferred;

e) The contract has commercial substance in terms of amount of future cash inflows;

f) The contract has commercial substance in terms of risk assessment and timing of contract obligations; and

g) It is probable that an entity will collect the consideration in terms of customer's ability and intention to pay.

(c)

(i) Explanation of contract modification

1. A contract modification is a change in the scope of a contact that is approved by the parties to the contract.
2. It exists when the parties to a contract approve a modification that creates new or changes existing enforceable rights and obligations of the parties to the contract.
3. It could be approved in writing, by oral or implied by the customary business practices.

(ii) Methods of accounting for contract modification

1. As a separate contract from the existing contract.
2. As a termination of the existing contract.
3. As part of the existing contract, that is, as cumulative catch-up adjustments.

Solution 2

(b) IFRS 15 is based on a core principle that requires an entity to recognize revenue:

a. In a manner that depicts the transfer of goods or services to customers;

b. At an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

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Applying this core principle involves following a five steps-model as follows:

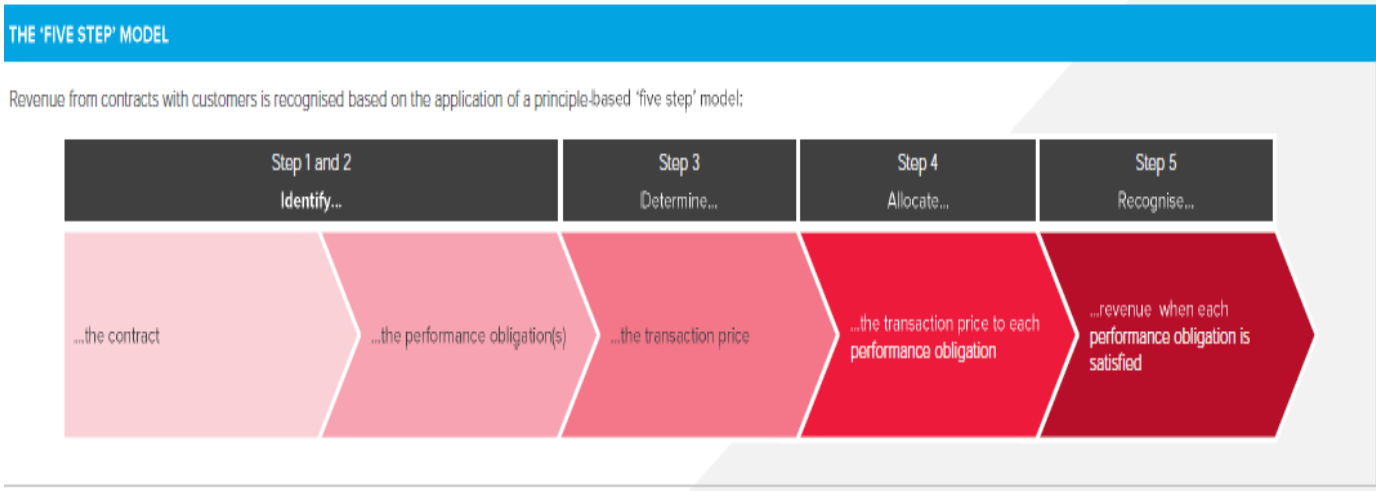
Step 1: Identify the contract(s) with a customer that is, whether the contract is within the scope of IFRS 15 and what to do if IFRS 15 does not apply.

Step 2: Identify the separate performance obligations in the contract that is, If IFRS 15 applies, whether the contract contains a single performance obligation or separate performance obligations.

Step 3: Determine the transaction price, that is how to identify the transaction price and whether this should be adjusted for time value of money. Also, what to do if the consideration varies depending on circumstance.

Step 4: Allocate the transaction price to the performance obligations that is how the transaction price should be allocated to the separate performance obligations.

Step 5: Recognise revenue when or as an entity satisfies performance obligations that is whether the performance obligation is satisfied over time or at a point in time.



Solution 3

(a) Five steps to be followed for revenue recognition under IFRS 15

(i) Identify the contract(s) with customer.

(ii) Identify the performance obligation in the contract create.

(iii) Determine the transaction price.

(iv) Allocate the transaction price to each of the separate performance obligations.

(v) Recognize the revenue associated with each performance obligation as the performance obligation is satisfied.

How IFRS 15 is expected to improve revenue recognition

a) The IASB issued IFRS 15 because the existing criteria for revenue recognition outlined in IAS 11 on contract and IAS – 18 on revenue where considered subjective.

b) It was difficult to verify the accuracy of the reported figure for revenue and associated costs.

c) One of the fundamental quantitative characteristics of useful financial information

which is referred to in the IASB conceptual framework is faithful presentation.

d) Information needs to be verifiable in order to ensure it meets these fundamental characteristics.

e) IFRS 15 provides a more robust framework upon which to base revenue recognition decision thus increasing the verifiability of the revenue figures hence its usefulness.

f) IFRS 15 also reduces window dressing of the financial statements, and it maintains the credibility for the entity's finances.

Solution 4

	Performance obligation standalone contract	%	Combined contract (Revenue)	Working
	₦		₦	
Handset	75,000	27.27	68,175)	(i.e. 27.27% * 250,000
Network Services	200,000	72.73	181,825)	(i.e. 72.73% * 250,000
	275,000	100	250,000	

Revenue recognition for the year end September 20x8

	₦
Revenue on handset (one-off)	68,175
Revenue network service (1/12 x 181, 825)	15,152
	83,327

Revenue recognition for the year ended September 30, 20x9

	₦
Revenue network service (11/12 x 181, 825)	166,673

Solution 5

- When the customer has a right to return products, the transaction price contains a variable element.
- Since this can be reliably measured, it is taken into account in measuring the revenue and the total revenue will be ₦19,200,000 i.e. (₦200,000 x 96).
- ₦20,000,000 i.e. (₦200,000 x 100) will be recognized as receivable.
- It implies that ₦800,000 i.e. (₦20,000,000 less ₦19,200,000) will be recognized as a

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refundable liability. This will be shown as current liability.

- The total cost of goods sold is (₦160,000 x 100) = ₦16,000,000 of this amount only ₦15,360,000 i.e. (₦160,000 x 96) will be shown as cost of sales.
- The other ₦640,000 i.e. (₦16,000,000 – ₦15,360,000) will be shown as a right of return assets under current assets (inventory).
- Reported Gross Profit = ₦3,840,000 (i.e. ₦ 19,2000,000 – ₦15, 360,000)

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CHAPTER 6

IAS2: INVENTORIES

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6 Inventories

6.0 Learning objective

This chapter covers IAS 5: Inventories.

6.1 Learning outcomes

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

a) Define inventory

b) Measure inventory at the lower of cost and net realizable value

c) Use cost formulas to arrive at an approximation to the cost of inventory

d) Explain how inventory valuation impacts profit or loss for the period

6.2 Inventory

6.2.1 Definition of inventory

The nature of inventories varies with the type of business. Inventories are:

a) Assets held for sale. For a retailer, these are items that the business sells – its stock-in trade. For a manufacturer, assets held for sale are usually referred to as 'finished goods';

b) Assets in the process of production for sale (work-in-progress' for a manufacturer); and

c) Assets in the form of materials or supplies to be used in the production process (raw materials in the case of a manufacturer).

IAS 2: Inventories set out the requirements to be followed when accounting for inventory.

Recording inventory

In order to prepare a statement of profit or loss it is necessary to be able to calculate gross profit. This requires the calculation of the cost of sales figures.

There are two main methods of recording inventory so as to allow the calculation of the cost of sales.

a) Periodic inventory system (period end system)

b) Perpetual inventory system

Each method uses a ledger account for inventory, but these have different roles.

Periodic inventory system (period end system) – summary

Opening inventory in the trial balance (a debit balance) and purchases (a debit balance) both transferred to cost of sales.

This clears both accounts.

Closing inventory is recognised in the inventory account as an asset (a debit

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balance) and the other side of the entry is a credit to cost of sales.

Cost of sales comprises purchase in the period adjusted for movements in inventory level from the start to the end of the period.

Illustration: Cost of

	Year 1	Year 2
	₦	₦
Opening inventory (a debit)	–	X
Purchases (a debit)	X	X
	X	X
Closing inventory (a credit)	(X)	(X)
Cost of sales	X	X

Any loss of inventory is automatically dealt with and does not require a special accounting treatment. Lost inventory is simply not included in closing inventory and thus is written off to cost of sales. There might be a need to disclose a loss as a material item of an unusual nature either on the face of the incomes statement or in the notes to the accounts if it arose in unusual circumstances

6.2.2 Perpetual inventory method

This is a system where inventory records are continuously updated so that inventory values are always available.

A single account is used to record all inventory movements. The account is used to record purchases in the period and inventory is brought down on the account at each year-end. The account is also used to record all issues out of inventory. These issues constitute the cost of sales.

When the perpetual inventory method is used, a record is kept of all receipts of items into inventory (at cost) and all issues of inventory to cost of sales.

Each issue of inventory is given a cost, and the cost of the items issued is either the actual cost of the inventory (if it is practicable to establish the actual cost) or a cost obtained using a valuation method.

Each receipt and issue of inventory is recorded in the inventory account. This means that a purchases account becomes unnecessary, because all purchases are recorded in the inventory account.

All transactions involving the receipt or issue of inventory must be recorded, and at any time, the balance on the inventory account should be the value of inventory currently held.

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Example:

Zaria Trading Company had opening inventory of ₦10,000. Purchases during the year were ₦30,000.

During the year inventory at a cost of ₦28,000 was transferred to cost of sales. Closing inventory at the end of Year 2 was ₦12,000.

The following entries are necessary during the period.

Inventory account

	₦		₦
Balance b/d Cash or creditors (purchases in the year)	10,000 30,000	Cost of sales	28,000
		Closing balance c/d	12,000
	40,000		40,000
Opening balance b/d	12,000		

Furthermore, all transactions involving any kind of adjustment to the cost of inventory must be recorded in the inventory account

Example:

Gombe Retail Limited (GR) had opening inventory of ₦100,000.

Purchases during the year were ₦500,000. Inventory with a cost of ₦18,000 was returned to a supplier. One of the purchases in the above amount was subject to an express delivery fee which cost the company an extra ₦15,000 in addition to the above amount.

GR sold goods during the year which had cost ₦520,000. Goods which had cost ₦20,000 were returned to the company.

Just before the year end goods which had cost ₦5,000 were found to have been damaged whilst being handled by GR's staff.

The following entries are necessary during the period.

	₦		₦
Balance b/d	100,000		
Cash or creditors (purchases in the year)	500,000	Returns to supplier	18,000
Special freight charge	15,000		
Returns from customers	20,000	Cost of goods sold	500,000
		Normal loss	5,000
		Closing balance c/d	112,000
	635,000		635,000
Opening balance b/d	112,000		

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Inventory cards

Example: Inventory ledger card

On1January accompany had an opening inventory of 100 units. During the month it made the following purchases:

5 April: 300 units

14 July: 500 units

22 October: 200 units

During the period it sold 800 units as follows:

9 May: 200 units

25 July: 200 units

23 November: 200 units

12 December:200 units

Each of these can be shown on an inventory ledger card as follows:

	Receipts (units)	Issues (units)	Balance (units)
Date	Units	Units	Units
1 January b/f	100		100
5 April (purchase)	300		300
			400
9 May (issue)		200	(200)
			200
14 July (purchase)	500		500
			700
25 July (issue)		200	(200)
			500
22 Oct (purchase)	200		200
			700
23 November (issue)		200	(200)
			500
12 December (issue)		200	(200)
	1,100	800	300

Inventory ledger cards also usually record cost information. This is covered in section 6.13 of this chapter.

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6.2.3 Summary of journal entries under each system

Entry	Periodic inventory	Perpetual inventory method
Opening inventory	Closing inventory as measured and recongnised brought forward from last period	Closing balance on the inventory account as at the end of the previous period
Purchase of inventory	Dr Purchases Cr Payables/cash Freight Pai	Dr Carriage inwards Cr Payables/cash
	Dr Carriage inwards Cr Payables/cash	Dr Inventory Cr Payables/cash
Return of inventory to supplier	Dr Payable Cr Purchase returns	Dr Payable Cr Inventory
Sales of inventory	Dr Receivable Cr Sales	Dr Receivable Cr Sales and Dr Cost of goods sold C inventory
Returns of goods by a supplier	Dr Sales returns Cr Receivables	Dr Sales returns Cr Receivables and Dr inventory Cr Cost of goods sold
Normal Loss	No double entry	Dr Cost of goods Cr Inventory
Abnormal loss	Dr Abnormal loss Cr Purchase	Dr Abnormal loss Cr Inventory
Closing Inventory	Counted, valued and recognized by: Dr Inventory (statement of financial position) Cr Cost of sales (cost of goods sold	Balance on the Inventory account

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6.2.4 Inventory Counts (Inventory takes)

An inventory takes is a physical verification of the amount of inventory that a business has.

Each item of inventory is counted and entered onto inventory sheets. The inventory counted can then be valued.

Periodic inventory systems

Inventory counts are vital for the operation of the periodic inventory system as it depends on the closing inventory at the end of each period being recognised in the system of accounts.

Perpetual inventory systems

Inventory counts are also important to the operation of perpetual inventory systems as the identify differences between the balance on the inventory account (the inventory that should be there) and the actual physical quantity of inventory.

The inventory account must be adjusted for any material difference.

Any difference should be investigated. Possible causes of difference between the balance on the inventory account and the physical inventory counted include the following.

a) Theft of inventory.

b) Damage to inventory with failure to record that damage.

c) Mis-posting of inventory receipts or issues (for example posting component A as component B).

d) Failure to record a receipt.

e) Failure to record an issue.

Timing of inventory counts

Ideally the inventory count takes place on the last day of the accounting period (the reporting date). However, this is not always possible due to the day on which the last day of the accounting period falls or perhaps, not having enough employees to count the inventory at all sites at the same time.

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If the inventory is counted at a date that differs from the reporting date the balance must be adjusted for transactions between the two dates.

Example: Timing of inventory counts

Sokoto Trading has a 31 December year end. It carried out an inventory count on 5th January 20 X 9. The count was valued at ₦2,800,000.

The following transactions took place between the 31 December and 5 January.

i. Sales of goods for ₦120,000. These goods cost ₦96,000.

ii. Purchases of goods for ₦136,000.

The inventory at the reporting date is calculated as follows:

	₦
Inventory on 5 January	2,800,000
Add back cost of inventory sold since 31 December	96,000
Deduct purchase since 31 December	(136,000)
Inventory at 31 December	2,760,000

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6.2.5 Disclosure requirements for inventory

IAS 2 requires the following disclosures in notes to the financial statements.

a) The accounting policy adopted for measuring inventories, including the cost measurement method used.

b) The total carrying amount of inventories, classified appropriately. (For a manufacturer, appropriate classifications will be raw materials, work-in-progress and finished goods.)

c) The amount of inventories carried at net realisable value or NRV.

d) The amount of inventories written down in value and so recognised as an expense during the period.

e) Details of any circumstances that have led to the write-down of inventories to NRV.

f) The amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the period.

g) The circumstances or events that led to the reversal of a write-down of inventories.

6.3 Measurement of Inventory

6.3.1 Introduction

Measurement of inventory can be extremely important for financial reporting, because the measurements affect both the cost of sales (and profit) and also total asset values in the statement of financial position.

There are several aspects of inventory measurement to consider:

a) Should the inventory be valued at cost, or might a different measurement be more appropriate?

b) Which items of expense can be included in the cost of inventory?

c) What measurement method should be used when it is not practicable to identify the actual cost of inventory?

IAS 2 gives guidance on each of these areas.

Measurement rule

IAS 2 requires that inventory must be measured in the financial statements at the **lower** of:

a) cost, or

b) net realisable value (NRV).

The standard gives guidance on the meaning of each of these terms.

Cost of inventories

IAS2 states that 'the cost of inventories shall comprise all costs of purchase, costs of

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conversion and other costs incurred in bringing the inventories to their present location and condition.

Purchase cost

The **purchase cost** of inventory will consist of the following:

a) the purchase price

b) plus import duties and other non-recoverable taxes (but excluding recoverable sales tax)

c) plus transport, handling and other costs directly attributable to the purchase (carriage inwards), if these costs are additional to the purchase price.

The purchase price **excludes** any settlement discounts and is the cost after deduction of trade discount.

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Example: Purchase cost I
Kaduna Consumer Electrics (KCE) buys goods from an overseas supplier. It has recently taken delivery of 1,000 units of component X.
The quoted price of component X was N1,200per unit but KCE has negotiated a trade discount of 5% due to the size of the order.
The supplier offers an early settlement discount of 2% for payment within 30 days and KCE intends to achieve this.
Import duties of N60 per unit must be paid before the goods are released through custom.
Once the goods are released through customs KCE must pay a delivery cost of N5,000 to have the components taken to its warehouse.

	N
Purchase price (1,000u N1,200 x 95%)	1,140,000
Import duties (1,000 x N60)	60,000
Delivery cost	5,000
Cost of inventory	1,205,000

The intention to take settlement discount is irrelevant.

Conversion costs

When materials purchased from suppliers are converted into another product in a manufacturing or assembly operation, there are also conversion costs to add to the purchase costs of the materials. Conversion costs must be included in the cost of finished goods and unfinished work in progress.

Conversion costs consist of:

a) costs directly related to units of production, such as costs of direct labour (i.e. the cost of the labour employed to perform the conversion work)

b) fixed and variable **production** overheads, which must be allocated to costs of items produced and closing inventories. (Fixed production overheads must be allocated to costs of finished output and closing inventories on the basis of the **normal production capacity** in the period)

c) other costs incurred in bringing the inventories to their present location and condition.

You may not have studied cost and management accounting yet, but you need to be aware of some of the costs that are included in production overheads (also known as factory overheads). Production overheads include:

- costs of indirect labour, including the salaries of the factory manager and factory supervisors;
- depreciation costs of non-current assets used in production; and
- costs of carriage inwards, if these are not included in the purchase costs of the materials.

Only production overheads are included in the costs of finished goods inventories and work-in-progress. Administrative costs and selling and distribution costs must not be included in the cost of inventory.

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Note that the process of allocating costs to units of production is usually called absorption. This is usually done by linking the total production overhead to some production variable, for example, time, wages, materials or simply the number of units expected to be made.

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Example: Conversion costs

Kaduna Consumer Electrics (KCE) manufactures control units for air conditioning systems.

The following information is relevant:

Each control unit requires the following:

1 component X at a cost of ₦1,205 each

1 component Y at a cost of ₦800 each Sundry raw materials at a cost of ₦150.

	₦
Factory rent	16,500
Energy cost	7,500
Selling and administrative costs	10,000

Each unit takes two hours to assemble. Production workers are paid ₦300 per hour.

Production overheads are absorbed into units of production using an hourly rate. The normal level of production per month is 1,000 hours.

	₦
Component X	1,205
Component Y	800
Sundry raw materials	150
	2,155
Labour (2 hours x ₦300)	600
Production overhead (₦16,500+7,500/1,000hours x 2 hours)	48
	2,803

These selling and administrative costs are not part of the cost of inventory.

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Normal production capacity

Production overheads must be absorbed based on normal production capacity even if this is not achieved in a period.

If production capacity is unusual in a particular period the overhead might be under or over absorbed.

Example: Normal production capacity

A business plans for production overheads of ₦1,000,000 per annum.

The normal level of production is 100,000 units per annum.

Due to supply difficulties the business was only able to make 75,000 units in the current year.

Other costs per unit were ₦126.

The cost per unit is:

	₦
Other costs	126
Production overhead (₦1,000,000/100,000units)	10
Unit cost	136

Note:

	₦
The amount absorbed into inventory is (75,000 x ₦10)	750,000
Total production overhead	1,000,000
The amount not absorbed into inventory	250,000

The ₦250,000 that has not been included in inventory is expensed (i.e., recognized in the statement of profit or loss).

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6.3.2 Net realisable value

Definition

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Net realisable value is the amount that can be obtained from selling the inventory in the normal course of business, less any further costs that will be incurred in getting it ready for sale or disposal.

a) Net realisable value is usually higher than cost. Inventory is therefore usually valued at cost.

b) However, when inventory loses value, perhaps because it has been damaged or is now obsolete, net realisable value will be lower than cost.

The cost and net realisable value should be compared for each separately - identifiable item of inventory, or group of similar inventories, rather than for inventory in total.

Example:

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	Cost	Sales price	Selling costs
Inventory item A1	8,000	7,800	500
Inventory item A2	14,000	18,000	200
Inventory item B1	16,000	17,000	200
Inventory item C1	6,000	7,500	150

The value of closing inventory in the financial statements:

		₦
A1	8,000 or (7,800 – 500)	7,300
A2	14,000 or (18,000 – 200)	14,000
B1	16,000 or (17,800 – 500)	16,000
C1	6,000 or (7,000 – 200)	6,000
Inventory measurement		43,300

Net realisable value might be lower than cost so that the cost of inventories may not be recoverable in the following circumstances:

a) inventories are damaged;

b) inventories have become wholly or partially obsolete; or

c) selling prices have declined.

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Accounting for a write down

When the cost of an item of inventory is less than its net realisable value the cost must be written down to that amount.

Component A1 in the previous example had a carrying value of ₦8,000 (being its cost) but its NRV was estimated to be ₦7,300. The item must be written down to this amount. How this is achieved depends on circumstance and the type of inventory accounting system.

Perpetual inventory systems

The situation here is similar to that for inventory loss.

The inventory must be written down in the system by the following journal:

Illustration:

	Debit	Credit
Cost of sales	X	
Inventory		X

Period end system / Periodic inventory system

If the necessity for the write down is discovered during an accounting period then no special treatment is needed. The inventory is simply measured at the NRV when it is included in the year-end financial statements. This automatically includes the write down in cost of sales.

If the problem is discovered after the financial statements have been drafted (and before they are finalised) the closing inventory must be adjusted as follows:

Illustration:

	Debit	Credit
Statement of profit or loss closing inventory (cost of sales)	X	
Inventory in the statement of financial position		X

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6.4 FIFO and weighted average cost methods

6.4.1 Cost formulas

With some inventory items, particularly large and expensive items, it might be possible to recognise the actual cost of each item.

In practice, however, this is unusual because the task of identifying the actual cost for all inventory items is impossible because of the large numbers of such items.

A system is therefore needed for measuring the cost of inventory.

The historical cost of inventory is usually measured by one of the following methods:

a) First in, first out (FIFO)

b) Weighted average cost (AVCO)

Illustration

On 1 January a company had an opening inventory of 100 units which cost ₦50 each.

During the month it made the following purchases:

5 April: 300 units at ₦60 each

14 July: 500 units at ₦70 each

22 October: 200 units at ₦80 each.

During the period it sold 800 units as follows: 9 May: 200 units

25 July: 200 units

23 November: 200 units

12 December:200 units

This means that it has 300 units left (100 + 300 + 500 + 200 – (200 + 200 + 200+200+200) but what did they cost?

FIFO and AVCO are two techniques that provide an answer to this question.

Note:

a) First in, first out (FIFO) tends to be used in periodic inventory systems but may be used in perpetual inventory systems also.

b) Weighted average cost (AVCO) is easier to apply when a perpetual inventory system is used.

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- **First-in-first-out method of measurement (FIFO)**

With the first-in, first-out method of inventory measurement, it is assumed that inventory is consumed in the strict order in which it was purchased or manufactured. The first items that are received into inventory are the first items that go out.

To establish the cost of inventory using FIFO, it is necessary to keep a record of:

a) The date that units of inventory are received into inventory, the number of units received and their purchase price (or manufacturing cost)

b) the date that units are issued from inventory and the number of units issued.

With this information, it is possible to put a cost to the inventory that is issued (sold or used) and to identify the cost of the items still remaining in inventory.

Since it is assumed that the first items received into inventory are the first units that are used, it follows that the value of inventory at any time should be the cost of the most recently-acquired units of inventory.

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Example: FIFO (returning to the previous example)

On 1 January a company had an opening inventory of 100 units which cost ₦50 each.

During the month it made the following purchases:

5 April: 300 units at ₦60 each (= ₦18,000)

14 July: 500 units at ₦70 each (=₦35,000)

22 October: 200 units at ₦80 each (= ₦16,000)

During the period it sold 800 units as follows:

9 May: 200 units

25 July: 200 units

23 November: 200 units

12 December:200 units

The cost of each material issue from store in October and the closing inventory using the FIFO measurement method is as follows:

FIFO measures inventory as if the first inventory sold is always the first inventory purchased.

Consider the flow of units:

	Bf (units)	5 April (units)	14 July (units)	22 October (units)
Purchased	100	300	500	200
Issues on:				
9 May (200)	(100)	(100)		
25 Jul (200)		(200)		
23 Nov (200)			(200)	
12 Dec (200)			(200)	
Closing inventory	–	–	100	200

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Example (continued): Measurement

Issues on 9 May	Cost per unit	₦
100 units in opening inventory	50	5,000
100 units purchased on 5 April	60	6,000
Cost of issue		11,000

Issues on 25 July	Cost per unit	
200 units purchased on 5 April	60	12,000
Cost of issue		12,000

Issues on 23 November	Cost per unit	
200 units purchased on 14 July	70	14,000
Cost of issue		14,000

Issues on 12 December	Cost per unit	
200 units purchased on 14 July	70	14,000
Cost of issue		14,000

Closing inventory	Cost per unit	
100 units purchased on 14 July	70	7,000
200 units purchased on 22 October	80	16,000
		23,000

This looks more complicated than it needs to be. This is because the cost of each individual issue has been calculated. However, usually we would not be interested in the cost of individual issues so much as the overall cost of sale and closing inventory. When this is the case the calculations become much easier.

This is because the total costs of buying the inventory are known so only the closing inventory has to be measured. This is done assuming that it is from the most recent purchases (because FIFO assumes that the inventory bought earlier has been sold).

Example (continued): Measuring closing inventory

		₦
Value of opening inventory		5,000
Purchases in the period (18,000+35,000+16,000)		69,000
		74,000
Value of closing inventory (31 December)		
(200 purchased on 22 October @ ₦80)	16,000	
(100 purchased on 14 July @ ₦70)	7,000	
		(23,000)
Cost of materials issued in October		51,000

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6.3.6 Inventory ledger card

The purchases and issues can be recorded on an inventory ledger card as follows:

Example: Inventory ledger card (FIFO)

	Receipts			Issues			Balance		
Date	Qty	@	₦	Qty	@	₦	Qty	@	₦
1 Jan b/f	100	50	5,000				100	50	5,000
5 Apr	300	60	18,000				300	60	18,000
							400	50/60	23,000
9 May				100	50	5,000	100	50	5,000
				100	60	6,000	100	60	6,000
				200	50/60	11,000	(200)	50/60	(11,000)
							200	60	12,000
14 Jul	500	70	35,000				500	70	35,000
							700	60/70	47,000
25 Jul				200	60	12,000	(200)	60	12,000
							500	70	35,000
22 Oct	200	80	16,000				200	80	16,000
							700	70/80	51,000
23 Nov				200	70	14,000	(200)	70	(14,000)
							500	70/80	37,000
12 Dec				200	70	14,000	(200)	70	(14,000)
	1,100		74,000	800		51,000	300	70/80	23,000

Note: 1,100 minus 800 equals 300

74,000 minus 51,000 equals 23,000

Weighted average cost (AVCO) method

With the weighted average cost (AVCO) method of inventory measurement it is assumed that all units are issued at the current weighted average cost per unit.

A new average cost is calculated whenever more items are purchased and received into store. The weighted average cost is calculated as follows:

Formula: Calculation of new weighted average after each purchase

$$\frac{\text{Cost of inventory currently in store + Cost of new items received}}{\text{Number of units currently in store + Number of new units received}} = \text{New weighted average}$$

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Items 'currently in store' are the items in store immediately before the new delivery is received.

Example: FIFO (returning to the previous example)

On 1 January a company had an opening inventory of 100 units which cost ₦50 each.

During the month it made the following purchases:

5 April: 300 units at ₦60 each (= ₦18,000)

14 July: 500units at ₦70 each (= ₦35,000)

22 October: 200 units at ₦80 each (= N16,000)

During the period it sold 800 units as follows:

9 May: 200 units

25 July: 200 units

23 November: 200 units

12 December: 200 units

Required

- What was the cost of the material issued from store in the year, using the weighted average cost (AVCO) measurement method?
- What was the value of the closing inventory on 31 December?

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The weighted average method calculates a new average cost per unit after each purchase. This is then used to measure the cost of all issues up until the next purchase.

This can be shown using an inventory ledger card as follows:

Example: Inventory ledger card (weighted average method)

	Receipts			Issues			Balance		
Date	Qty	@	₦	Qty	@	₦	Qty	@	₦
1 Jan b/f	100	50	5,000				100	50	5,000
5Apr	300	60	18,000				300	60	18,000
							400	**57.5**	23,000
9May				200	57.5	11,500	(200)	57.5	(11,500)
							200	57.5	11,500
14Jul	500	70	35,000				500	70	35,000
							700	**66.43**	46,500
25Jul				200	66.43	13,286	(200)	66.43	(13,286)
							500	66.43	33,214
22Oct	200	80	16,000				200	80	16,000
							700	**70.31**	49,214
23Nov				200	70.31	14,062	(200)	70.31	(14,062)
							500	70.31	35,152
12Dec				200	70.31	14,062	(200)	70.31	(14,062)
	1,100		74,000	800		52,910	300	70/80	21,090

Figures in bold have been calculated as an average cost at the date of a purchase.

Note: 1,100 minus 800 equals 300

Summary

	₦
Value of opening inventory,1	5,000
Purchases in the period	69,000
	74,000
Value of closing inventory, 31 October (see above)	(21,090)
Cost of materials issued in October	
(See figures above: 11,500 + 13,286 + 14,062+ 14,062)	52,910

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Profit impact

Inventory valuation has a direct effect on profit measurement.

Under the periodic inventory system closing inventory is credited to cost of sales. If the value of closing inventory is increased by ₦100 then profit would increase by the same amount.

Under the perpetual inventory system cost of sales is comprised of the transfers from the inventory account and the closing inventory is the balance on the account. However, if the closing inventory balance is changed for whatever reason (say because of a difference between the closing inventory on the account and the actual closing inventory measured) the difference impacts the cost of sales and hence gross profit. In other words, profit is affected by the value assigned to closing inventory.

The figures derived from the cost formula examples above can be used to demonstrate the profit impact of different inventory values.

Example: Profit impact of inventory valuation

The company in the previous examples has sales of ₦100,000 in the year.

	₦	₦
Sales	100,000	100,000
Cost of sales:		
Opening inventory	5,000	5,000
Purchases	69,000	69,000
	74,000	74,000
Closing inventory:		
FIFO	(23,000)	
AVCO		(21,090)
Cost of sales	(51,000)	(52,910)
Gross profit	49,000	47,810

The profit difference is entirely due to how closing inventory is measured under each system.

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6.5 Chapter review

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

a) define inventory;

b) measure inventory at the lower of cost and net realizable value;

c) use cost formulas to arrive at an approximation to the cost of inventory; and

d) explain how inventory valuation impacts profit or loss for the period.

6.6 End of chapter questions and suggested solutions

6.6.1 Questions

Question 1

IAS 2 - Inventories; sets out the requirements to be followed when accounting for inventories.

Required:
Enumerate **SEVEN** disclosure requirements for inventories to be shown in notes to the financial statements.

Question 2
IAS 2 - Inventories sets out the requirements to be followed when accounting for inventory and specifies two methods of recording inventory so as to allow the calculation of cost of sales.

Required:

a) Explain the term, Perpetual inventory system" and identify **FIVE** possible causes of differences between the balance on the inventory account and the physical inventory counted.

b) State the disclosure requirements for inventory in notes to the financial statements.

Question 3
There are several costs included in the cost of inventories, however, there are some costs that should not be included in the cost of inventories.

Required:
State **FOUR** costs that must be excluded from the cost of inventories.

Question 4

The following have been extracted from the books of Innocent Enterprises:

An inventory item costing ₦48,000 was bought for a profitable special order made by a customer. Since buying, the cost has reduced to ₦40,000.

Required:
Value the above inventory in line with IAS 2 – Inventories.

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6.6.2 Suggested solutions

Solution 1
Disclosure requirements for inventory according to IAS 2
IAS 2 requires the following disclosures in notes to the financial statements.

a) The accounting policy adopted for measuring inventories, including the cost measurement method used.
b) The total carrying amount of inventories, classified appropriately.
c) (For a manufacturer, appropriate classifications will be raw materials, work-in-progress and finished goods.)
d) The amount of inventories carried at net realisable value (NRV).
e) The amount of inventories written down in value and so recognised as an expense during the period.
f) Details of any circumstances that have led to the write-down of inventories to NRV.
g) The amount of any reversal or any write-down value that is recognised as a reduction in the amount of inventories as expense in the period.
h) The circumstances or events that led to the reversal of a write-down of inventories.

Solution 2

a) Perpetual inventory system
This is a system where inventory records are continuously updated so that inventory values are always available. A single account is used to record all inventory movements. The account is used to record purchases in the period and inventory is brought down on the account at each year-end.
The account is also used to record all issues out of inventory.
All transactions involving the receipt or issue of inventory must be recorded and at any time, the balance on the inventory account should be the value of inventory currently held.
The following are the possible cause of differences between the balance on the inventory account and the physical inventory counted:

- Theft of inventory;
- Damage to inventory with failure to record that damage;
- Mis-posting of inventory receipts or issues (for example posting component A as component B);
- Failure to record a receipt; and
- Failure to record an issue.

b) Disclosure requirements for inventory
IAS 2 requires the following disclosures in the notes to the financial statements:

- The accounting policy adopted for measuring inventories, including the cost measurement method used;
- The total carrying amount of inventories, is classified appropriately. For a manufacturer, appropriate classifications will be raw materials, work-in-progress and finished goods;
- The amount of inventories carried at net realisable value (NRV);
- The amount of inventories written-down value and so recognised as an expense during the period;
- Details of any circumstances that have led to the write-down of inventories to NRV;

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- The amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period; and
- The circumstances or events that led to the reversal of a write-down of inventories.

Solution 3

- Selling costs
- Warehousing or storage cost.
- Abnormal wastage cost.
- General administrative and overhead cost.

Solution 4

The inventory item should be valued at lower of cost and Net Realizable Value that is, at ₦48,000 because Net Realizable Value is not provided (The ₦40,000 is a replacement cost) and because the inventory is going to be used for a profitable special order which suggests that the Net Realizable Value will be greater than the cost of ₦48,000.

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Skills Level
Financial Reporting

CHAPTER 7

IAS16: PROPERTY, PLANT AND EQUIPMENT

Contents

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7.2 Initial measurement of property, plant and equipment
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7 Property, Plant and Equipment

7.0 Learning objective

This chapter covers measurement, accounting for and disposal of Property, Plant and Equipment (PPE) according IAS 16.

7.1 Learning outcomes

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

a) measure property, plant and equipment on initial recognition;

b) measure property, plant and equipment after initial recognition using the cost model and the revaluation model;

c) account for disposals of property plant and equipment; and

d) construct basic notes to the financial statements in respect of property plant and equipment.

7.2 Initial Measurement of Property, Plant and Equipment

7.2.1. 1Introduction

Rules on accounting for property, plant and equipment are contained in *IAS 16: Property, plant and equipment.*

Definition

Definition: Property, plant and equipment

Property, plant and equipment are tangible items that:

- are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- are expected to be used during more than one period.

Items such as spare parts, stand-by equipment and servicing equipment are recognised as property, plant and equipment when they meet the above definition. If this is not the case, they are recognised as inventory.

Initial recognition

The cost of an item of property, plant and equipment must be recognised as an asset if, and only if:

a) it is probable that future economic benefits associated with the item will flow to the entity; and

b) the cost of the item can be measured reliably.

Items of property, plant and equipment may be acquired for safety or environmental reasons. At first sight it looks as if such items would not be recognised as property, plant and equipment according to the recognition criteria because they do not directly increase future economic benefits. However, they may be necessary in order that a company obtain the future economic benefits from its other assets, so they do qualify for recognition.

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Illustration:

A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals.

This would be recognized as an asset because without them the company cannot make and sell chemicals.

7.2.2 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 at tribute to that asset when initially recognised in accordance with the specific requirements of other IFRSs.

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless it is capitalised in accordance with *IAS 23: Borrowing costs* (covered later).

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Example: Deferred consideration

A company buys a machine on 1 January 20 X 7.
The terms of the purchase are that the company will pay ₦5million for the machine on 31 December 20 X 7 (1 year later).
An appropriate discount rate is 6%

1 January 20 X 7 – Initial recognition

Initial measurement of the purchase price ₦5m x $\frac{1}{(1+0.06)}$ = ₦ 4,716,981

	Debit	Credit
Property, plant and equipment	4,716,981	
Liability		4,716,981

31 December 20 X 7 – Date of payment

Recognition of interest expense ₦4,716,981 x 6% =283,019

	Debit	Credit
Statement of profit or loss	283,019	
Liability		283,019

	₦
Balance on the liability Balance brought forward	4,716,981
Interest expense recognised in the period	283,019
	5,000,000
Cash/bank	(5,000,000)
	–

Exchange transactions

An asset may be acquired in exchange for another asset. The cost of such asset is measured at its fair value unless:

a) the exchange transaction lacks commercial substance; or

b) the fair value of neither the asset received, nor the asset given up 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.

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Lack of commercial substance

The determination of whether an exchange transaction has commercial substance depends on the extent to which future cash flows are expected to change as a result of the transaction. If there is minimal impact on future cash flows then the exchange lacks commercial substance.

Elements of cost

The definition of 'cost' for property, plant and equipment has close similarities with the cost of inventories, although property, plant and equipment will often include more items of 'other expense' within cost.

The cost of an item of property, plant and machinery consists of:

a) its purchase price after any trade discount has been deducted, plus any import taxes or non-refundable sales tax; plus

b) 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. These directly attributable costs may include:

   a) employee costs arising directly from the installation or construction of the asset;

   b) the cost of site preparation;

   c) delivery costs (carriage inwards);

   d) installation and assembly costs;

   e) testing costs to assess whether the asset is functioning properly (net of sale proceeds of items produced during the testing phase); and

   f) professional fees directly attributable to the purchase.

c) 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. This will be explained in more detail in chapter 13 which covers *IAS 37: Provisions, contingent liabilities and contingent assets*.

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Example: Cost

A company has purchased a large item of plant. The following costs were incurred.

List price of the machine	1,000,000
Trade discount given	50,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
Administration expense	150,000
Test run cost	75,000

The test run cost was to ensure that the asset was installed and working correctly. Items of inventory were produced during the test run. These had a sale value of ₦10,000.

Local government officials have granted the company a license to operate the asset on condition that the company will remove the asset and return the site to its former condition at the end of the asset's life.

The company has recognised a liability of ₦250,000 in respect of the expected clearance cost.

The cost of the asset is as follows:

	₦
Purchase price of the machine (1,000,000 – 50,000)	950,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
Decommissioning cost	250,000
Test run cost (75,000 –10,000)	65,000
	1,705,000

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.

Cost of self-constructed assets

The cost of a self-constructed asset is determined using the same principles as for an acquired asset.

A company might make similar assets for sale in the normal course of business. The cost of an asset for the company to use itself would normally be the same as the cost of an asset for sale as measured according to *IAS 2: Inventories*.

IAS23: Borrowing costs, deals with whether interest costs on borrowing to finance the construction of a non-current asset should be included in the cost of the asset. This is covered in the next chapter.

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Not part of cost

Only those costs necessary to bring an asset to a condition and location where it is capable of operating in the manner intended by management are recognised.

IAS 16 provides the following list of costs that are not costs of an item of property, plant and equipment:

a) costs of opening a new facility;

b) costs of introducing a new product or service (including costs of advertising and promotional activities);

c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

d) administration and other general overhead costs.

7.2.3 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:

a) improves the asset (for example, by enhancing its performance or extending its useful life); or

b) 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.

A basic rule is that improvements are capitalised but repairs are expensed. You may have to correct situations when an amount spent has not been treated correctly. This is covered in section 6 of this chapter.

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.

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Example: Major overhaul

A shipping company is required to put its ships into dry dock every three years for an overhaul, at a cost of ₦3,000,000. The ships have a useful life of 20 years. A ship is purchased from a ship builder at a cost of ₦200 million.

Initial recognition

₦3,000,000 of the asset cost should be treated as a separate component and depreciated over three years.

The rest of the cost of the ship (₦197million) should be depreciated over 20 years.

End of year 3

An overhaul is required.

The cost of the overhaul is capitalised and added to the asset's cost.

The cost (₦3,000,000) and accumulated depreciation of the depreciated component is removed from the accounts.

7.2.4 Measurement after initial recognition

IAS 16 allows a choice of accounting treatments after initial recognition.

All items of property, plant and equipment in a class can be accounted for using one of two models:

a) Cost model - Property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses.

b) 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 above choice must be applied consistently. A business cannot carry one item of property, plant & equipment at cost and revalue a similar item. However, a business can use different models for different classes of property, plant & equipment. For example, companies might use the cost model for plant and equipment but use the revaluation model for property.

Depreciation is an important component of both models.

7.3 Depreciation and Carrying Amount

You should be familiar with the measurement and recognition of depreciation from your previous studies. This section provides a reminder of the key concepts.

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7.3.1 Depreciation

Depreciation is an expense that matches the cost of a non-current asset to the benefit earned from its ownership. It is calculated so that a business recognises the full cost associated with a non-current asset over the entire period that the asset is used.

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:

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an entity.

Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses. (Net book value (NBV) is a term that is often used instead of carrying amount).

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Parts of an asset

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 component assets and each

depreciated separately.

Illustration: Cost

A company has purchased a new Gulf Stream jet for ₦5,500 million.
The company has identified the following cost components and useful lives in respect of this jet.

	₦ million	Useful lives
Engines	2,000	3 years
Airframe	1,500	10 years
Fuselage	1,500	20 years
Fittings	500	5 years
	5,500	

Depreciation is charged as an expense in the statement of profit or loss each year over the life of the asset unless it relates to an asset being used to construct another asset. In this case the depreciation is capitalised as part of the cost of that other asset in accordance with the relevant standard (For example: *IAS 2: Inventories; IAS 16 Property, plant and equipment; IAS 38; Intangible assets*).

Accounting for depreciation

The double entry for depreciation should be familiar to you from your earlier studies. This section gives a brief recap.

Illustration: Depreciation double entry

	Debit	Credit
Depreciation expense	X	
Accumulated depreciation		X

The balance on the depreciation expense account is taken to the statement of profit or loss as an expense for the period.

The non-current asset figure in the statement of financial position is made up of two figures, the cost less accumulated depreciation.

Illustration: Carrying amount of a non-current asset

	N	
Non-current asset at cost	X	
Less accumulated depreciation	(X)	This figure appears on the face of the statement of financial position
Carrying amount (not book value)	X	

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Depreciable amount and depreciation period

The depreciable amount of an asset must be allocated on a systematic basis over its useful life.

Commencement of depreciation

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. This might be before the asset is actually used.

Cessation of depreciation

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.

Residual value

In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

However, in some cases, the residual value may be equal to or greater than the asset's carrying amount. In this case the depreciation charge would be zero.

Land and buildings

Land and buildings are separable assets and are dealt with separately for accounting purposes, even when they are acquired together.

Land normally has an unlimited life and is therefore not depreciated. However, there are exceptions to this. If land has a physical attribute that is used over a period, then the land should be depreciated over this period.

Example: Land

Okene Quarries has purchased as Its from which they will extract grave lf or sale to the construction industry.

The site cost ₦50,000,000.

It is estimated that gravel will be extracted from the site over the next

20years. The land must be depreciated over 20years.

Buildings normally have a limited life and are therefore depreciable assets.

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- **Reviews of the remaining useful life and expected residual value**

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.

Example:

Benin City Engineering owns a machine which originally cost ₦60,000 on 1 January 20 X 3.

The machine was being depreciated over its useful life of 10 years on a straight- line basis and has no residual value.

On 31 December 20 X 6 Benin City Engineering revised the total useful

Life for the machine to eight years (down from the previous10).

Required: Calculate the depreciation charge for 20X6 and subsequent years.

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.

Answer

The change in accounting estimate is made at the end of 20X6 but may be applied to the financial statements from 20X6 onwards.

	₦
Cost on 1 January 20 X 3	60,000
Depreciation for 20 X 3 to 20X5 (60,000×3/10)	(18,000)
Carrying amount at end of 20 X 5	42,000

Remaining useful life at the end of 20X5 = 8 – 3 years = 5 years.

Depreciation for 20 X 6 and subsequent years = ₦42,000÷5years = ₦8,400.

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Practice questions

A machine was purchased three years ago on 1 January Year 2. It cost ₦150,000 and its expected life was 10 years with an expected residual value of ₦30,000.

Due to technological changes, the estimated life of the asset was re- assessed during Year 5. The total useful life of the asset is now expected to be 7 years and the machine is now considered to have no residual value.

The financial year of the entity ends on 31 December.

What is the depreciation charge for the year ending 31 December Year 5

7.3 Depreciation method

The depreciation method used should reflect the way in which the economic benefits of the asset are consumed by the business over time.

The main choice is between the straight-line method and the reducing balance method (also known as the diminishing balance method).

Straight-line method

Definition: Straight line depreciation

The depreciable amount is charged in equal amounts to each reporting period over the expected useful life of the asset.

$$\text{Depreciation charge For the year} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected useful life (years)}}$$

The charge in the first and last year is time apportioned.

Example: Straight line depreciation – mid-year acquisition

A machine cost ₦250,000. It has an expected economic life of five years.

It is expected that the machine will have a zero-scrap value at the end of its useful life.

The machine was bought on the 1st September and the company has a 31st December year end.

The depreciation charge in the first year of ownership is:

$$\text{Depreciation charge} = \frac{250{,}000}{5 \text{ years}} \times \frac{4}{12} = ₦\,6{,}667$$

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Reducing balance method

Definition: Reducing balance method

The annual depreciation charge is a fixed percentage of the carrying amount of the asset at the start of the period.

Formula: Reducing balance depreciation

Depreciation charge for the year	=	Carrying amount at the start of the year	x	Fixed Percentage

Example: Reducing balance method

A machine cost N100,000 on 30 September.

The company has a 31 December year end.

It has an expected life of five years, and it is to be depreciated by the reducing balance method at the rate of 30% each year.

Annual depreciation and carrying amount over the life of the asset will be as follows.

Year	Carrying amount at start		Annual depreciation charge	Carrying amount at end
	₦	₦	₦	₦
1	100,000	x30%x3/12	7,500	92,500
2	92,500	x30%	27,750	64,750
3	64,750	x30%	19,425	45,325
4	45,325	x30%	13,598	31,727
3	27,750 x 70%			19,425
4	19,425 x 70%			13,598

Note that the depreciation in the year after the first full year's depreciation (year 2) can be calculated by multiplying the previous year's charge by (1– the reducing balance percentage).

Formula: Calculation of reducing balance percentage

$$x = n\left(\sqrt{Residual\ value/Cost}\right) - 1$$

Where:

x=The reducing balance percentage

n = Expected useful life.

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Example: Reducing balance

An asset cost N10,000 and has an expected residual value of N2,000 at the end of its expected useful life which is 5years.

The reducing balance percentage is calculated as follows.

This percentage reduces ₦10,000 to 2,000 over 5 years.

Year	Carrying amount at start of year	Annual depreciation charge (at (27.5% reducing balance)	Carrying amount at end of year
	₦	₦	₦
1	10,000	2,750	7,250
2	7,250	1,994	5,256
3	5,256	1,445	3,811
4	3,811	1,048	2,763
5	2,763	763	2,000

Depreciation by number of units produced
Note that the depreciation charge in year 5 contains a rounding difference of 3.

Definition

Depreciation is calculated by expressing the useful life of an asset in terms of its expected total output and allocating the annual charge to depreciation based on actual output.

Formula: Depreciation by number of units

$$\text{Depreciation charge} = \frac{\text{Cost – residual value}}{\text{Total expected production over the life of the asset}} \times \text{Number of units produced in period}$$

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7.3.4 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.

Example:

Oyo Fabrics owns a machine which originally cost ₦30,000 on 1 January 20 X 3. It has no residual value.

It was being depreciated over its useful life of 10 years on a straight-line basis.

At the end of 20 X 6, when preparing the financial statements for 20 X 6, Oyo Fabrics decided to change the method of depreciation, from straight-line to the reducing balance method, using a rate of 25%.

Required

Calculate the depreciation charge for 20 X 6.

Answer

The change in accounting estimate is made at the end of 20 X 6 but is applied to the financial statements from 1 January 20 X 6.

The reducing balance method of depreciation is applied to the 20 X 6 statements.

	₦
Coston1January 20X3	30,000
Depreciation for 20X3 to 20X5 (30,000×3/10)	(9,000)
Carrying amount at end of 20 X 5	21,000

Depreciation for 20 X 6 will therefore be ₦ 21,000 × 25% = ₦5,250.

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7.3.5 Impairment

Both the cost model and the revaluation model refer to impairment losses. IAS 36 *Impairment of assets* contains detailed guidance on impairment.

Definition

Impairment loss: The amount by which the carrying amount of an asset (or a cash-generating unit) exceeds its recoverable amount.

An impairment loss is a write down in the value of an asset to its recoverable amount. IAS 36 operates to ensure that assets are carried in the financial statements at no more than their recoverable amount. (This is very similar to the rule that requires inventory to be measured at the lower of cost and net realisable value).

The recoverable amount of an asset is defined as the higher of its:

a) Fair value less costs to sell (the amount that would be received for the asset in an orderly transaction between market participants less costs of selling it); and

b) Value in use (the present value of future cash flows from using an asset, including its eventual disposal).

You will not be asked to compute these figures in the exam, but you might be given the two amounts and be expected to identify the recoverable amount and account for any impairment loss.

Example: Impairment

The following information relates to 3 assets:

	Asset1	Asset 2	Asset 3
Carrying amount	80,000	120,000	140,000
Value in use	150,000	105,000	107,000
Fair value less cost to sell	60,000	90,000	110,000
Recoverable amount	150,000	105,000	110,000
Impairment loss	nil	15,000	30,000

Approach

Impairment of an asset should be identified and accounted for as follows:

a) At the end of each reporting period, a business should assess whether there are any indications that an asset may be impaired.

b) If there are such indications, the business should estimate the asset's recoverable amount.

c) When the recoverable amount is less than the carrying amount of the asset, the carrying amount should be written down to this amount. The amount by

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which the value of the asset is written down is an impairment loss.

d) This impairment loss is recognised as a loss for the period.

e) 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).

f) There is no specific guidance on the double entry needed to record impairment. One way of accounting for it is to set up an accumulated impairment loss account and account for it just like depreciation.

7.4 Revaluation of Property, Plant and Equipment

7.4.1 Revaluation and the entity's accounting policy

An item of property, plant and equipment is recognised at cost when it is first acquired.

IAS 16 allows a business to choose one of two measurement models as its accounting policy for property, plant and equipment after acquisition. The same model should be applied to all assets in the same class.

The two measurement models for property, plant and equipment after acquisition are:

a) cost model (i.e., cost less accumulated depreciation); and

b) revaluation model (i.e., revalued amount less accumulated depreciation since the most recent revaluation).

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.

Revaluation model – Issues

The following accounting issues have to be addressed when using the revaluation model:

Issue
a. What happens to the other side of the entry when the carrying amount of an asset is changed as a result of a revaluation adjustment? An asset value may increase or decrease. What happens in each case?
b. How is the carrying amount of the asset being revalued changed? The carrying amount is located in two accounts (cost and accumulated depreciation) and it is the net amount that must be changed so how is this done?
c. How often should the revaluation take place?

Accounting for revaluation

When a non-current asset is revalued, its 'carrying amount' in the statement of financial position is adjusted from carrying amount to its fair value (normally current market value) at the date of the revaluation.

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How the carrying amount is changed will be addressed later. This section concentrates on the other side of the entry.

Asset carried at cost revalued upwards

An increase in value is credited to other comprehensive income and accumulated in equity under the heading of revaluation surplus.

Example: Upward revaluation

Land was purchased for 100 on the first day of the 20 X 6 accounting period. The business revalues land as permitted by the IAS16.

The land was revalued to 130 at the end of the first year of ownership.

Double entry: IAS 16	**Debit**	**Credit**
Land	30	
Other comprehensive income (and accumulated in a revaluation surplus).		30

Extract from the statement of financial position as at 31/12/X6

	IFRS
Property, plant and equipment	130
Equity (revaluation surplus)	30

Asset carried at cost revalued downwards

A decrease in value is debited as an expense to the statement of profit or loss.

Example: Downward revaluation

Land was purchased for 100 on the first day of the 20 X 6 accounting period. The business revalues land as permitted by the IAS 16.

The land was revalued to 90 at the end of the first year of ownership.

	Debit	**Credit**
Statement of profit or loss	10	
Land		10

Asset carried at a revaluation deficit is revalued upwards

An asset might be carried at an amount lower than its original cost as a result of being revalued downwards.

If the asset is later revalued upwards, the revaluation increase is recognised in the statement of profit or loss to the extent of the previously recognised expense. That part of any increase above the previously recognised expense is recognised in the usual way, in other comprehensive income (IAS 16).

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Asset carried at a revaluation surplus revalued downwards

An asset might be carried at an amount higher than its original cost as a result of being revalued upwards.

If the asset is later revalued downwards, the revaluation decrease is recognised in other comprehensive income to the extent of the previously recognised surplus. That part of any decrease above the previously recognised surplus is recognised in the statement of profit or loss the usual way.

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Example: Downward revaluation – Accounted for under IAS 16

A business purchased a plot of land on the first day of the 20 X 6 accounting period. The business applies the IAS 16 revaluation model to the measurement of land after initial recognition. The business has a policy of revaluing land annually.

The initial amount recognised and the year-end values are shown below:

	₦
Measurement on initial recognition	100
Valuation as at:	
31 December 20X6	130
31 December 20X7	110
31 December 20X8	95
31 December 20X9	116

The double entries are as follows:

31 December 20X6	**Debit**	**Credit**
Land (130 – 100)	30	
Other comprehensive income		30

31 December 20X7	**Debit**	**Credit**
Other comprehensive income	20	
Land (110 – 130)		20

The fall in value reverses a previously recognised surplus. It is recognized in OCI to the extent that it is covered by the surplus.

31 December 20X8	**Debit**	**Credit**
Other comprehensive income	10	
Statement of profit or loss	5	
Land (95 – 110)		15

The fall in value in part reverses a previously recognised surplus. It is recognized in OCI to the extent that it is covered by the surplus. This reduces the revaluation surplus to zero.

Any amount not covered by the surplus is recognised as an expense in the statement of profit or loss.

31 December 20 X 9	**Debit**	**Credit**
Land (116 – 95)	21	
Statement of profit or loss		5
		16

Other comprehensive income arise in value that reverses a previously recognised expense is recognised in the statement of profit or loss to the extent that it reverses the expense. Any amount above this is recognised in other comprehensive income.

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		Land	Other comprehensive income	Statement of profit or loss
At start		100	–	–
Double entry		30	30Cr	
31/12/X6		**130**		
b/f		130		

Example (continued) –Overview

31/12/X7		**110**				
b/f		110				
Adjustment		(15)		10Dr		5Dr
31/12/X8		**95**				
b/f		95				
Adjustment	Adjustment	21	(20)	16Cr	20Dr	5Cr –
31/12/X9		**116**				

Changing the carrying amount of a revalued asset.

In the previous example land was revalued. Land is not depreciated so the carrying amount of land is represented in a single account. This made it easy to change:

The carrying amount of depreciable assets is the net of balances on two separate accounts. The double entry to revalue the asset must take this into account.

IAS 16 allows a choice of two approaches which differ in the treatment of the accumulated depreciation account.

When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:

Method 1

Restate accumulated depreciation proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount.

Method 2

Step 1: Transfer the accumulated depreciation to the asset account. The result of this is that the balance on the asset account is now the carrying amount of the asset and the accumulated depreciation account in respect of this asset is zero.

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Step 2: Change the balance on the asset account to the revalued amount.

Example: Method 1

A building owned by a company is carried at ₦20million (Cost of ₦25 million less accumulated depreciation of ₦5million. The company's policy is to apply the revaluation model to all its land and buildings.

A current valuation of this building is now ₦26million.

	Before		After
Cost	25	x 26/20	32.5
Accumulated depreciation	(5)	x 26/20	(6.5)
Carrying amount	20	x 26/20	26

Journals	₦m	₦m
Asset	7.5	
Accumulated depreciation		1.5
Revaluation surplus		6

Step 1	₦m	₦m
Accumulated depreciation	5	
Asset		5
Step 2		
Asset (₦26 – ₦20m)	6	
Revaluation surplus		6

Alternatively, this could be done with a single journal: Asse

(₦26 – ₦25m)	1	
Accumulated depreciation	5	
Revaluation surplus		6

	Before	1	2	After
Cost 25		(5)	6	26
Accumulated depreciation	(5)	5		–

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Carrying amount	20	26

Example: Method 2

A building owned by a company is carried at ₦20million (Cost of ₦25million less accumulated depreciation of ₦5million. The company's policy is to apply the revaluation model to all of its land and buildings.

A current valuation of this building is now ₦26 million

Step 1	**Nm**	**Nm**
Accumulated depreciation	5	
Asset		5
Step 2		
Asset (N26 – N20m)		
	6	
Revaluation surplus		6
Alternatively, this could be done with a single journal: Asset (N26 – N25m)		
	1	
Accumulated depreciation	5	
Revaluation surplus		6

Before	**1**	**2**	**After**
Cost 25	(5)	6	26
Accumulated depreciation (5)	5		–
Carrying amount 20			26

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Example:

An office building was purchased four years ago for ₦3 million.

The building has been depreciated by ₦100,000.

It is now re-valued to 4million.

Show the book-keeping entries to record the revaluation.

Answer

Building account

	₦		₦
Opening balance b/f	3,000,000	Accumulated depreciation	100,000
Other comprehensive Income	1,100,000	Closing balance c/f	4,000,000
	4,100,000		4,100,000
Opening balance b/f	4,000,000		

Accumulated depreciation of building account

	₦		₦
Building account	100,000	Opening balance b/f	100,000

Other comprehensive income

	₦		₦
		Building account	1,100,000

Tutorial note:

The balance on this account is transferred into a revaluation surplus account as follows:

Other comprehensive income

	₦		₦
Revaluation surplus	1,100,000	Building account	1,100,000

Revaluation surplus

	₦		₦
		Other comprehensive income	1,100,000

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7.4.1 Depreciation of a revalued asset

After a non-current asset has been revalued, depreciation charges are based on the new valuation.

Example:

An asset was purchased three years ago, at the beginning of Year1, for N100,000. Its expected useful life was six years, and its expected residual value was N10,000.
It has now been re-valued to N120,000. Its remaining useful life is now estimated to be three years, and its estimated residual value is now N15,000.
The straight-line method of depreciation is used.

Required

a. What amount is recognised in other comprehensive income at the end of Year 3?
b. What is the annual depreciation charge in Year 4?
c. What is the carrying amount of the asset at the end of Year 4?

Answer

Original annual depreciation (for Years 1–3) = ₦(100,000–10,000)/6years= ₦15,000

Practice question

A company owns a building which was purchased three years ago for N1 million. The building has been depreciated by ₦60,000.
It is now to be revalued to ₦2million. Show the book-keeping entries to record the revaluation.

Cost	100,000
Less: Accumulated depreciation at the time of Revaluation (= 3years x ₦15,000)	(45,000)
Carrying amount at the time of the revaluation	55,000
Revalued amount of the asset	120,000
Recognised in other comprehensive income (and accumulated in are valuation surplus in equity)	65,000

Revised annual depreciation =₦(120,000–15,000)/3years= ₦35,000.
The annual depreciation charge in Year 4 will therefore be ₦35,000.

Revalued amount	120,000
Less: depreciation charge in Year 4	(35,000)
Carrying amount at the end of Year 4	85,000

7.4.2 Realisation of the revaluation surplus

All assets eventually disappear from the statement of financial position either by becoming fully depreciated or because the company sells them.

If nothing were done this would mean that there was a revaluation surplus on the face of the statement of financial position that related to an asset that was no longer owned.

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 (or realised).

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This might happen over several years as the asset is depreciated or at a point in time when the asset is sold.

Revalued assets being depreciated

Revaluation of an asset causes an increase in the annual depreciation charge. The difference is known as excess depreciation (or incremental depreciation):

Excess depreciation is the difference between:

a) the depreciation charge on the re-valued amount of the asset, and

b) the depreciation that would have been charged on historical cost.

Each year a business might make a transfer from the revaluation surplus to the retained profits equal to the amount of the excess depreciation.

Illustration:

	Debit	Credit
Revaluation surplus Retained earnings	X	X

Revalued assets being sold

When a revalued asset is sold the business might transfer the balance on the revaluation surplus in respect of the asset into retained earnings. The journal entry would be the same as above.

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Example:

An asset was purchased two years ago at the beginning of Year 1 for ₦600,000. It had an expected life of 10 years and nil residual value.

Annual depreciation is ₦60,000 ($₦^{600,000}/_{10years}$) in the first two years.

At the end of Year 2 the carrying value of the asset- ₦480,000.

After two years it is re-valued to ₦640,000.

Double entry: Revaluation

	Debit	Credit
Asset (₦640,000– ₦600,000)	40	
Accumulated depreciation	120	
Revaluation surplus		160

Each year the business is allowed to make a transfer between the revaluation surplus and retained profits:

Double entry: Transfer

	Debit	Credit
Revaluation surplus ($^{160}/_{8}$)	20	
Retained profits		20

7.4.2 Revaluation model: the frequency of revaluations

When the revaluation model is applied to the measurement of property, plant and equipment, revaluations must be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

The frequency of revaluations should depend on the volatility in the value of the assets concerned. When the value of assets is subject to significant changes (high volatility), annual revaluations may be necessary.

However, such frequent revaluations are unnecessary for items subject to only insignificant changes in fair value. In such cases it may be necessary to revalue the item only every three or five years.

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7.5 Derecognition of Property, Plant and Equipment

7.5.1 Gain or loss on disposal of a non-current asset

Property, plant and equipment are eventually disposed of:

a) by sale, or

b) if they have no sale value, through disposal as scrap.

Disposal can occur at any time and need not be at the end of the asset's expected useful life.

There is a gain or loss on disposal of the asset, as follows:

Illustration: Gain or loss on disposal

Sale proceeds on disposal		₦ X
Less disposal costs		(X)
Net disposal value		X
Asset at cost	X	
Less: accumulated depreciation	(X)	
Carrying amount at date of disposal		(X)
Gain /loss on disposal		X

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Example:

A non-current as set originally cost ₦75,000. Accumulated depreciation is ₦51,000.

The asset is now sold for ₦18,000. Disposal costs are ₦500.

What is the gain or loss on disposal?

Answer

Gain or loss on disposal	₦	₦
Sale proceeds on disposal		18,000
Less disposal costs		(500)
Net disposal value		17,500
Asset at cost	75,000	
Less: accumulated depreciation	(51,000)	
Carrying amount at date of disposal		(24,000)
Loss on disposal		(6,500)

Practice question **3**

A non-current asset cost ₦96,000 and was purchased on 1 June Year 1. Its expected useful life was five years and its expected residual value was ₦16,000. The asset is depreciated by the straight-line method.

The asset was sold on1September Year 3 for ₦68,000. There were no disposal costs.

It is the company policy to charge depreciation on a monthly basis.

The financial year runs from 1 January to 31 December.

What was the gain or loss on disposal?

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Practice question **4**

A non-current asset was purchased on 1 June Year 1 for ₦216,000. Its expected life was 8 years and its expected residual value was ₦24,000. The asset is depreciated by the straight-line method. The financial year is from 1 January to 31 December.

The asset was sold on 1 September Year 4 for ₦163,000. Disposal costs were ₦1,000.

It is the company policy to charge a proportionate amount of depreciation in the year of acquisition and in the year of disposal, in accordance with the number of months for which the asset was held.

What was the gain or loss on disposal?

7.5.2 Accounting for the disposal of property, plant and equipment

In the general ledger the gain or loss on disposal of a non-current asset is recorded in a **disposal of asset account**. The double entry transactions required are as follows – for an asset recorded at cost rather than at a re-valued amount.

Step 1: Transfer the cost of the non-current asset from the asset account to the disposal account:

Step 2: Transfer the accumulated depreciation on the asset from the accumulated depreciation account to the disposal account:

Illustration:

	Debit	Credit
Disposal account	X	
Non-current asset account (cost of the asset)		X
Accumulated depreciation account (or Allowance for depreciation account)	X	
Disposal account		X

The carrying amount of the asset is now in the disposal account.

Step 3: Record the disposal costs in the disposal account.

Illustration:

	Debit	Credit
Disposal account (disposal expenses)	X	
Bank or Payables account		X

Step 4: Record the sale proceeds in the disposal account:

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Illustration:

	Debit	Credit
Bank or Receivables account	X	
Disposal account (sale proceeds)		X

Step 5: The balance on the disposal account is the gain or loss on disposal. This is transferred to the statement of profit or loss.

Example:

A non-current asset cost ₦82,000 when purchased. It was sold for ₦53,000 when the accumulated depreciation was ₦42,000. Disposal costs were ₦2,000.

Required

Show the book-keeping entries to record the disposal.

Answer

Disposal of asset account

	₦		₦
Non-current asset account	82,000	Accumulated depreciation account	42,000
Disposal expenses (Bank)	2,000	Sales value (Receivables)	53,000
Gain on disposal (statement of profit or loss)	11,000		
	95,000		95,000

Non-current asset account

	₦		₦
Opening balance	82,000	Disposal account	82,000

Accumulated depreciation account

	₦		₦
Disposal account	42,000	Opening balance	42,000

Receivables account

	₦		₦
Disposal account (sale value of disposal)	53,000		

Bank account

	₦		₦
		Disposal account	2,000

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Non-current asset accounts in the general ledger are usually maintained for a category of assets rather than for individual assets. This means that when a non- current asset is disposed of, there will be a closing balance to carry forward on the asset account and the accumulated depreciation account.

Example:

In the previous example, suppose that the balance on the non-current asset account before the disposal was ₦500,000 and the balance of the accumulated depreciation account was ₦180,000.

The accounting entries would be as follows:

Property, plant and equipment account

	₦		₦
Opening balance b/f	500,000	Disposal account	82,000
		Closing balance c/f	418,000
	500,000		500,000
Opening balance b/f	418,000		

Accumulated depreciation account

	₦		₦
Disposal account	42,000	Opening balance b/f	180,000
Closing balance c/f	138,000		
	180,000		180,000
		Opening balance b/f	138,000

Practice question

A motor vehicle cost ₦80,000 two years ago. It has been depreciated by the reducing balance method at 25% each year. It has now been disposed for ₦41,000. Disposal costs were ₦200. **5**

The balance on the motor vehicles account before the disposal was ₦720,000 and the balance on the accumulated depreciation of motor vehicles account was ₦250,000.

Show the book-keeping entries to record the disposal.

7.5.6 Disposal of property, plant and equipment: part-exchange of an old asset

Sometimes, a supplier will agree to take an old asset in part-exchange for the sale of a new asset. This practice is quite common, for example, with motor vehicles. A business entity may buy a new motor vehicle from a car dealer, and the car dealer will take an old motor vehicle in part-exchange for the new one.

Disposals of assets in part-exchange for a new asset are accounted for in much the

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same way as disposals of property, plant and equipment for cash. The only difference is that:

a) The disposal value of the old asset is the amount that the seller of the new asset allows in part-exchange for the new asset.

b) The cost of the new asset is the full purchase price, but the double entry is partly to bank/payables (for the cash payment) and partly to the disposal account for the old asset (for the part-exchange value).

Example:

Entity X has several motor cars that are accounted for as property, plant and equipment.

As at 1January Year 5, the cost of the entity's cars was ₦200,000 and the accumulated depreciation was ₦80,000.

On 2 January Year 5, Entity X bought a new car costing ₦50,000.

The car dealer accepted a car owned by Entity X in part-exchange, and the part- exchange value of this old car was ₦4,000.

This car originally cost ₦30,000 and its accumulated depreciation is ₦25,000.

Required

a. Calculate the gain or loss on disposal of the old car.

b. Show how the purchase of the new car and the disposal of the old car will be recorded in the ledger accounts of Entity X.

Answer

(a)

	₦	₦
Sale proceeds on disposal (part-exchange value)		4,000
Less disposal costs		0
Net disposal value		4,000
Asset at cost	30,000	
Less: Accumulated depreciation	(25,000)	
Carrying amount at date of disposal		(5,000)
Loss on disposal		(1,000)

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Answer (b)

Disposal of asset account

	₦		₦
Motor vehicles account	30,000	Accumulated depreciation account	25,000
		Motor vehicles account (Trade-in value)	4,000
		Loss on disposal (statement of profit or loss)	1,000
	30,000		30,000

Motor vehicles account

1 January	₦		₦
Opening balance	200,000	Disposal account	30,000
Bank (50,000 – 4,000)	46,000		
Disposal of asset account	4,000	Closing balance	220,000
	250,000		250,000
2 January			
Opening balance	220,000		

Accumulated depreciation account

1 January	₦		₦
Disposal account	25,000	Opening balance	80,000
Closing balance	55,000		
	80,000		80,000
2 January			
		Opening balance	55,000

Bank account

	₦		₦
		Motor vehicles account (Cash paid for new car)	46,000

Statement of profit or loss

	₦		₦
Disposal account (Loss on disposal)	1,000		

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Practice question **6**

A company has several motor cars that are accounted for as non-current assets. As at 1 January Year 2, the cost of the cars was ₦120,000 and the accumulated depreciation was ₦64,000.

During January the company bought a new car costing ₦31,000 and was given apart-exchange allowance against an old car of ₦8,000. The car being part exchanged originally cost ₦28,000 and its accumulated depreciation is ₦18,000.

Required

a. Calculate the gain or loss on disposal of the old car.

b. Show how the purchase of the new car and the disposal of the old car will be recorded in the ledger accounts.

7.6 Disclosure Requirements of IAS 16

7.6.1 Disclosure requirements of IAS16

IAS 16 requires the following disclosures in the notes to the financial statements, for each major class of property, plant and equipment.

a) The measurement bases used (cost or revaluation model);

b) The depreciation methods used;

c) The useful lives or depreciation rates used;

d) Gross carrying amounts and the accumulated depreciation at the beginning and at the end of the period;

e) A reconciliation between the opening and closing values for gross carrying amounts and accumulated depreciation, showing:

i. Additions during the year;

ii. Disposals during the year;

iii. Depreciation charge for the year;

iv. Assets classified as held for sale in accordance with IFRS 5;

v. Acquisitions of assets through business combinations;

vi. Impairment losses;

vii. The effect of revaluations.

The following is an example of how a simple table for tangible non-current assets may be presented in a note to the financial statements.

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Illustration:

	Property	Plant and equipment	Total
Cost	**₦m**	**₦m**	**₦m**
At the start of the year	7,200	2,100	9,300
Additions	920	340	1,260
Disposals	(260)	(170)	(430)
At the end of the year	7,860	2,270	10,130
Accumulated depreciation			
At the start of the year	800	1,100	1,900
Depreciation expense	120	250	370
Accumulated depreciation on disposals	(55)	(130)	(185)
At the end of the year	865	1,220	2,085
Carrying amount			
At the start of the year	6,400	1,000	7,400
At the end of the year	6,995	1,050	8,045

7.6.2 Accounting policies

IAS 1 requires the disclosure of accounting policies used that are relevant to an understanding of the financial statements. Property, plant and equipment often includes the largest numbers in the statement of financial position and results in significant expense in the statement of profit or loss.

One of the learning outcomes in this area is that you should be able to formulate accounting policies for property, plant and equipment.

There are many aspects of accounting policy for property plant and equipment. Below is a typical note which covers many of the possible areas.

Illustration: Accounting policy – Property, plant and equipment

Property, plant and equipment comprises freehold and leasehold land and buildings, plant and machinery, fixture sand fittings, vehicles, office equipment and capital work in progress.

Land and buildings

Land and buildings comprise mainly factories, warehousing and offices.

Freehold land and buildings are shown at their fair value less accumulated depreciation. Valuations are performed with sufficient regularity to ensure that the fair value of a revalued asset does not differ materially from its carrying amount.

Increases in the carrying amount arising on revaluation of land and buildings are recognised in other comprehensive income and accumulated as a revaluation surplus in

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equity.

Decreases that offset previous increases of the same asset are charged directly to the revaluation surplus. Any amounts not so covered are recognized in profit or loss for the period.

Depreciation is based on the carrying amount of the asset after the revaluation. The incremental depreciation is the difference between the depreciation based on historical cost and depreciation based on fair value. Each year this amount is transferred from the revaluation surplus to accumulated profits.

Any accumulated depreciation at the date of revaluation is eliminated against the gross carrying amount of the asset, and the net amount is restated to the revalued amount of the asset.

When revalued assets are sold, the amounts included revaluation surplus in respect of that asset is transferred to accumulated profits.

Freehold land has an indefinite useful life and is not depreciated. Freehold buildings are depreciated on a straight-line basis over their useful economic lives over as shown below.

Leasehold land and buildings are all depreciated on a straight-line basis over the lease term.

Other tangible non-current assets

All other property, plant and equipment is carried at historical cost less accumulated depreciation and accumulated impairment losses.

Historical cost includes expenditure that is directly attributable to the acquisition of the items, the cost of replacing parts of the plant and equipment and borrowing costs capitalised in accordance with IAS 23 - Borrowing costs.

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Illustration (continued): Accounting policy – Property, plant and equipment

Depreciation is calculated using the straight-line method to allocate their cost or revalued amounts to their residual values over their estimated useful lives, as follows:

Buildings 35-50 years

Machinery 5 to15 years

Vehicles 3 years

Furniture, fittings and equipment 5 to 10 years

The residual values and useful lives of assets are reviewed on an annual basis and adjusted as appropriate.

Note from the above that there are two important areas where policies should be explained to users of financial statements. These are:

a) the depreciation policy; and

b) the policy for subsequent measurement of property, plant and equipment.

Depreciation policy

The depreciable amount of an asset must be written off over its useful life. Formulating a policy in this area involves:

a) estimating the useful lives of different categories of assets;

b) estimating residual values; and

c) choosing a method.

Policy for subsequent measurement

Formulating a policy in this area involves:

a) deciding whether to fair value any ssets

b) identifying classes of assets so that the policy can be applied to all assets in that class;

c) deciding on how to apply the IAS 16 guidance on frequency of revaluation; and

d) deciding how to change the carrying amount of the asset.

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Illustration: Accounting policy

Property, plant and equipment, except freehold land, are stated at cost less accumulated depreciation and any identified impairment loss.

Freehold land is stated at cost less any identified impairment loss.

Cost in relation to self-constructed assets includes direct cost of material, labour and applicable manufacturing overheads and borrowing costs on qualifying asset. Depreciation is charged to income, unless it is included in the carrying amount of another asset, on straight line method whereby cost of an asset is written off over Its estimated useful life at the rates given in note XX.

Residual value and the useful life of an asset are reviewed at least at each financial year-end.

Depreciation on additions is charged from the month in which an asset is acquired, while no depreciation is charged for the month in which the asset is disposed of.

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7.7 Multiple assets

Exam questions on property, plant and equipment usually involve multiple assets with the need to keep track of additions and disposals in a period.

In any one year the charge for depreciation will be made up as follows:

Illustration: Make-up of depreciation charge

	₦
Depreciation of assets held for the whole year (these are assets held at the start less disposals)	X
Depreciation of assets sold in the year (up to the date of sale)	X
Depreciation of assets bought in year (from the date of purchase)	X
Depreciation charge for the year	X

It is often useful to construct a working to calculate the depreciation charge for different components of the asset base.

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Example: Depreciation of several assets (straight line)

A business has entered into the following transactions involving plant and equipment over the last three years.

1 January 20 X 4	Bought several items of plant and equipment for ₦800,000.
30 June 20 X 5	Bought several items of plant and equipment for ₦500,000.
28 February 20 X 6	Bought several items of plant and equipment for ₦240,000.
31 March 20 X 6	Sold some of the items which it had purchased on 1 January 2 0 X 4. These items had cost ₦300,000.

The company depreciates assets on a straight-line basis at 10%per annum.

The depreciation in 20X4, 20X5 and 20X6 can be calculated as follows:

	Depreciation:		
	20X4	**20X5**	**20X6**
20 X 4 purchase (₦800,000)	80,000	80,000	
800,000 u 10%(20X4 and 20X5)			
In 20X6 this must be split:			
Assets retained: 500,000 x 10%			50,000
Assets sold: 300,000 x 10% x $^{3}/_{12}$			7,500
			57,500
20X5 purchase (₦500,000)			
500,000 x 10% x $^{6}/_{12}$		25,000	
500,000 x 10%			50,000
20X6 purchase (₦240,000)			
240,000 x 10% x $^{10}/_{12}$			20,000
Depreciation charge	80,000	105,000	127,500

Depreciation on the assets sold:

300,000 x 10% x 2.25(2+$^{3}/_{12}$) = ₦67,500

Examples are more complicated when depreciation is calculated using the reducing balance method.

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Example: Depreciation of several assets (reducing balance)

A business has entered into the following transactions involving plant and equipment over the last three years.

1 January 20 X 4	Bought several items of plant and equipment for ₦800,000.
30 June 20 X 5	Bought several items of plant and equipment for ₦500,000.
28 February 20 X 6	Bought several items of plant and equipment for ₦240,000.
31 March 20 X 6	Sold some of the items which it had purchased on 1 January 20 X 4. These items had cost ₦300,000.

The company depreciates assets using 20% reducing balance.

The depreciation in 20X4, 20X5 and 20X6 can be calculated as follows:

Depreciation:

	20X4	20X5	20X6
20 X 4 purchase (₦800,000)			
800,000 x 20%	160,000		
(800,000 – 160,000) x 20%		128,000	
In 20X6 the carrying amount of the asset (800,000 – 160,000 -128,000 = 512,000) must be split:			
Assets retained (512,000 x 500/800): 320,000 u20%			64,000
Assets sold:(512,000 x 300/800): 192,000 x 20% x 3/12			9,600
			73,600
20 X 5 purchase (₦500,000)			
500,000 x 20% x 6/12		50,000	
(500,000 – 50,000) x 20%			90,000
20X6 purchase (₦200,000)			
240,000 x 20% x 10/12			40,000
Depreciation charge	160,000	178,000	203.600

Depreciation on the assets sold:

	₦
300,000 x 20%	60,000
(300,000 – 60,000) x 20%	48,000
(300,000–60,000–48,000) x 20% x 3/12	9,600
	117,600

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Correcting errors

Questions might feature mistakes made in terms of a transaction incorrectly classified as capital or as repair.

Example: Error: Repair incorrectly capitalised

The balance on a business's plant account as at 31 December is as follows.

Cost	1,200,000
Accumulated depreciation	(500,000)
Carrying amount	700,000

The company has discovered that a repair which cost ₦200,000 was incorrectly capitalised on 31 July.

Depreciation is charged at 15% reducing balance.

Correction of the error:

The amount capitalised would have been depreciated so the amount must be removed from cost and the depreciation incorrectly charged must be removed.

The correcting journals are:	Dr	Cr
Statement of profit or loss: line item to which repairs are charged	200,000	
Plant – cost		200,000
and		
Accumulated depreciation (200,000 x 15% x 5/12)	12,500	
Statement of profit or loss: Depreciation expense		12,500

The impact on the carrying amount of the plant is as follows:

	Before (₦)		
Cost	1,200,000	(200,000)	1,000,000
Accumulated depreciation	(500,000)	12,500	(487,500)
Carrying amount	700,000		512,500

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Example: Errors: Asset incorrectly expensed

The balance on a business's plant account as at 31 December is as follows.

Cost	1,200,000
Accumulated depreciation	(500,000)
Carrying amount	700,000

The company has discovered that on 31 July an amount of ₦200,000 was charged to the statement of profit or loss but it should have been capitalised.

Depreciation is charged at 15% reducing balance.

Correction of the error:

The correcting journals are:	Dr	Cr
Plant – cost	200,000	
Statement of profit or loss: line item to which repairs are charged		200,000
and		
Statement of profit or loss: Depreciation expense	12,500	
Accumulated depreciation (200,000 x 15% x 5/12)		12,500

The impact on the carrying amount of the plant is as follows:

	Before (₦)		
Cost	1,200,000	200,000	1,400,000
Accumulated depreciation	(500,000)	(12,500)	(512,500)
Carrying amount	700,000		887,500

7.8 Chapter review

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

a) Measure property, plant and equipment on initial recognition;

b) Measure property, plant and equipment after initial recognition using the cost model and the revaluation model;

c) Account for disposals of property plant and equipment; and

d) Construct basic notes to the financial statements in respect of property plant and equipment.

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Solutions To Practice Questions

Solution **1**

Original depreciation = $(150{,}000 - 30{,}000)/10$ = ₦12,000 per annum

Carrying amount at start of year 5 = 150,000 – (12,000x3)

= ₦114,000

If the total useful life is anticipated to be7years then there are four years remaining.

Depreciation charge for year 5= $₦114{,}000/4$ = ₦28,500

Solution **2**

a

Building account

	₦(000)		₦(000)
Balance b/d	1,000		
Other comprehensive income (₦2m – ₦1m)	1,000	Balance c/d	2,000
	2,000		2,000
Balance b/d			

b

Accumulated depreciation

	₦(000)		₦(000)
Other comprehensive income	60	Balance b/d	60
	60		60

Other comprehensive income

YEAR 1	₦(000)		₦ (000)
		Building account	1.000
Balance c/d	1,060	Accumulated depreciation	60
	1,060		1,060
		Balance b/d	1,060

This balance would be transferred to a revaluation surplus account in equity.

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Solution **3**

Annual depreciation = ₦$^{(96,000-16,000)}/_{5years}$=

₦16,000. Monthly depreciation= ₦$^{16,000}/_{12}$=

	₦	₦
Disposal value less disposal costs		68,000
Cost of the asset	96,000	
Accumulated depreciation at the time of disposal (27months x ₦1,333.33)	(36,000)	
Carrying amount at the date of disposal		60,000
Gain on disposal		8,000

Solutions **4**

Annual depreciation= ₦$^{(216,000-24,000)}/_{8years}$= ₦24,000.

	₦	₦
Disposal value		163,000
Less disposal costs		(1,000)
		162,000
Accumulated depreciation at the time of disposal		
Year to 31 December Year 1:(₦24,000 x $^{7}/_{12}$)	14,000	
Years 2 and 3:(₦24,000 x 2years)	48,000	
Year to 31 December Year 4: (₦24,000 x $^{8}/_{12}$)	16,000	
	78,000	
Cost of the asset	216,000	
Carrying amount at the date of disposal		138,000
Gain on disposal		24,000

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Solution **5**

	₦	₦
Cost of the asset	80,000	
Year 1 depreciation (x 25%)	(20,000)	20,000
Carrying amount at end of Year 1	60,000	
Year 2 depreciation (x 25%)	(15,000)	15,000
Accumulated depreciation at date of disposal		35,000

b

Disposal account

	₦		₦
Motor vehicles account	80,000	Accumulated depreciation	35,000
Bank (disposal costs)	200	Receivables	41,000
		Statement of profit or loss (loss on disposal)	4,200
	80,200		80,200

Motor vehicles

	₦		₦
Opening balance b/d	720,000	Disposal of asset account	80,000
		Closing balance c/d	640,000
	720,000		720,000
Opening balance b/d	640,000		

c

Accumulated depreciation on motor vehicles

	₦		₦
Disposal of asset account	35,000	Opening balance b/f	250,000
Closing balance c/d	215,000		
	250,000		250,000
		Opening balance b/d	215,000

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Solution **6**

	₦	₦
Sale proceeds on disposal (part-exchange value)		8,000
Asset at cost	28,000	
Less: Accumulated depreciation	(18,000)	
Carrying amount at date of disposal		(10,000)
Loss on disposal		(2,000)

	₦		₦
Motor vehicles account	28,000	Disposal account	28,000
		Accumulated depreciation account	18,000
		Motor vehicles account (Trade-in value)	8,000
			2,000
	28,000		28,000

b Motor vehicles

	₦		₦
Opening balance	120,000	Disposal account	28,000
Bank (31,000 – 8,000)	23,000		
Disposal of asset account	8,000	Closing balance	123,000
	151,000		151,000
Opening balance	151,000		

c Accumulated depreciation on motor vehicles

	₦		₦
Disposal account	18,000	Opening balance	64,000
Closing balance	46,000		
	64,000		64,000
		Opening balance	46,000

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7.9 End of chapter questions and suggested solution

7.9.1 Questions

Question 1

IAS 16 prescribes the principles and the valuation methods in recognizing items of property, plant and equipment in financial statements of an entity. Describe the TWO methods of valuation recognised in IAS 16 on property, plant and equipment.

Question 2

Noodles Nigeria Limited (NNL) manufactures various type of noodles in Oluyole for sale across the states in Nigeria. Recently, to continue to sustain leadership of the company in the Nigerian market, on September 1 2015; a brand new machine was bought from a supplier under the following conditions:

	₦'000
Supplier's invoice price	500,000
Trade discount applicable to invoice price	25%
Discount applicable on invoice price for early settlements	5%
Freight and shipment cost	100,000
Stevedore expenses	20,000
Initial operating losses	10,000
Handling cost	15,000
Electrical and installation cost	25,000
Interest on loan to the point of usage	12,000
Interest on loan after the usage	18,000
Pre-operation expenses	5,000
Staff training in use of the machine	4,000
Professional and consultancy fee on advice to buy the machine	30,000
Purchase of a four-year maintenance contract	120,000
Pre-production testing cost	13,000
Estimated residual value	90,000

Estimated useful life in machine output/units 5,000,000

Actual output	Y/E 31/8/2016	Y/E 31/8/2017	Y/E 31/8/2018	Y/E 31/8/2019
	'000	'000	'000	'000
Outputs/units	1,000	1,200	1,400	800

On September 1, 2016, NNL Limited decided to upgrade the machine by adding new major components at a cost of N300, 000,000. As a result of the new upgrade, there was an increase in the remaining useful life of the output to 8,000,000 units on September 1, 2016 and the residual value of the machine was revised to N114, 000,000.

Required:

a. Describe what is meant by depreciable amount within the context of IAS 16 on property, plant and equipment (PPE).

b. Highlight THREE characteristics of depreciable assets under IAS 16.

c. Describe the TWO models of accounting for cost of property, plant and equipment (PPE) under IAS 16.

Calculate the following:

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a) Machine cost.

b) Revenue expenditure over the years in the statement of profit or loss.

c) Carrying amounts of the machine over the years.

Solution 1

Models of valuation recognised in IAS 16 – Property, Plant and Equipment. All items of property, plant and equipment in a class can be accounted for using one of two models:

18 Cost model - Property, plant and equipment are carried at cost less any accumulated depreciation and any accumulated impairment losses; and

ii. Revaluation model - Property, plant and equipment are 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.

Solution 2

- The Depreciable amount is the cost of an asset, or other amount substituted for cost (in the financial statements), less its residual value i.e. Cost less residual value.

- **Characteristics of depreciable assets**
  - It must have a limited useful life.
  - The useful life must be more than 1 year.
  - It must be acquired for production of goods and services of the entity.
  - Must not have intention of selling it in the ordinary course of business.

- **Models of accounting for cost of PPE**

  IAS 16 allows a choice of accounting treatments after initial recognition. All items of property, plant and equipment in a class can be accounted for using one of two models:

  - Cost model: Under this model, property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses.
  - Revaluation model: Under this 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.

- **Computation of cost of the machine as at:**

September 1, 2015	₦'000
Suppliers invoice price	500,000
Trade discount to invoice price at 25%	(125,000)
Freight and shipment cost	100,000
Stevedore expenses	20,000

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Handling cost	15,000
Electrical and installation cost	25,000
Professional and consultancy fee	30,000
Pre-production testing cost	13,000
	578,000

Subsequent measure as at September 1, 2016	₦'000
Carrying value after year 1 (i.e. 31/08/2016)	480,400
Upgrade expenditure	300,000
	780,000

(ii) **Revenue expenditure over the years in the financial statement**

(iii) **Computation of carrying amount of the machine over the years**

	2016	2017	2018	2019
	₦'000	₦'000	₦'000	₦'000
Depreciation	97,600	199,920	233,240	133,280
Initial operating losses	10,000			
Interest on loan after usage	18,000			
Pre-operational expenses	5,000			
Staff training	40,000			
Maintenance contract	30,000	30,000	30,000	30,000
	212,600	229,920	263,249	163,280

	Depreciable Amount ₦'000	Output 000	Workings	Depreciation ₦'000	Carrying amount ₦'000
Depreciable amount 578m – 90m	488,000				
Total output		5,000			
Year 1 – 2016		1,000	1,000/5,000 * 488m	97,600	570,400
Depreciable amount = 780.4m – 114m	666,400				
Total output		8,000			
Year 2 – 2017		2,400	2,400/8,000 * 666.4m	199,920	580,400
Year 2 – 2018		2,800	2,800/8,000 * 666.4m	233,240	347,240
Year 4 – 2019		1,600	1,600/8000 * 666.4m	133,280	213,960
Year 5 - 2020		1,200	1200/8000 * 666.4m	99,960	114,000

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CHAPTER 8

NON-CURRENT ASSETS: SUNDRY STANDARDS

Contents

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8 Non-Current Assets: Sundry Standards

8.0 Learning objective

This chapter covers treatment of Non-Current Assets, borrowing costs, government grants and assistance and investment properties.

8.1 Learning outcomes

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

a. identify borrowing costs;

b. measure borrowing costs;

c. capitalise borrowing costs that relate to the production of quality in gas sets;

d. account for government grants related to income;

e. account for government grants related to assets;

f. define investment property; and

g. account for investment property using one of the two permitted methods.

8.2 IAS 23: Borrowing Costs

8.2.1 Introduction

A company might incur significant interest costs if it has to raise a loan to finance the purchase or construction of an asset. *IAS 23: Borrowing costs* defines borrowing costs and sets guidance on the circumstances under which are to be capitalised as part of the cost of qualifying assets.

Definition: Borrowing costs

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

Definition: Qualifying asset

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

Any of the following may be qualifying assets depending on circumstances:

a) inventories;

b) items of property, plant and equipment; and

c) intangible assets.

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The following are not qualifying assets:

a) inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets; and

b) assets that are ready for their intended use or sale when acquired. Qualifying assets are usually self-constructed non-current assets.

8.5.2 Borrowing costs eligible for capitalisation

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset must be capitalised as part of the cost of that asset. All other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those that would have been avoided if the expenditure on the qualifying asset had not been made.

This includes the costs associated with specific loans taken to fund the production or purchase of an asset and general borrowings. General borrowings are included because if an asset were not being constructed it stands to reason that there would have been a lower need for cash.

Funds specifically borrowed to obtain a qualifying asset

When a specific loan is taken in order to obtain a qualifying asset the borrowing costs eligible for capitalisation are the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

Example: Specific borrowings

On 1 January 20 X 9 Owerri Engineering issued a bond to raise ₦25,000,000 to fund a capital project which will take three years to complete.

Amounts not yet needed for the project are invested on a temporary basis.

During the year to 31 December 20 X 9, Owerri Engineering spent ₦9,000,000 on the project.

The cost of servicing the bond was ₦1,250,000 during this period and the company was able to earn ₦780,000 through the temporary reinvestment of the amount borrowed.

The amounts recognised as capital work in progress in the period was:

Costs incurred (labour, material, overhead etc.)	9,000,000
Interest capitalised:	
Actual interest cost	1,250,000
Less: return on temporary investment	(780,000)
	470,000
Additions to capital work in progress	9,470,000

General funds used for the purpose of obtaining a qualifying asset

When general borrowings are used the amount of borrowing costs eligible for capitalisation is obtained by applying a capitalisation rate to the expenditures on that asset.

The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings that are outstanding during the period except for borrowings made

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specifically for the purpose of obtaining a qualifying asset.
The amount of borrowing costs capitalised cannot exceed the amount of borrowing costs it incurred during a period.

Example: General borrowings: Capitalisation rate

Shaki Construction has three sources of borrowing:

	Average loan in the year(₦)	Interest expense incurred in the year(₦)
7-year loan	8,000,000	800,000
10-year loan	10,000,000	900,000
Bank overdraft	5,000,000	900,000

The 7-year loan has been specifically raised to fund the building of a qualifying asset.

A suitable capitalisation rate for other projects is found as follows:

	Average loan in the year(₦)	Interest expense incurred in the year (₦)
10-year loan	10,000,000	900,000
Bank overdraft	5,000,000	900,000
	15,000,000	1,800,000

Capitalisation rate = $^{1,800,000}/_{15,000,000}$ x 100 = 12%

Alternatively:

Rate on 10-year loan = $^{900,000}/_{10,000,000}$ x 100=9%

Rate on bank overdraft = $^{900,000}/_{5,000,000}$ x 100=18%

Weighted average: $\left(9\% \times {}^{10,000,000}/_{15,000,000}\right) + \left(18\% \times {}^{5,000,000}/_{15,000,000}\right)$

6% + 6% = 12%

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The capitalisation rate is applied from the time expenditure on the asset is incurred.

Example: General borrowings: Capitalisation rate

Continuing the example above, Shaki Construction has incurred the following expenditure on a project funded from general borrowings for year ended 31 December 20X9.

Date incurred:	**Amount (₦)**
31st March	1,000,000
31st July	1,200,000
30th October	800,000

The amount capitalised in respect of capital work in progress during 20X9 is as follows:

	₦
31st March – Expenditure	1,000,000
Interest (1,000,000 x 12% x 9/12)	90,000
31st July –Expenditure	1,200,000
Interest (1,200,000 x 12% x 5/12)	60,000
30th October –Expenditure	800,000
Interest (800,000 x 12% x 2/12)	16,000
	3,166,000

8.5.3 Period of capitalisation

Commencement of capitalisation

Capitalisation of borrowing costs should start only when:

a) expenditures for the asset are being incurred; and

b) borrowing costs are being incurred, and

c) activities necessary to prepare the asset have started.

Suspension of capitalisation

Capitalisation of borrowing costs should be suspended if development of the asset is suspended for an extended period of time.

Cessation of capitalisation

Capitalisation of borrowing costs should cease when the asset is substantially complete. The costs that have already been capitalised remain as a part of the asset's cost, but no additional borrowing costs may be capitalised.

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8.3 IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

8.3.1 Introduction and definitions

In many countries the government provides financial assistance to industry.

Definition: Government assistance

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

Government assistance takes many forms varying both in the nature of the assistance given and in the conditions which are usually attached to it. The purpose of the assistance may be to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided.

Government assistance does not include benefits provided only indirectly through action affecting general trading conditions (e.g., provision of infrastructure in development areas).

A common form of government assistance is a government grant.

Definition: Government grant

Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

A government grant may take a variety of forms, including:

a) a receipt of cash;

b) a reduction in a liability;

c) the benefit of a low interest rate loan; or

d) a forgivable loan from the government.

Definition: Forgivable loans

Forgivable loans are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

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The form of the grant does not affect how it is accounted for.

8.5.4 Accounting treatment of government grants

A grant must not be recognised until there is reasonable assurance that:

a) the entity will comply with any conditions attaching to the grant; and

b) the grant will be received.

Once these recognition criteria are met, the grants should be recognised in profit or loss over the periods necessary to match them with their related costs.

IAS 20 defines the following two types of government grant based on the purpose for which the grant is given:

a) grants related to assets; and

b) grants related to income.

Definition: Types of government grant

Grants related to assets: are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long- term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

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

In most cases the periods over which the costs or expenses related to a government grant are recognised are readily ascertainable.

a) Grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses.

b) Grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.

Both types of grants must be reported on a systematic basis through the statement of profit or loss (profit or loss).

Grants related to income

For grants related to income, IAS 20 states that an 'income approach' should be used, and the grant should be taken to income over the periods necessary to match the grant with the costs that the grant is intended to compensate.

IAS 20 allows two methods of doing this:

a) **Method 1**. Include the grant for the period as 'other income' forinclusion on profit or loss for the period

b) **Method 2**. Deduct the grant for the period from the related expense.

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Example: Grant related to income

A company receives a cash grant of ₦30,000 on 31 December Year 0.

The grant is towards the cost of training young apprentices, and the training programme is expected to last for 18 months from 1 January Year 1.

Actual costs of the training were ₦50,000 in Year 1 and ₦25,000 in Year 2.

The grant would be accounted for as follows:

At 31 December Year 0 the grant would be recognised as a liability and presented in the statement of financial position split between current and non- current amounts. ₦20,000 (12months/18months u ₦30,000) is current and would be recognised in profit **for Year1**. The balance is non-current.

At the end of year 1 there would be a current balance of ₦10,000 (being the non- current balance at the end of Year 0 reclassified as current) in the statement of financial position. This would be recognized in profit in Year 2.

Extracts from the financial statements are as follows:
Statement of financial position (extracts)

	31 December Year 0	31 December Year 1	31 December Year 2
Current liabilities			
Deferred income	20,000	10,000	–
Non-current liabilities			
Deferred income	10,000	–	–

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Statement of profit or loss (extracts)

	31 December Year 1	31 December Year 2
Method 1		
Training costs	(50,000)	(25,000)
Government grant received	20,000	10,000
Method 2		
Training costs (50,000 – 20,000)	30,000	
Training costs (25,000 – 10,000)		15,000

Grants related to assets

For grants related to assets, IAS 20 allows two methods of doing this:

a) **Method 1**. Deduct the grant from the cost of the related asset. The asset is included in the statement of financial position at cost minus the grant.
Depreciate the net amount over the useful life of the asset.

b) **Method 2**. Treat the grant as deferred income and recognise it as income on a systematic basis over the useful life of the asset.

These two methods achieve the same effective result.

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Example: Grant related to an asset

A company receives a government grant of ₦400,000 towards the cost of an asset with a cost of ₦1,000,000.

The asset has an estimated useful life of 10 years and no residual value.

The amounts could be reflected in the financial statements prepared at the end of Year 1 in accordance with IAS 20 in the following ways:

Method 1:

Statement of financial position (extract)

Property, plant and equipment	₦
Cost (1,000,000 – 400,000)	600,000
Accumulated depreciation	(60,000)
Carrying amount	540,000

Included in statement of profit or loss (extract)	₦
Depreciation charge(₦600,000/10years)	60,000

Method2:

Statement of financial position (extract)

Property, plant and equipment	₦
Cost	1,000,000
Accumulated depreciation	(100,000)
Carrying amount	900,000
Current liabilities Deferred income	40,000
Non-current liabilities	
Deferred income	320,000

At the end of year 1 there would be ₦360,000 of the grant left to recognise in profit in the future at ₦40,000per annum. ₦40,000 would be recognised in the next year and is therefore current. The balance is non-current.

Included in statement of profit or loss (extract)	₦
Expense: Depreciation charge(₦1,000,000/10years)	(100,000)
Income: Government grant (₦$^{400,000}/_{10\text{years}}$)	40,000

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Practice questions **1**

On January Year 1 Entity O purchased a non-current asset with a cost of ₦500,000 and received a grant of ₦100,000 in relation to that asset.

The asset is being depreciated on a straight-line basis over five years.

Show how the asset and the grant would be reflected in the financial statements at the end of the first year under both methods of accounting for the grant allowed by IAS 20.

Grant received/receivable subject to conditions already met

A government grant may be awarded to in order to provide immediate financial support rather than as incentive to undertake specific expenditures or as compensation for expenses already incurred in a previous period.

In these cases, the double entry would be as follows:

Illustration: Double entry – grant with no conditions to meet

	Debit	Credit
Cash/receivable	X	
Statement of profit or loss		X

8.3.5 Repayment of government grants

A government grant may become repayable. In this case it is accounted for as a change in accounting estimate (***IAS 8:*** *Accounting policies, changes in accounting estimates and errors*).

A repayment of a grant related to income is first applied against any unamortised deferred credit recognised in respect of the grant with any difference recognised immediately in profit or loss.

A repayment of a grant related to an asset is accounted for as follows:

a) If the grant has been recognised as a reduction of the cost of the asset the repayment increases its carrying amount;

b) If the grant has been recognised as deferred income the repayment reduces the deferred income balance.

c) In either case the extra depreciation that would have been recognised in profit or loss to date in the absence of the grant is recognised immediately in profit or loss.

Circumstances giving rise to repayment of a grant related to an asset might be an indication of impairment of the asset. In this case the rules *in* ***IAS 36*** *Impairment of assets* apply.

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Example: Repayment of a grant related to an asset (deducted from the cost of the asset)

A company received a government grant of ₦400,000 towards the cost of an asset with a cost of ₦1,000,000.

The asset has an estimated useful life of 10 years and no residual value. The company deducted the grant from the cost of the asset.

Three years after the asset was purchased the company discovered an irregularity in their original application for the grant. As a result of this the company was required to repay the grant to the government.

Carrying amount of the asset before repayment:

Property, plant and equipment	₦
Cost (1,000,000 – 400,000)	600,000
Accumulated depreciation (3 x 60,000)	(180,000)
Carrying amount	420,000

Double entry on repayment:

	Dr	Cr
Property, plant and equipment	400,000	
Cash		400,000

The company has recognised a depreciation expense for this asset of ₦180,000 over the last three years.

If the grant had not been received the company would have recognised a depreciation expense of ₦300,000 over this period.

This is ₦120,000 more than they have recognised due to the original accounting for the grant.

Double entry to account for extra depreciation

	Dr	Cr
Profit or loss	120,000	
Property, plant and equipment		120,000

Summary: carrying amount after the adjustment would be:

	₦
Carrying amount before adjustments	420,000
Repayment of grant	400,000
Adjustment to depreciation	(120,000)
Carrying amount after the adjustment	700,000

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Example: Repayment of a grant related to an asset (recognised as deferred income)

A company received a government grant of ₦400,000 towards the cost of an asset with a cost of ₦1,000,000.

The asset has an estimated useful life of 10 years and no residual value. The company recognised the grant as deferred income.

Three years after the asset was purchased the company discovered an irregularity in their original application for the grant. As a result of this the company was required to repay the grant to the government.

Carrying amounts of the asset and deferred income before repayment carrying

	At start	Recognised over last 3 years	amounts before repayment
Asset	1,000,000	(300,000)	700,000
Deferred income	(400,000)	120,000	(280,000)
Net amount	600,000	(180,000)	420,000

Double entry on repayment:

	Dr	Cr
Deferred income	400,000	
Cash		400,000

The company has recognised a net expense for this asset of ₦180,000 over the last three years.

If the grant had not been received the company would have recognized a depreciation expense of ₦300,000 over this period.

This is ₦120,000 more than they have recognized due to the original accounting for the grant.

Double entry to account for extra depreciation

	Dr	Cr
Profit or loss	120,000	
Deferred income		120,000

Summary: deferred income balance after the adjustment would be: ₦

Carrying amount before adjustments	(280,000)
Repayment of grant	400,000
Adjustment to depreciation	(120,000)
Carrying amount after the adjustment	nil

:

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Non-monetary government grants

A government grant may take the form of a transfer of a non-monetary asset (e.g., airport landing rights, import quotas etc.).

In these cases, both the grant and the asset can be measured either at:

a) fair value; or

b) a nominal amount.

8.3.5 Disclosure requirements

IAS 20 requires the following disclosures in the notes to the financial statements:

a) the accounting policy adopted for government grants, including the method of presentation in the financial statements;

b) the nature and extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited; and

c) unfulfilled conditions and other contingencies attaching to government assistance (if this assistance has been recognised in the financial statements).

Government assistance

The following forms of government assistance are excluded from the definition of government grants:

a) Assistance which cannot reasonably have a value placed upon them (e.g., free technical or marketing advice); and

b) Transactions with government which cannot be distinguished from the normal trading transactions (e.g., a government procurement policy that is responsible for a portion of sales).

It might be necessary to disclose the nature, extent and duration of the assistance in order that the financial statements may not be misleading when the impact of the assistance is significant.

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8.4 IAS 40: Investment Property

8.4.1 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.

Investment property differs from other property, which is:

a) used in the production or supply of goods, or for administrative purposes; or

b) held for sale in the ordinary course of business.

Investment property includes the building, whilst it is under construction for eventual use as an investment property.

The property could be owned or held under a lease. The following are **not** investment property:

a) property intended for sale in the ordinary course of business;

b) property being constructed or developed on behalf of third parties; or

c) owner-occupied property.

8.4.2 Accounting treatment of investment property

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:

a) it is probable that future economic benefits associated with the property will flow to the entity, and

b) 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.

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Measurement after recognition
After initial recognition an entity may choose as its accounting policy:

a) the fair value model, or

b) 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.

Fair value model for investment property

Under the **fair value model** the entity should:

a) revalue all its investment property to 'fair value' (open market value) at the end of each financial year, and

b) recognise any resulting gain or loss in profit or loss for the period. The property would not be depreciated.

This is different to the revaluation model of IAS 16, where gains are reported as other comprehensive income and accumulated as a revaluation surplus.

Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".

If it is not possible to arrive at a reliable fair value figure then the cost model should be adopted. This is an exception to the rule that **all** investment property must be valued under either one model or the other.

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Cost model for investment property

The **cost model** follows the provisions of IAS 16. The property is valued at cost and the non-land element is depreciated.

Example: Accounting for investment property

On 1 January Year 1 Entity P purchased a building for its investment potential. The building cost ₦1million with transaction costs of ₦10,000.

The depreciable amount of the building component of the property at this date was ₦300,000.

The property has a useful life of 50 years.

At the end of Year 1 the property's fair value had risen to ₦1.3 million.

The amounts which would be included in the financial statements of Entity P at 31 December Year 1, under the cost model are as follows:

Cost model

The property will be included in the statement of financial position as follows:

	₦
Cost (1,000,000 + 10,000)	1,010,000
Accumulated depreciation (300,000 ÷ 50 years)	(6,000)
Carrying amount	1,004,000

The statement of profit or loss will include depreciation of ₦6,000.

The amounts which would be included in the financial statements of Entity P at 31 December Year 1, under the fair value model are as follows:

Fair value model

The property will be included in the statement of financial position at its fair value of ₦1,300,000.

The statement of profit or loss will include again of ₦290,000 (₦1,300,000 – ₦1,010,000) in respect of the fair value adjustment.

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8.4.5 Why investment properties are treated differently from other properties

Most properties are held to be used directly or indirectly in the entity's business. For example, a factory houses plant and equipment which is used to produce goods for sale. The property is being consumed, and it is appropriate to depreciate it over its useful life.

An investment property also differs from other properties because it generates revenue and cash flows largely independently of other assets held by an entity.

Furthermore, an investment property is held because it is expected to generate wealth through rental income and capital appreciation. The fair value model is based on the idea that rental income and changes in fair value are inextricably linked as integral components of the financial performance of an investment property and measurement at fair value is necessary if that financial performance is to be reported in a meaningful way.

The most relevant information about an investment property is its fair value (the amount for which it could be sold). Depreciation is largely irrelevant. Therefore, it is appropriate to re-measure an investment property to fair value each year and to recognise gains and losses in profit or loss for the period.

IAS 40 allows a choice of accounting treatment for two reasons. Firstly, in order to give preparers and users time to gain experience in using a fair value model and secondly, to allow time for countries with less developed property market and valuation professions to mature.

8.4.6 Transfers and disposals of investment property

If a property is transferred into or out of this category it must be reclassified as an investment property or as no longer being an investment property. A transfer of investment property can only be made where there is a change of use as illustrated below. A change of use must be evidenced (e.g., commencement of owner occupation) rather than merely be a change in management's intention.

Circumstance	Transfer to/from	Deemed transfer value
Commencement of owner-occupation	Transfer from investment property to owner-occupied property	Fair value at the date of change of use becomes the deemed cost for future accounting purposes
End of owner-occupation	Transfer from owner-occupied property to investment property	Where investment properties are measured at fair value, revalue in accordance with IAS 16 prior to the transfer
Commencement of development with a view to sale	Transfer from investment property to inventories	Fair value at the date of change of use becomes the deemed cost for future accounting purposes
Commencement of a lease to another party	Transfer from inventories to investment	Fair value at the date of the transfer, and any difference compared to previous carrying amount is

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Gain or loss on disposal

Gains or losses on disposals of investment properties are included in profit or loss in the period in which the disposal occurs.

Example: Disposal of investment property

The investment property in the previous example was sold early in Year 2 for ₦1,550,000,

Selling costs were ₦50,000. **Required**

The amount that would be included in the statement of profit or loss for Year 2 in respect of this disposal under the cost model is as follows:

Cost model	₦
Sale value	1,550,000
Selling costs	(50,000)
Net disposal proceeds	1,500,000
Minus: Carrying amount	(1,004,000)
Gain on disposal	496,000

The amount that would be included in the statement of profit or loss for Year 2 in respect of this disposal under the fair value model is as follows:

(**Fair value model**	₦
Sale value	1,550,000
Selling costs	(50,000)
Net disposal proceeds	1,500,000
Minus: Carrying amount	(1,300,000)
Gain on disposal	200,000

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Disclosure requirements

The following disclosures are required by IAS 40 in the notes to the accounts.

Disclosure requirements applicable to both the fair value model and the cost model

a) whether the fair value model or the cost model is used.

b) the methods and assumptions applied in arriving at fair values.

c) the extent to which the fair value of investment property was based on a valuation by a qualified, independent valuer with relevant, recent experience.

Amounts recognised in income or expense in the statement of profit or loss for:

a) rental income from investment property;

b) operating expenses in relation to investment property;

c) details of any restrictions on the ability to realise investment property or any restrictions on the remittance of income or disposal proceeds; and

d) the existence of any contractual obligation to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

Disclosure requirements applicable to the fair value model only

There must be a reconciliation, in a note to the financial statements, between opening and closing values for investment property, showing:

a) additions during the year;

b) assets classified as held for sale in accordance with IFRS 5;

c) net gains or losses from fair value adjustments; and

d) acquisitions through business combinations.

This reconciliation should show separately any amounts in respect of investment properties included at cost because their fair values cannot be estimated reliably.

For investment properties included at cost because fair values cannot be estimated reliably, the following should also be disclosed:

a) a description of the property;

b) an explanation as to why fair values cannot be determined reliably; and

c) if possible, the range within which the property's fair value is likely to lie.

Disclosure requirements applicable to the cost model only

a. The depreciation methods used.

b. The useful lives or depreciation rates used.

c. Gross carrying amounts and accumulated depreciation at the beginning and at the end of the period.

A reconciliation between opening and closing values showing:

a) additions

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b) depreciation

c) assets classified as held for sale in accordance with IFRS5

d) acquisitions through business combinations

e) impairment losses

f) transfers.

When the cost model is used, the fair value of investment property should also be disclosed. If the fair value cannot be estimated reliably, the same additional disclosures should be made as under the fair value model.

8.5 Chapter review

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

a) Identify borrowing costs;

b) Measure borrowing costs;

c) Capitalise borrowing costs that relate to the production of qualifying assets;

d) Account for government grants related to income;

e) Account for government grants related to assets;

f) Define investment property; and

g) Account for investment property using one or two permitted method.

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SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

The amounts could be reflected in the financial statements prepared at the end of Year 1 in accordance with IAS 20 in the following ways:

Method 1:

Statement of financial position

Property, plant and equipment	₦
Cost (500,000 – 100,000)	400,000
Accumulated depreciation	(80,000)
Carrying amount	320,000

Included in statement of profit or loss	₦
Depreciation charge (₦400,000/5years)	80,000

Method 2:

Statement of financial position

Property, plant and equipment	
Cost	500,000
Accumulated depreciation	(100,000)
Carrying amount	₦400,000
Current liabilities Deferred income	20,000
Non-current liabilities	
Deferred income	60,000

At the end of year 1 there would be ₦80,000 of the grant left to recognise in profit in the future at ₦20,000 per annum. ₦20,000 would be recognised in the next year and is therefore current. The balance is non-current

Included in statement of profit or loss	₦
Expense: Depreciation charge (₦500,000/5years)	(100,000)
Income: Government grant (₦100,000/5years)	20,000

8.6 End of chapter questions and suggested solutions

8.6.1 Questions

Question 1: Capitalisation of Borrowing Costs

On 1 January 20X6, Salawu Co secured a ₦1.5 million general-purpose borrowing facility at an annual interest rate of 9%, specifically to finance the construction of two qualifying assets — Asset

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Ami and Asset Edu. Both assets met the criteria for recognition as qualifying assets under IAS 23 (Borrowing Costs) and were expected to take approximately 12 months to complete. Construction activities commenced on both projects on 1 January 20X6.

The drawdown and utilisation of the loan occurred in two tranches. On 1 January 20X6, ₦250,000 was allocated to Asset Ami and ₦500,000 to Asset Edu. A second tranche was disbursed on 1 July 20X6, with an additional ₦250,000 allocated to Asset Ami and ₦500,000 to Asset Edu. By the end of the financial year, the total expenditure amounted to ₦500,000 for Asset Ami and ₦1,000,000 for Asset Edu. Unutilised loan funds were temporarily invested at an annual return of 7% throughout the year.

Additional Information:

a) Salawu Co applies the weighted-average expenditure method for capitalising borrowing costs.

b) Ignore the effects of compounding interest.

c) The reporting period ends on December 31, 20X6.

Required:

Prepare a computation to determine:

a) The amount of borrowing costs eligible for capitalisation in accordance with IAS 23 for each of the qualifying assets (Asset Ami and Asset Edu).

b) The total capitalised cost of each asset as at December 31, 20X6.

All workings must be clearly shown and appropriately labelled.

Question 2

a. The Federal Government of Nigeria is committed to improving Medium, Small and Micro Enterprises (MSME) programme. In view of this, the government issued directives to the Central Bank of Nigeria (CBN) to give grants to MSME that has at least 25% local equity participation.

Required:

a. Explain the TWO types of grant/government assistance that are recognised by IAS 20 on accounting for government grants and disclosure of government assistance.

b. Outline the TWO methods of presenting grant/government assistance that are recognised by IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance.

c. During the year ended June 30, 2019, Gbogbonise Enterprises having qualified for the 25% local equity participation, received the following grants from Central Bank of Nigeria (CBN).

i. On September 1, 2018, a grant of ₦1million was received from CBN. The grant was in respect of training casual workers. The training cost incurred by Gbogbonise Enterprises in this respect, was ₦1.75million.

ii. On November 1, 2018, Gbogbonise Enterprises acquired plant and equipment costing

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₦8.75million and received a grant of N2.5million from Central Bank of Nigeria (CBN) in respect of the purchase. The plant and equipment which has a residual value of N1.25million is depreciated on straight line basis over its useful life of 5 years.

iii. On June 1, 2019, a grant of ₦2.5million was made by CBN. The grant was in respect of the relocation costs that Gbogbonise Enterprises had incurred for the movement of its business to a free trade zone allocated to

iv. Medium, Small and Micro Enterprises (MSME). The grant is repayable in full unless Gbogbonise Enterprises recruits at least one hundred (100) employees from the free trade zone local area by the end of the month of June 2019. Gbogbonise is finding it difficult to recruit this number of employees in the local area.

Required:
Prepare extracts of statement of financial position and statement of profit or loss of Gbogbonise Enterprises for the year ended June 30, 2019, using the two methods of presenting grants in the financial statement of business entities.

8.6.2 Suggested solutions

Solution 1:
Capitalisation of Borrowing Costs under IAS 23
Step 1: Understand the Setup

a) Loan Amount = ₦1,500,000
b) Interest Rate on Loan = 9%
c) Investment Rate on Surplus = 7%
d) Period = 1 January – 31 December 20X6 (full year)
e) No compound interest; simple interest only.

Step 2: Analyse the Expenditures

Date	Expenditure on Ami (₦)	Expenditure on Edu (₦)	Total (₦)
1 Jan 20X6	250,000	500,000	750,000
1 Jul 20X6	250,000	500,000	750,000
Total	500,000	1,000,000	1,500,000

Step 3: Calculate Weighted Average Expenditure

Asset Ami:

a. 1 Jan: ₦250,000 × 12/12 = ₦250,000
b. 1 Jul: ₦250,000 × 6/12 = ₦125,000
c. Weighted Average = ₦375,000

Asset Edu:

a. 1 Jan: ₦500,000 × 12/12 = ₦500,000
b. 1 Jul: ₦500,000 × 6/12 = ₦250,000
c. Weighted Average = ₦750,000

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Step 4: Total Borrowing Cost Incurred
Interest = ₦1,500,000 × 9% = ₦135,000
Step 5: Less: Investment Income on Surplus Funds
Investment Income = ₦750,000 × 7% × 6/12 = ₦26,250
Step 6: Net Borrowing Cost Eligible for Capitalisation
Net Capitalisable Borrowing Cost = ₦135,000 – ₦26,250 = ₦108,750

Step 7: Apportion Borrowing Cost to Assets
Total Weighted Average = ₦1,125,000

Asset Ami: (₦375,000 / ₦1,125,000) × ₦108,750 = ₦36,250
Asset Edu: (₦750,000 / ₦1,125,000) × ₦108,750 = ₦72,500

Step 8: Final Cost of Each Asset

Asset	Expenditure (₦)	Capitalised Borrowing Cost (₦)	Total Cost (₦)
Ami	500,000	36,250	536,250
Edu	1,000,000	72,500	1,072,500

Solution 2

a) Two types of government grant in line with IAS 20 are:

a. Grant related to assets: This is a type of grants by the government to assist the qualifying companies in the acquisition of a particular asset. It can be accounted for in the statement of financial position, using any of the following two ways:

b. Deduct the grant from the original cost of the assets: Under this, the amount of government grants received will be deducted from the cost of the assets and the depreciation will be based on the reduced cost.

c. Set up grant as deferred income: Under this, the asset will be accounted for as if there were no grants, while the grants will be recognized as an income over the estimated useful life of the asset.

Grants related to income: This is a type of grant by government which is not meant to acquire a particular asset.
It is an income grant to finance the operations of the company.
It is recognised in the income statement in the period received or when deemed to have been received.

b. The two methods of presenting grants in line with IAS 20 are:

a. **Capital approach**: Under this approach, the grants are regarded as a financing device and as result credited directly to equity in the statement of financial position. This implies that the grants are not earned, they are incentives without related cost and should not be taken to profit or loss.

b. **Income approach**: Under this approach, the grants are regarded as an income and not capital. They are not received from shareholders, hence should not be credited directly to equity.

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(b) Method 1 – (net grants off related expenditure) i.e. capital approach

(i) Gbogbonise enterprises statement of financial position (extract) AS AT JUNE 30, 2019

Non-current assets	₦'000
Property plant and equipment. (w1)	5,583
Current liabilities	
Other current liabilities	2,500

(w1) Working notes	₦'000
PPE – Cost (8,750 – 2,500)	6,250
Accumulated depreciation (8,750 – 2,500) ÷ 5 8/12)	(667)
	5,583

Gbogbonise enterprises
Statement of profit or loss (extract) for the year ended June 30, 2019

	N"000
Depreciation charged	667
Training (1.75 – 1)	750

Method 2 – Showing grants separately from related expenditure
Gbogbonise enterprises i.e. income approach
Statement of financial position (extract) as at June 30, 2019

Non-current assets	₦'000
Property plant & equipment (w2)	7,750
Current liabilities	
Other current liabilities (w3)	4,667

Working Notes:	₦'000
(w2) PPE – Cost	8,750
Accumulated depreciation (8,750 – 1,250) ÷ 5 x 8/12	(1,000)
	7,750
(w3) Other current liabilities	
Deferred Income relating to Govt. Grant (2,500 –(2,500 ÷ 5 x 8/12)	2,167
Government grants repayable	2,500
	4,667

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Skills Level
Financial Reporting

CHAPTER 9

IAS 38: INTANGIBLE ASSETS

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9 IAS 38: Intangible Assets

9.0 Learning Objective

This chapter covers the treatment of intangible assets under IAS 38.

9.1 Learning outcomes

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

a) Explain and apply the recognition rules to intangible assets acquired in different ways;

b) Measure intangible assets on initial recognition; and

c) Measure intangible assets after initial recognition using the cost model and the revaluation model.

9.2 Introduction

IAS 38: Intangible assets set out rules on the recognition, measurement and disclosure of intangible assets.

IAS 38 establishes similar rules for intangible assets to those set out elsewhere (mainly in IAS 16) for tangible assets. It was developed from the viewpoint that an asset is an asset so there should be no real difference in how tangible and intangible assets are accounted for. However, there is an acknowledgement that it can be more difficult to identify the existence of an intangible asset, so IAS 38 gives broader guidance on how to do this when an intangible asset is acquired through a variety of means.

9.3 IAS 38: Intangible Assets

a) requires intangible assets to be recognised in the financial statements if, and only if, specified criteria are met and explains how these are applied, however an intangible asset is acquired.

b) A key issue with expenditure on 'intangible items' is whether it should be treated as an expense and included in full in profit or loss for the period in which incurred, or whether it should be capitalised and treated as a long-term asset.

c) IAS 38 sets out criteria to determine which of these treatments is appropriate in given circumstances.

d) explains how to measure the carrying amount of intangibles assets when they are first recognised and how to measure them at subsequent reporting dates.

e) Most types of long-term intangible asset are 'amortised' over their expected useful life. (Amortisation of intangible assets is the equivalent of depreciation of tangible non-current assets.)

f) sets out disclosure requirements for intangible assets in the financial statements.

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9.3.1 Definition of an intangible asset

Definitions

An asset: A resource controlled by the company as a result of past events and from which future economic benefits are expected to flow.

Intangible asset: An identifiable, non-monetary asset without physical substance.

An intangible asset is a type of asset. Therefore, expenditure on an intangible item must satisfy both definitions before it can be considered to be an asset.

The existence of control is useful in deciding whether an intangible item meets the criteria for treatment as an asset.

Control means that a company has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.

Control would usually arise where there are legal rights, for example legal rights over the use of patents or copyrights. Ownership of legal rights would indicate control over them. However, legal enforceability is not a necessary condition for control.

For tangible assets such as property, plant and equipment the asset physically exists, and the company controls it. However, in the case of an intangible asset, control may be harder to achieve or prove.

Some companies have tried to capitalise intangibles such as the costs of staff training or customer lists on the basis that they provide access to future economic benefits. However, these would not be assets as they are not controlled.

a) Staff training: Staff training creates skills that could be seen as an asset for the employer. However, staff could leave their employment at any time, taking with them the skills they have acquired through training.

b) Customer lists: Similarly, control is not achieved by the acquisition of a customer list, since most customers have no obligation to make future purchases. They could take their business elsewhere.

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Commentary on the definitions of Control

Future economic benefits

These may include revenues and/or cost savings.

Evidence of the probability that economic benefits will flow to the company may come from:

a) Market research.

b) feasibility studies; and,

c) a business plan showing the technical, financial and other resources needed and how the company will obtain them.

Need to be identifiable

An intangible asset must also be 'identifiable'. Intangibles, by their very nature, do not physically exist. It is therefore important that this 'identifiability test' is satisfied.

IAS 38 states that to be identifiable an intangible asset:

a) must be separable; or

b) must arise from contractual or other legal rights.

To be separable, the intangible must be capable of being separated or divided from the company, and sold, transferred, licensed, rented or exchanged.

Many typical intangibles such as patent rights, copyrights and purchased brands would meet this test, (although they might fail other recognition criteria for an intangible asset).

Without physical substance

Non-physical form increases the difficulty of identifying the asset.

Certain intangible assets may be contained in or upon an article which has physical substance (e.g., floppy disc). Whether such assets are treated as tangible or intangible requirements. This judgement is based on which element is the most significant.

a) Computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment (IAS 16). The same applies to the operating system of a computer.

b) Computer software, other than the operating system, is an intangible asset.

The same applies to licences, patents or motion picture films acquired or internally generated by the reporting company.

Identifiable assets that result from research and development activities are intangible assets because any physical element of those assets (for example, a prototype) is secondary to the knowledge that is the primary outcome of those activities.

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9.3.2 Recognition criteria for intangible assets

Introduction

If an intangible item satisfies the definitions, it is not necessarily recognised in the financial statements. In order to be recognised it must satisfy the recognition criteria for intangible assets.

If an item meets the definitions of being an asset, and being intangible, certain recognition criteria must be applied to decide whether the item should be recognised as an intangible asset.

Recognition

An intangible asset is recognised when it:

a) complies with the definition of an intangible asset; and

b) meets the recognition criteria set out in the standard.

Recognition criteria

An intangible asset must be recognised if (and only if):

a) it is probable that future economic benefits specifically attributable to the asset will flow to the company; and

b) the cost of the asset can be measured reliably.

The probability of future economic benefits must be assessed using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

These recognition criteria are broadly the same as those specified in IAS 16 for tangible non-current assets.

Measurement

An intangible asset must be measure at cost when first recognised.

Means of acquiring intangible assets

A company might obtain control over an intangible resource in a number of ways. Intangible assets might be:

a) purchased separately;

b) acquired in exchange for another asset;

c) given to a company by way of a government grant;

d) internally generated; or

e) 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.

a) Exchange transactions

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Separate acquisition

Recognition guidance

The probability recognition criterion is always satisfied for separately acquired intangible assets.

The price paid to acquire separately an intangible asset normally reflects expectations about the probability that the future economic benefits embodied in the asset will flow to the company. The effect of the probability is reflected in the cost of the asset.

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.

Cost guidance

Cost is determined according to the same principles applied in accounting for other assets.

The cost of a separately acquired intangible asset comprises:

a) its purchase price, including any import duties and non-refundable purchase taxes, after deducting any trade discounts and rebates; and

b) any directly attributable expenditure on preparing the asset for its intended use. For example:

    a) costs of employee benefits (as defined in IAS 19, Employee Benefits) arising directly from bringing the asset to its working condition;

    b) professional fees for legal services; and

    c) costs of testing whether the asset is functioning properly.

The recognition of costs ceases when the intangible asset is in the condition necessary for it to be capable of operating in the manner intended by management.

Deferred payments are included at the cash price equivalent and the difference between this amount and the payments made are treated as interest.

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:

a) the exchange transaction lacks commercial substance; or,

b) 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.

Note that these rules are the same as those described for tangible assets in an earlier chapter.

9.3.4 Granted by government

A government transfers or allocates intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

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An intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant.

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance, allows the intangible asset and the grant to be recorded at fair value initially or at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use.

9.3.5 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:

a) The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it.

b) Most subsequent expenditure is likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria.

c) Also, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole.

Maintenance expenditure is expensed.

9.4 Internally generated intangible assets

9.4.1 Internally generated intangible items

An internally generated intangible asset is an asset created by a company through its own efforts. (An internally generated asset differs from an acquired asset that has been purchased from an external seller.) For example, a publishing company may build up legal copyrights by publishing books.

It can sometimes be difficult for a company to assess whether an internally- generated asset qualifies for recognition as an asset in the financial statements because:

a) it is not identifiable; or

b) its cost cannot be determined reliably.

Recognition prohibited

IAS 38 prohibits the recognition of the following internally generated intangible items:

a) goodwill;

b) brands;

c) 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);

d) publishing titles; and

e) customer lists.

Recognition of these items as intangible assets when they are generated internally is prohibited because the internal costs of producing these items cannot be distinguished

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separately from the costs of developing and operating the business as a whole.

Note that any of these items would be recognised if they were purchased separately.

Goodwill

Most businesses have a value which is greater than the value of their net assets. This is because there are other factors that contribute to the total value, for example, the trading potential of a business.

> **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.

In other words, the goodwill is an asset (insofar as it will generate future benefits) that is unrecognised. It is measured as the difference of the value of a business as a whole over the value of its net assets. As stated above, this is the case for most businesses and it is described as internally generated goodwill. Internally generated goodwill is not recognised as an asset.

When a company buys a controlling interest in another company, part of the purchase consideration is to pay for the other company's goodwill. This is recognised as an asset in the group accounts of the company that has made the purchase. This is not covered by this standard and is explained in more detail later in chapters 19 and 20)

The value of a business as a whole might be less than the value of its net assets, but this is not discussed further at this point.

Other internally generated intangibles

IAS 38 provides further guidance on how to assess whether other internally generated intangibles assets meet the criteria for recognition.

9.4.2 Research and development

The term 'research and development' is commonly used to describe work on the innovation, design, development and testing of new products, processes and systems.

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) a research phase; and

b) a development phase.

If the research phase cannot be distinguished from the development phase the expenditure on the project is all treated as that incurred on the research phase.

Research phase

> **Definition: Research**
>
> Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

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Examples of research activities include:

a) Activities aimed at obtaining new knowledge.

b) The search for and evaluation of applications of knowledge obtained from research.

c) The search for alternative materials, products or processes.

d) The formulation and testing of possible alternatives for new materials, products or processes.

Research costs cannot be an intangible asset. Expenditure on research should be recognised as an expense as it is incurred and included in profit or loss for the period.

Development phase

> **Definition: Development**
>
> Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Examples of development activities include:

a) the design, construction and testing of pre-production prototypes and models;

b) the design of tolls involving new technology;

c) the construction and operation of a pilot plant that is not large enough for economic commercial production; and

d) the design, construction and testing of new materials, products or processes.

Accounting treatment of development costs

Development costs are capitalised when they meet certain further criteria. (These comprise more detailed guidance on whether it is probable that future economic benefits from the asset will flow to the entity and whether the cost can be measured reliably).

Development costs must be recognised as an intangible asset, but only if all the following conditions can be demonstrated.

a) It is technically feasible to complete the development project.

b) The company intends to complete the development of the asset and then use or sell it.

c) The asset that is being developed is capable of being used or sold.

d) 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.

e) Resources are available to complete the development project.

f) The development expenditure can be measured reliably (for example, via costing records).

If any one of these conditions is not met, the development expenditure must be treated in the same way as research costs and recognised in full as an expense when it is incurred.

Only expenditure incurred after all the conditions have been met can be capitalised.

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Once such expenditure has been written off as an expense, it cannot subsequently be reinstated as an intangible asset.

Example: Accounting treatment of development costs

Company Q has undertaken the development of a new product. Total costs to date have been ₦800,000. All of the conditions for recognizing the development costs as an intangible asset have now been met.

However, ₦200,000 of the ₦800,000 was spent before it became clear that the project was technically feasible, could be resourced and the developed product would be saleable and profitable.

Development costs.

The ₦200,000 incurred before all of the conditions for recognizing the development costs as an intangible asset were met must be written off as an expense.

The remaining ₦600,000 should be capitalised and recognized as an intangible asset (development costs).

Initial measurement

The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria for such assets.

Expenditure recognised as an expense in previous annual financial statements or interim financial reports may not be capitalised.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, and is necessary to creating, producing, and preparing the asset for it to be capable of operating in the manner intended by management.

Where applicable cost includes:

a) expenditure on materials and services used or consumed;

b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset; and

c) any expenditure that is directly attributable to generating the asset.

In addition, IAS 23 specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset. The IAS 23 guidance was covered in the previous chapter.

Costs that are not components of cost of an internally generated intangible asset include:

a) selling and administration overhead costs;

b) initial operating losses incurred;

c) costs that have previously been expensed, (e.g., during a research phase) must

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not be reinstated; and,

d) training expenditure.

9.5 Intangible assets acquired in a business combination

This section relates to intangible assets acquired when a company (the acquirer) buys a controlling interest in another company (the acquiree). The section largely relates to the recognition of intangibles in the consolidated financial statements of the parent.

9.5.1 Recognition guidance

Any intangible asset identified in a business combination will be recognised as both recognition criteria are deemed to be recognised.

The probability recognition criterion always considered to be satisfied for intangible assets acquired in business combinations. This is because the fair value of an intangible asset reflects expectations about the probability that the expected future economic benefits embodied in the asset will flow to the company. In other words, the entity expects there to be an inflow of economic benefits.

The reliable measurement criterion is always considered to be satisfied for intangible assets acquired in business combinations. If an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset.

Commentary

This means that an intangible asset that was not recognised in the financial statements of the new subsidiary might be recognised in the consolidated financial statements.

Illustration: Recognition

Company X buys 100% of Company Y.

Company Y owns a famous brand that it launched several years ago.

Analysis

The brand is not recognized in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group view point the brand is a purchased asset. Part of the consideration paid by Company X to buy Company Y was to buy the brand and it should be recognised in the consolidated financial statements.

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Examples of intangible assets

The following are all items that would meet the definition of an intangible asset if acquired in a business combination.

a) Market related intangibles

   a) Trademarks, trade names, service marks, collective marks and certification marks;
   b) Internet domain names;
   c) Newspaper mastheads; and
   d) Non-competition agreements

b) Customer related intangibles

   i. customer lists;
   ii. order or production backlog;
   iii. customer contracts and the related customer relationships; and

c) Artistic related intangibles:

   i. plays, operas and ballets;
   ii. books, magazines, newspapers and other literary works;
   iii. musical works (compositions, song lyrics and advertising jingles);
   iv. pictures and photographs;
   v. video and audio-visual material;
   vi. music videos; and
   vii. television programmes.

d) Contract based intangibles:

   a) Licensing and royalty agreements;
   b) Construction permits;
   c) Franchise agreements;
   d) Operating and broadcasting rights; and
   e) Use rights such as drilling, water, air, mineral, timber-cutting and route authorities.

e) Technology based intangibles

   i. Patented and unpatented technology
   ii. Computer software and databases
   iii. Trade secrets (secret formulas, processes, recipes)

9.5.2 Cost guidance

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.

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9.5.3 In-process research and development

Another similar example involves 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:

a) meets the definition of an asset; and

b) is identifiable, i.e., is separable or arises from contractual or other legal rights.

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 as 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 know how, 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 (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group view point 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 know how resulting from the project and it should be recognised in the consolidated financial statements at its fair value of ₦500,000.

Subsequent expenditure on an acquired in-process research and development project

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.

This means that further expenditure on such a project would not be capitalised unless the criteria for the recognition of internally generated intangible assets were met.

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9.6 Measurement after initial recognition

9.6.1 Choice of policy

Intangible assets are recognised at cost when first acquired.

IAS 38 allows a business to choose one of two measurement models as its accounting policy for property, intangible assets after acquisition. The same model should be applied to all assets in the same class.

The two measurement models for intangible assets after acquisition are:

a) cost model (i.e. cost less accumulated depreciation); and

b) revaluation model (i.e., revalued amount less accumulated depreciation since the most recent revaluation).

9.6.2 Class of assets

The same model should be applied to all assets in the same class. A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:

a) brand names;

b) mastheads and publishing titles;

c) computer software;

d) licences and franchises;

e) copyrights, patents and other industrial property rights, service and operating rights;

f) recipes, formulae, models, designs and prototypes; and

g) intangible assets under development.

Cost model

An intangible asset is carried at its cost less any accumulated amortisation and any accumulated impairment losses after initial recognition.

a) Revaluation model

Intangible assets can be revalued according to the same rules as those applied to the revaluation of property, plant and equipment. These were explained in detail in the previous chapter so will be covered in less detail here.

An intangible asset is carried at a revalued amount, (its fair value at the date of the revaluation less any subsequent accumulated amortisation and any accumulated impairment losses).

This is only allowed if the fair value can be determined by reference to an active market in that type of intangible asset.
Active markets for intangible assets are rare. Very few companies revalue intangible assets in practice.

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 anytime; and
c) prices are available to the public.

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The requirement that intangible assets can only be revalued with reference to an active market is a key difference between the IAS 16 revaluation rules for property, plant and equipment and the IAS 38 revaluation rules for intangible assets.

An active market for an intangible asset might disappear. If the fair value of a revalued intangible asset can no longer be measured by reference to an active market the carrying amount of the asset going forward is its revalued amount at the date of the last revaluation less any subsequent accumulated amortisation and impairment losses.

Frequency of revaluations

Revaluations must be made with sufficient regularity so that the carrying amount does not differ materially from its fair value at the reporting date.

The frequency of revaluations should depend on the volatility in the value of the assets concerned. When the value of assets is subject to significant changes (high volatility), annual revaluations may be necessary.

However, such frequent revaluations are unnecessary for items subject to only insignificant changes in fair value. In such cases it may be necessary to revalue the item only every three or five years.

Changing the carrying amount of the asset

When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:

Method 1: Restate accumulated depreciation proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount.

Method 2:

a) **Step 1:** Transfer the accumulated depreciation to the asset account. The result of this is that the balance on the asset account is now the carrying amount of the asset and the accumulated depreciation account in respect of this asset is zero.

b) **Step 2:** Change the balance on the asset account to the revalued amount.

Accounting for the revaluation

The revaluation is carried out according to the same principles applied in accounting for other assets.

	IAS 38	
Realisati	Upwards revaluations	Recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.
	However:	an increase is recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.
	Downward revaluations	Recognised in profit or loss.
	However:	A decrease is recognised in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset thus reducing the amount accumulated in equity under the heading of revaluation surplus.

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on of the revaluation surplus

Most intangible assets eventually disappear from the statement of financial position either by becoming fully amortised or because the company sells them.

If nothing were done this would mean that there was a revaluation surplus on the face of the statement of financial position that related to an asset that was no longer owned.

IAS 38 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.

Revaluation of an asset causes an increase in the annual depreciation charge. The difference is known as excess depreciation (or incremental depreciation):

Excess depreciation is the difference between:

a) the depreciation charge on the re-valued amount of the asset, and

b) the depreciation that would have been charged on historical cost.

Each year a business might make a transfer from the revaluation surplus to the retained profits equal to the amount of the excess depreciation.

9.6.3 Amortisation of intangible assets

A company must assess whether the useful life of an intangible asset is:

a) finite: or

b) indefinite.

If the useful life of an intangible asset is assessed as being finite the company must assess its useful life.

An intangible asset is assessed as having an indefinite useful life when (based on an analysis of all of the relevant factors) there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows.

Intangibles with a finite useful life

The depreciable amount of an intangible asset with a finite useful life is allocated on a systematic basis over its useful life.

Amortisation begins when the asset is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Amortisation ends at the earlier of the date that the asset is classified as held for sale in accordance with IFRS 5 and the date that the asset is derecognised.

The amortisation method used must reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method must be used.

The residual value of an intangible asset must be assumed to be zero unless:

a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

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b) there is an active market for the asset and:

   a) residual value can be determined by reference to that market; and

   b) it is probable that such a market will exist at the end of the asset's useful life.

The amortisation period and the amortisation method must be reviewed at least at each financial year-end.

a) Where there is a change in the useful life, 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.

b) 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.

Intangibles with an indefinite useful life

Where the useful life is assessed as indefinite:

a) the intangible asset should not be amortised; but

b) 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.

If they do not, the change in the useful life assessment from indefinite to finite is accounted for as a change in an accounting estimate in accordance with IAS 8. This means that the carrying amount at the date of the change is amortised over the estimated useful life from that date.

9.6.4 Disposals of intangible assets

The rules for de-recognition of intangible assets (accounting for their 'disposal') are the same as for property, plant and equipment under IAS 16. There is a gain or loss on disposal equal to the difference between the net disposal proceeds and the carrying value of the asset at the time of disposal.

9.7 Disclosure requirements

In the financial statements, disclosures should be made separately for each class of intangible asset. (Within each class, disclosures must also be made by internally-generated intangibles and other intangibles, where both are recognised.)

Most of the disclosure requirements are the same as for tangible non-current assets in IAS 16. The only additional disclosure requirements are set out below.

a) Whether the useful lives of the assets are finite or indefinite.

b) If the useful lives are finite, the useful lives or amortisation rates used.

c) If the useful lives are indefinite, the carrying amount of the asset and the reasons supporting the assessment that the asset has an indefinite useful life.

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Example:

An example is shown below of a note to the financial statement with disclosures about intangible assets

	Internally-generated development costs	Software licences	Goodwill	Total
	₦	₦	₦	₦
Cost				
At the start of the year	290	64	900	1,254
Additions	60	14	-	74
Additions through business combinations	-	-	20	20
Disposals	(30)	(4)	-	(34)
At the end of the year	320	74	920	1,314
Accumulated depreciation and impairment losses				
At the start of the year	140	31	120	291
Amortisation expense	25	10	-	35
Impairment losses	-	-	15	15
Accumulated amortisation on disposals	10	2	-	12
At the end of the year	175	43	135	353
Net carrying amount				
At the start of the year	150	33	780	963
At the end of the year	145	31	785	961

For any intangible asset that is individually material to the financial statements, the following disclosure is required:

a) description

b) its carrying amount

c) the remaining amortisation period.

d) The total amount of research and development expenditure written off (as an expense) during the period must also be disclosed.

9.7.1 Accounting policies

IAS 1 requires the disclosure of accounting policies used that are relevant to an understanding of the financial statements. Property, plant and equipment often include the largest numbers in the statement of financial position and the results in significant expense in the statement of profit or loss.

One of the learning outcomes in this area is that you be able to formulate accounting policies for property, plant and equipment.

There are several areas that are important to explain to users of financial statements.

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9.7.2 Amortisation policy

The depreciable amount of an intangible asset must be written off over its useful life.

Formulating a policy in this area involves estimating the useful lives of different categories of intangible assets.

Under the guidance in IAS 38 the estimated residual values of an asset would usually be zero and the straight-line method would usually be used.

Other explanations:

This is not so much about choosing a policy as explaining situations to users:

a) Development expenditure: Does the company have any?

b) Intangible assets acquired in business combinations in the period.

c) Whether the company has intangible assets assessed as having an indefinite useful life.

Below is a typical note which covers many of the possible areas of accounting policy for intangible assets.

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Illustration: Accounting policy – Intangible assets

The intangible assets of the group comprise patents, licences and computer software.

The group accounts for all intangible assets at historical cost less accumulated amortisation and accumulated impairment losses.

Computer software

Development costs that are directly attributable to the design and testing of identifiable and unique software products controlled by the group are recognised as intangible assets when the following criteria are met:

a) it is technically feasible to complete the software product so that it will be available for use;
b) management intends to complete the software product and use or sell it;
c) there is an ability to use or sell the software product;
d) it can be demonstrated how the software product will generate probable future economic benefits;
e) adequate technical, financial and other resources to complete the development and to use or sell the software product are available; and
f) the expenditure attributable to the software product during its development can be reliably measured.

Directly attributable costs that are capitalised as part of the software product include the software development employee costs and an appropriate portion of relevant overheads.

Development expenditures that do not meet these criteria are recognised as an expense as incurred. Costs associated with maintaining computer software programmes are recognised as an expense as incurred.

Useful lives

Depreciation is calculated using the straight-line method to allocate their cost or revalued amounts to their residual values over their estimated useful lives, as follows:

a) Patents: 25 to 30 years
b) Licenses 5 to15 years
c) Computer software 3 years

All intangible assets are estimated as having a zero residual value.

9.8 Chapter review

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

a) Explain and apply the recognition rules to intangible assets acquired indifferent ways;
b) Measure intangible assets on initial recognition; and
c) Measure intangible assets after initial recognition using the cost model and the revaluation model.

9.9 End of chapter question and suggested solution

QUESTION

a) IAS 38 - Intangible Assets allows a business to choose one of two measurement models as its accounting policy for intangible assets after acquisition.

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However, the same model should be applied to all assets in the same class.

Required:

Discuss the TWO measurement models for intangible assets.

b) Olumo-Taxi Limited's financial year ends on December 31. The company adopted the revaluation model for its intangible assets and revalues them on a regular three-year cycle. However, for intangible assets with a finite life, Olumo-Taxi Limited transfers the relevant amount from revaluation reserve to retained earnings each year.

During year 2019 Olumo-Taxi Limited incurred N700,000 on the process of preparing an application for licences for 15 taxis to operate in an holiday resort very close to Abeokuta, In order to prevent congestion and excessive traffic pollution, the licencing authority only allowed a small number of taxi to operate.

The outcome of the company"s application was uncertain up to November 30, 2019 when the local government authority accepted its application. In December 2019, Olumo-Taxi Limited incurred a cost of N90,000 in registering its licences. The licences were for a period of 9 years from January 1, 2019.
The licences are freely transferable and an active market in them exists. The fair value at December 31, 2019 was N94,500 per taxi and Olumo-Taxi Limited carried them at fair value in its statement of financial position at December 31, 2019.

At December 31, 2022 Olumo Taxi Limited undertook its regular revaluation.

On that date the licensing authority announced that it would triple the number of licences offered to taxi operators and there were transactions in the active market for licences which has six years to run at N45,000.

Required:

Calculate, with explanations, the carrying amount and revaluation surplus of the intangible assets of Olumo-Taxi Limited according to IAS 38 as at:

a) December 31, 2019
b) December 31, 2022 (before regular revaluation)
c) December 31, 2022 (after regular revaluation)

Solution

a. (i) Cost model

a) An intangible asset is carried at cost less accumulated amortisation and any accumulated impairment losses after initial recognition.

(ii) Revaluation model

b) Intangible assets can be revalued according to the same rules as those applied to the revaluation of property, plant and equipment.

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c) An intangible asset is carried at a revalued amount (its fair value at the date of the revaluation less any subsequent accumulated amortisation and any accumulated impairment losses).

d) This is only allowed if the fair value can be determined by reference to an entire market in that type of intangible assets.

a) Calculation and explanation of the carrying amount and revaluation surplus of the intangibles

a) Carrying amount as at December 31, 2019

	₦
Cost of registering licence	90,000
Revaluation surplus account [N94,500 x 15 – N90,000]	1,327,500
Carrying amount Dec 31, 2019 (Fair value)	1,417,500

Explanations:

a) The initial cost of ₦700,000 incurred should be written off into the statement of profit or loss because the generation of its future economic benefits is not probable then.

b) The fair value of the licence as at December 31, 2019 would be ₦1,417,500 [N 94,500 x 15 taxis] since the cost is N90,000 the revaluation reserve account will be credited with N1,327,500 and intangible asset debited with same amount.

c) Calculation as at December 31, 2022 (Before regular revaluation)

Explanations:

a) The accumulated amortization on the revalued amount for 3 years will be (₦ 1,417,500 * 3/9) = ₦ 472,500 whereas, the accumulated amortization would hae been (₦90,000 * 3/9) = ₦ 30,000.

Carrying amount:

	₦
Bal. B/fwd (Jan 1. 2020)	1,417,500
Less: Amortization	(472,500)
Carrying amount	945,000
Revaluation surplus (Jan. 1, 2020)	1,327,500
Transfer to retained earnings (₦ 1,327,500 * 3/9)	(442, 500)
Revaluation surplus bal. Dec 31, 2022)	885,000

b) Calculation as at December 31, 2022 (After regular revaluation)

c) Carrying amount of the licence immediately before revaluation is ₦945,000 (₦1,417,500 - ₦472,500).

d) The revalued carrying amount is ₦675,000 (₦45,000 * 15)

e) There is a deficit of (₦945,000 - ₦ 675,000) = ₦270,000 which should be recognised in the revaluation reserve.

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Therefore, Revaluation reserve:

	₦
Balance B/fwd regular revaluation	885,000
Less deficit	(270,000)
Revaluation reserve Dec 31, 2022	615,000
Carrying amount	₦ 675,000

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Skills Level
Financial Reporting

CHAPTER 10

IAS 36: IMPAIRMENT OF ASSETS

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10 IAS 36: Impairment of assets

10.0 Learning objective

This chapter covers the treatment of impairment of assets in compliance IAS 36.

10.1 Learning outcomes

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

a) explain the objective of IAS 36;

b) explain the IAS 36 impairment review process;

c) estimate recoverable amount and hence impairment loss (if any);

d) account for impairment loss on assets carried under a cost model;

e) account for impairment loss on revalued assets;

f) define a cash-generating unit; and

g) allocate impairment loss to assets within a cash generating unit.

10.2 Impairment of assets

- **Objective and scope of IAS 36**

An asset is said to be impaired when its recoverable amount is less than its carrying amount in the statement of financial position.

From time to time an asset may have a carrying value that is greater than its fair value, but this is not necessarily an 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:

a) inventories (IAS 2);

b) construction contracts (IAS 11);

c) deferred tax assets (IAS 12);

d) financial assets (IAS 39);

e) investment property held at fair value (IAS 40);

f) non-current assets classified as held for sale (IFRS 5).

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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.

10.2.3 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.

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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 assets' 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 overvalued 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 calculating the recoverable amount of the item in question and comparing this to its carrying amount.

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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:

a) an intangible asset with an indefinite useful life; and

b) goodwill acquired in a business combination.

Measuring recoverable amount

It has been explained that recoverable amount is the higher of an asset's:

a) fair value less costs of disposal; and

b) 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:

a) estimating future cash flows from the use of the asset (including those from ultimate disposal)

b) 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.

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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.

	₦000
Fair value less costs of disposal	
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.

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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 recognize 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:

(i) The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).

(ii) The impairment loss recognised 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	

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Other comprehensive income	20,000	
Property, plant and equipment		24,642

Following the recognition of 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:

i. The carrying amount of the machine on 31 December Year 2 and hence the revaluation surplus arising on 1 January Year 3.

ii. The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).

The impairment loss recognised in the year to 31 December Year 4.

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Summary of the approach

Impairment of an asset should be identified and accounted for as follows:

a) At the end of each reporting period, the entity should assess whether there are any indications that an asset may be impaired.

b) If there are such indications, the entity should estimate the asset's

Recoverable amount.

a. 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**.

b. This impairment loss is recognised as a loss for the period.

c. 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.

d. 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).

10.3 Cash Generating Units

10.3.1 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.

10.3.2 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:

Carry out an impairment review on each of the cash-generating units (excluding the goodwill) and recognise any impairment losses that have arisen.

Then carry out an impairment review for the entity as a whole, including the goodwill.

10.3.3 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

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allocated across the assets of the cash-generating unit in the following order:

a. first, to the goodwill allocated to the cash-generating unit

b. 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).

However, the carrying amount of an asset cannot be reduced below the highest of:

a) its fair value less costs of disposal (if determinable);

b) its value in use (if determinable); and

c) zero.

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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 ₦140million.

The impairment loss would be allocated across the assets of the cash-generating unit as follows:

There is a total impairment loss of ₦20million (=₦160m – ₦140m).

Of this, ₦10million is allocated to goodwill, to write down the goodwill to ₦0. The remaining ₦10million is then allocated to the other assets pro-rata.

Therefore:

₦6million (=₦10m × 90/150) of the impairment loss is allocated to property, plant and equipment, and ₦4million = ₦10m×60/150) of the loss is allocated to the other assets in the unit.

The allocation has the following result:

	Before loss	Impairment loss	After loss
	₦m	₦m	₦m
Property, plant and equipment	90	(6)	84
Goodwill	10	(10)	–
Other assets	60	(4)	56
	160	(20)	140

10.3.4 Disclosure requirements for the impairment of assets

For all impairments, the following disclosures should be made for each class of assets:

a. The amount of impairment losses recognised in profit or loss for the period and the line item in which those items are included.

b. been recognised (or reversed) in other comprehensive income for the period (and in the revaluation reserve).

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10.4 Chapter review

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

a) Explain the objective of IAS 36;

b) Explain the IAS 36 impairment review process;

c) Estimate recoverable amount and hence impairment loss (if any);

d) Account for impairment loss on assets carried under a cost model;

e) Account for impairment loss on revalued assets;

f) Define a cash generating unit; and

g) Allocate impairment loss to assets within a cash generating unit.

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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

a. Impairment loss at the beginning of Year 4 of ₦104,000 (₦204,000 – ₦100,000). This is charged to profit or loss.

b. 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).

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10.5 End of Chapter Question and suggested solution

10.5.1 Question

The following issues relating to Chestnut Co's non-current assets are outstanding for the year ended 31 December 20X7:

Factory
At 1 January 20X7, Chestnut Co's factory had a carrying amount of ₦ 5m. It has a remaining useful life of ten years at that date. On 31 December 20X7 there was an impairment review of the factory and the recoverable amount was deemed to be ₦2.5m. Chestnut Co's factory had previously been revalued upwards and the revaluation surplus has a credit balance of ₦1m relating to this factory.

Head Office
Chestnut Co's head office cost ₦12m on 1 January 20X1 and is being depreciated over 40 years life.
On 31 December 20X4, there was an impairment review of the head office and the recoverable amount was deemed to be ₦9m. A more recent valuation, at 31 December 20X7, has estimated that the recoverable amount of the head office is ₦11m.

Machinery
On 1 April 20X7, Chestnut Co received a grant of ₦2.6m towards new production machinery. The machinery cost ₦4m and is expected to have a useful life of five years. Depreciation is charged on a straight-line proportionate basis. Chestnut Co uses the cost model when accounting for its head office, and the deferred income method in relation to government grants

Required:

a. Explain which assets of a company, such as Chestnut Co, are required to undergo an **annual impairment review** according to International Accounting Standards. In your answer, identify the characteristics of such assets and justify whether the **head office** and **machinery** of Chestnut Co would fall under this requirement.

b. Discuss the appropriate accounting treatment under **IAS 36 – Impairment of Assets** for a situation where a company, like Chestnut Co, has both **depreciation** and **impairment** losses on its factory during the financial year ending 31 December 20X7. Explain the correct **journal entry**, indicating how the loss should be recorded in the financial statements, and the rationale behind the debit and credit entries involved.

c. Describe how the **carrying amount** of a non-current asset such as Chestnut Co's **head office building** is determined in the statement of financial position as at 31 December 20X7. Your explanation should include considerations for cost, depreciation, revaluation (if applicable), and impairment losses.

Solution

a. According to IAS 36 *Impairment of Assets*, an asset is only required to undergo an impairment review when there are indications that it may be impaired. Annual impairment reviews are mandatory only for specific types of assets such as goodwill, intangible assets with indefinite useful lives, and intangible assets not yet available for use. In the case of

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Chestnut Co, the **head office** and **machinery** are not among the categories requiring **mandatory annual reviews**. Instead, they should only be reviewed for impairment if there are **indicators** such as physical damage, obsolescence, poor performance, or significant market decline. The fact that these assets may have previously been impaired does not require automatic annual reviews. Therefore, unless new indicators exist, neither the head office nor the machinery of Chestnut Co needs an annual impairment review.

b. In accordance with IAS 36, the accounting treatment for an impairment and depreciation of a factory asset must be systematically recorded. For Chestnut Co, as of 1 January 20X7, the factory's carrying amount was ₦5 million with a useful life of ten years. This results in an annual depreciation of ₦0.5 million (₦5m ÷ 10). Therefore, by 31 December 20X7, the factory's depreciated value is ₦4.5 million. However, an impairment review determined that the **recoverable amount** was only ₦2.5 million, indicating an **impairment loss** of ₦2 million (₦4.5m – ₦2.5m). Since the factory previously had a **revaluation surplus** of ₦1 million, this surplus must first be utilized to absorb part of the impairment loss. Under IAS 36, impairment losses on revalued assets are treated as **revaluation decreases**, and hence, ₦1 million of the impairment is charged to the revaluation surplus, while the remaining ₦1 million is charged to the **statement of profit or loss**. Including the depreciation expense of ₦0.5 million, a total of ₦1.5 million is recognized as an expense in the statement of profit or loss, and the total reduction in the non-current asset's carrying amount is ₦2.5 million.

   The appropriate journal entry is:
   a. Dr Statement of Profit or Loss: ₦1.5 million
   b. Dr Revaluation Surplus: ₦1 million
   c. Cr Non-Current Assets: ₦2.5 million

c. The **carrying amount** of a non-current asset such as Chestnut Co's **head office** is calculated based on its historical cost, adjusted for depreciation and any impairment losses or reversals. Initially valued at ₦12 million with a useful life of 40 years, the annual depreciation amounts to ₦0.3 million. By 31 December 20X4, the head office would have been depreciated for 3 years (from 1 January 20X1), resulting in a carrying amount of ₦10.8 million (₦12m × 36/40). On that date, an impairment review identified a **recoverable amount** of ₦9 million, and thus, an **impairment loss** of ₦1.8 million was recognized in the profit or loss.

   By 31 December 20X7, the asset was valued at ₦11 million. However, since the head office is accounted for using the **cost model**, any **reversal of impairment** must not exceed the carrying amount that would have been recorded had no impairment occurred. Without impairment, accumulated depreciation for 7 years would be ₦2.1 million (₦0.3m × 7), and the asset would have been carried at ₦9.9 million (₦12m – ₦2.1m).
   Therefore, the maximum allowable **reversal of impairment** is ₦0.9 million (₦9.9m – ₦9m), and the carrying amount of the head office on the statement of financial position as of 31 December 20X7 is **₦9.9 million**, not the full ₦11 million valuation.

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Skills Level
Financial Reporting

CHAPTER 11

IFRS 5: NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

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11 Non-current Assets Held for Sale and Discontinued Operations

11.0 Learning objective

This chapter covers the treatment of Non-current Assets held for sales and discontinued operations in accordance with IFRS 5.

11.1 Learning outcomes

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

a) apply the held for sale criteria and identify if an asset is held for sale;

b) measure assets classified as held for sale at the lower of carrying amount and fair value less costs to sell;

c) account for any loss arising on classification of an asset as held for sale;

d) allocated any loss arising to assets within a disposal group classified as held for sale;

e) explain and apply the presentation rules on assets held for sale;

f) explain and apply the presentation rules on disposal groups held for sale; and

g) define and explain the accounting treatment for discontinued operations.

11.2 Sale of Non-Current Assets

11.2.1 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:

a) on disposal of the asset; or

b) 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

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11.2.2 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:

a) subject to an impairment test;

b) presented on a separate category on the face of the statement of financial position; and

c) 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:

11.3 Introduction to IFRS 5

11.3.1 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:

a) measured at the lower of carrying amount and fair value less costs to sell;

b) not depreciated; and

c) 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:

a) non-current assets;

b) disposal groups; and

c) discontinued operations.

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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.

11.3.2 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:

a) deferred tax assets (IAS 12 Income Taxes).

b) assets arising from employee benefits (IAS 19 Employee Benefits).

c) financial assets within the scope of IAS 39 Financial Instruments: Recognition and Measurement.

d) non-current assets that are accounted for in accordance with the fair value model in IAS 40 Investment Property.

e) non-current assets that are measured at fair value less estimated point-of- sale costs in accordance with IAS 41 Agriculture.

f) contractual rights under insurance contracts as defined in IFRS 4 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:

a) used to the end of their economic life; or

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b) closed rather than sold.

A non-current asset (or disposal group) that is to be abandoned must not be classified as held for sale.

11.4 Classification of Non-Current Assets (Or Disposal Groups) As Held for Sale

11.4.1 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.

11.4.2 Criteria

The following conditions must apply at the reporting date for an asset (or disposal group) to be classified as held for sale:

a) 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, i.e.:

i. the appropriate level of management must be committed to a plan to sell the asset (or disposal group);

ii. an active programme to locate a buyer and complete the plan must have been initiated; and

iii. the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value;

b) 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).

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Example: Classification of asset as held for sale

Entity had the following asset at 31 March Year 4.

A property that it offered for sale for ₦5million 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 ₦4million 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 affirm 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.

11.5 Measurement of Non-Current Assets (Or Disposal Groups) Classified as Held for Sale

11.5.1 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:

a) their carrying amount (i.e., current values in the statement of financial position, as established in accordance with accounting standards and

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principles), and

b) 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 ₦17million 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.

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 re-measured and should continue to be carried at ₦20 million.

(A gain is not recognised on reclassification as held for sale).

A gain on disposal will be included in profit for the period when the disposal actually occurs.

Practice question **1**

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.

Calculate the entries that are required in the statement of profit or loss for Year 4 and Year 5.

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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:

a) goodwill; then

b) 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 (at re-valued amounts)	52,000
Property, plant and equipment (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. The entity must recognize an impairment loss of ₦30,000 (₦190,000 **a)** ₦160,000)

Allocation of the impairment loss:

The first ₦20,000 of the impairment loss reduces the good will to zero.

The remaining ₦10,000 of the impairment loss should be allocated to the non-current assets in the disposal group prorate a to their carrying value.

	Carrying amount before allocation	Impairment loss	Carrying amount after allocation
	₦	₦	₦
Goodwill	20,000	20,000	–
Property, plant and equipment (at re-valued amounts)	52,000	3,939	48,061
Property, plant and equipment (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.

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Subsequent re-measurement

Subsequent re-measurement of the non-current asset (or disposal group) might lead to:

a) a further impairment loss - which must be recognised; or

b) a gain, which is recognised but only to the extent that it is covered by a previously recognised impairment loss.

11.5.4 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:

i. 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

ii. its recoverable amount at the date of the subsequent decision not tosell.

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.

11.6 Presentation and Disclosure

11.6.1 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.

Practice question

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.

Calculate the entries that are required in the statement of profit or loss for Year 4 and Year 5.

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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 re-measurement 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 re-measuring 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:

(1) a description of the non-current asset (or disposal group);

(2) 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;

(3) if applicable, the segment in which the non-current asset (or disposal group) is presented in accordance with ***IFRS 8 Operating segments***.

11.7 Discontinued Operations

11.7.1 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:

a) closing down some operations will affect the future financial prospects of the entity.

b) 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.

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11.7.2 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:

(a) represents a separate major line of business or geographical area of operations,

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) 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.

11.7.1 Presentation and disclosure of discontinued operations

Presentation in the statement of profit or loss

The following must be disclosed for discontinued operations:

a) a single amount on the face of the statement of profit or loss comprising the total of:

b) the post-tax profit or loss of discontinued operations; and

c) 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

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discontinued operation.

a) an analysis of this single amount:

   i. the revenue, expenses and pre-tax profit or loss of discontinued operations.

   ii. the related income tax expense.

   iii. 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

   iv. the related income tax expense.

b) 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).

c) The analysis is not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

d) 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.

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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.

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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	

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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	2,500
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 groups1and2(₦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 presentation in the statement of financial position therefore differs from the presentation in the statement of profit or loss.

11.8 Chapter review

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

a) apply the held for sale criteria and identify if an asset is held for sale;

b) measure assets classified as held for sale at the lower of carrying amount and fair value less costs to sell;

c) account for any loss arising on classification of an asset as held for sale;

d) allocated any loss arising to assets within a disposal group classified as held for sale;

e) explain and apply the presentation rules on assets held for sale;

f) explain and apply the presentation rules on disposal groups held for sale; and

g) define and explain the accounting treatment for discontinued operations.

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Solution **1**

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 x 4 years/ 8 years	(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

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Solution **2**

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 x 4 years/8 years	(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

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11.9 End of chapter questions and suggested solutions

Question 1
International Financial Reporting Standards (IFRS 5) on Non-Current Assets held for Sale and Discontinued Operations specifies the accounting treatment for assets held for sale and disclosure of discontinued operations.

Required:
Discuss the conditions which must exist in order to classify a Non-Current Asset as being held for sale and explain the accounting treatments that apply when such classification is deemed appropriate.

Question 2

- BN Ltd classified an asset as held for sale on 31 March 20X2. The asset had a carrying amount of ₦ 900, a fair value of ₦800, and estimated disposal costs of ₦50. In line with **IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations**, explain how the asset should be measured at the reporting date. Justify your answer by discussing the applicable measurement rule and how it is applied in this scenario.

- Explain the criteria that must be met under **IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations** for an asset to be classified as "held for sale." Discuss the significance of these criteria and evaluate which conditions must be satisfied before such classification is appropriate.

- According to **IFRS 5**, certain disclosures must be made in relation to discontinued operations.
  Discuss the key financial figures that should be presented **on the face** of the statement of profit or loss in relation to a discontinued operation. Justify why each item is either required to be shown or can be excluded from presentation.

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- Rural Ltd has disposed of two business sectors during the year:

    1. **Sector X**, which operated exclusively in Country A (where Rural has no other operations) and generated 30% of the company's total revenue.
    2. **Sector Y**, which operated in the same country as the company's head office, produced a different product line, and accounted for 10% of total revenue.

Using the guidance in **IFRS 5**, assess whether either Sector X or Sector Y qualifies as a **discontinued operation**. Provide a reasoned judgment based on the standard's definition and disclosure requirements.

11.9.2 Suggested solutions

Solution 1
Conditions that Must Exist before Classifying a Non-Current Asset as being held for Sale

i. A non-current asset is classified as held for sale, if its carrying amount will be recovered principally through a sales transaction rather than through continuing use. For this to be the case, the following criteria must be met:

ii. The asset must be available for immediate sale in its present condition; and the sale must be highly probable.

IFRS 5 lists the following conditions which must be met if a sale is to be considered as highly probable:

i. The management is committed to a plan to sell the asset;
ii. An active programme has been initiated to locate a buyer and complete the plan;
iii. The asset is being actively marketed at a sale price that is reasonable in relation to its current value;
iv. A complete sale is expected within one year from the date of classification (may be extended if any delay is caused by circumstance beyond the entity's control);
v. It is unlikely that there will be any significant changes to the plan or that the plan will be withdrawn;
vi. If these criteria are not satisfied at the end of the reporting period, the assets should not be classified as held for sale; and
vii. If the criteria are satisfied after the reporting period but before the financial statements are authorised for issue, the fact that the assets are not classified as held for sale should be disclosed in the notes to the financial statements.

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iii. The Accounting Treatment for Non-Current Assets Held for Sale

i. A non-current asset or disposal group that is held for sale is measured at the lower of its carrying amount and net realisable value (fair value less costs to sell).
ii. Where net realisable value is lower than carrying value, this represents an impairment loss which should be recognized immediately.
iii. Non-current assets held for sale should not be subjected to annual depreciation even where the asset is still being used by the entity in ordinary course of business.
iv. IFRS 5 requires that assets held for sale to be presented separately on the face of the statement of financial position and information concerning discontinued operation should be disclosed in the financial statements.

Solution 2

- According to **IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations**, an asset classified as held for sale must be measured at the **lower of its carrying amount and fair value less costs to sell**. In the scenario presented, the asset has a carrying amount of ₦900, a fair value of ₦800, and estimated disposal costs of ₦50. The fair value less costs to sell is therefore ₦750 (₦800 - ₦50). Since this amount is lower than the carrying amount, the asset should be written down and reported at **₦750** on the statement of financial position as at 31 March 20X2.

  This treatment reflects the intention of IFRS 5 to ensure that assets held for sale are not overstated in financial reports and that any impairment loss is recognized immediately. Other values such as just the fair value (₦800) or fair value plus costs to sell are not acceptable for measurement under the standard.

- To classify an asset as **held for sale** under **IFRS 5**, several strict criteria must be satisfied to ensure that the sale is genuine and imminent. These criteria include:

  - The asset must be available for immediate sale in its present condition;
  - Management must be committed to a plan to sell the asset;
  - An active programme to locate a buyer and complete the sale should be initiated;
  - The asset must be actively marketed at a price that is reasonable in relation to its fair value; and
  - The sale is expected to be completed within **twelve months** from the date of classification.

In the scenario discussed, the statement that the sale is expected to be completed within **one month** is **not a requirement** under IFRS 5. The standard allows up to twelve months. Therefore, the correct application of IFRS 5 requires all other conditions to be satisfied, while expecting completion within one month is unnecessary and misrepresents the standard.

- Under **IFRS 5**, when an entity discontinues a major line of business or geographical area of operations, the results of that discontinued operation must be presented

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separately in the financial statements. Specifically, only the **profit or loss after tax** from the discontinued operation is required to be shown **on the face** of the **statement of profit or loss**.

Revenue and gross profit from discontinued operations are **not shown separately** on the face of the statement. Instead, detailed breakdowns— including revenue and gross profit— should be disclosed **in the notes** to the financial statements. This approach helps maintain clarity on the performance of continuing operations while ensuring users of financial statements still have access to detailed information about discontinued segments.

- In determining whether a business segment qualifies as a **discontinued operation** under **IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations**, it is essential to consider whether the segment represents a **separate major line of business** or **geographical area of operations**.
  In this case, **Sector X** is the only operation of Rural Ltd in Country A. However, despite this, it does **not qualify** as a discontinued operation because it contributes **only 0.5% of the total revenue** of the company. This contribution is considered immaterial, and thus, Sector X does not meet the threshold of being a **major geographical area of operations**. As such, Rural Ltd is not required to report Sector X as a discontinued operation.

  Conversely, **Sector Y** satisfies the requirements for classification as a discontinued operation. It represents a **separate major line of business**, contributes a **significant portion of Rural Ltd's total revenue**, and is distinct in terms of the products it offers compared to the rest of the company. The operation is also located in the same country as the head office, but its relevance lies in the nature of its business, not its geography. Given these factors, Sector Y qualifies for disclosure as a **discontinued operation** in the financial statements for the current year, in accordance with IFRS 5.

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Skills Level
Financial Reporting

CHAPTER 12

IFRS 16: LEASES

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12 Leases

12.0 Learning objective

This chapter covers the treatment of leases in financial statements in accordance with IFRS 16.

12.1 Learning Outcomes

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

a) Prepare and present extracts of financial statements in respect of lessee accounting.

12.2 Introduction and definitions

12.2.1 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 the 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.

12.2.2 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.

12.2.3 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 world wide 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.

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12.2.4 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.

12.2.5 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.

a) Contracts must be assessed at the inception date to find out if they are a lease or if they contain a lease.

b) 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.

12.2.6 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:

1. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
2. periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

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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 rent 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 the 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 = 5years 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 = 5years 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

12.2.7 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.

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In a straightforward 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:

1. fixed payments (including in-substance fixed payments), less any lease incentives.
2. variable lease payments that depend on an index or a rate;
3. the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
4. 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 less or 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 requires 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.

12.2.8 Residual values

When a company that owns an asset leases it to another party they have two interests in that asset:

a) It gives them a right to receive a series of rentals over the lease term; and

b) 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 short fall.

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 less or 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 realization of which by a less or is not assured or is guaranteed solely by a party related to the lessor.

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The guaranteed and unguaranteed residual values might influence the lessor's classification of a lease and therefore how it is accounted for.

12.2.9 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:

- the present value of the lease payments and the unguaranteed residual value; to equal
- 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 cashflows 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.

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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	Cashflow	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)

It is unlikely that you will have to calculate the interest rate implicit in the lease in an exam question. The workings have been provided here to illustrate the definition.

12.2.10 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.

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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	Cashflow	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)

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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 less or 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.

12.3 Lessee Accounting

12.3.1 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

12.3.2 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.

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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.

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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:

On initial recognition	**Dr**	**Cr**
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

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12.3.6 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.

a) 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

b) 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	
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:

a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term; or

b) 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:

a) the end of its useful life; or

b) the end of the lease term.

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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 the mover 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.

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.

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 recognized on initial recognition of the lease)	X
Plus: Interest accrued	X
Minus: Repayments (lease payments) Repayment	(X)
of loan principal	(X)
Adjustment on remeasurement of the liability (see later)	X
Amount owed now.	X

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Lease liability		X
Cash/bank	**Debit**	
	X	
		Credit

Illustration: Lease payment

In effect, each lease payment consists of two elements:

c) a finance charge (interest charge) on the liability; and

d) 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.

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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 (5u100,000)	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

Allocating the finance charge (interest)

The total finance charge for a leased asset is allocated "so as to provide a

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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).

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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 short fall. 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.

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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 less or the guaranteed residual value Lease liability	40,000	
Asset held under lease		35,000
Cash/bank		5,000

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

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

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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 Lessee's lease payments:	**Payments in advance** ₦	**Payments in arrears (see section 2.3)** ₦
Annual rentals (4 u100,000)	400,000	
Annual rentals (5 u100,000)		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

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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, then that payment is a current liability. Therefore, in the above example the ₦100,000 paidon1JanuaryYear2isa current liability and the balance ₦266,881) is an on-current liability.

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Example: Current and non-current

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:

1. The interest recognised in year1 but unpaid at the year-end (₦40,387);
2. The current element of the capital owed on the lease (₦59,613); and

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3. the non-current element of the capital owed on the lease (₦266,881).

Example: Current and non-current

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		
		₵		₵	₵

	interest
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 al ease commencing on1 January Year1 is ₦10,000.

The lease is for three years with payments of ₦4,021 annually on 1 January Year1, 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.

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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. laptops and mobile phones).

The election must be made by a 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, an 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.

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.

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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.

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 cashflows 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:

a) depreciation charge for right-of-use assets by class of underlying asset;

b) interest expense on lease liabilities;

c) expense relating to:

   i. 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);

   ii. 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);

   iii. variable lease payments not included in the measurement of lease liabilities;

d) income from subleasing right-of-use assets;

e) total cash outflow for leases;

f) additions to right-of-use assets;

g) gains or losses arising from sale and leaseback transactions; and

h) 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

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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	100,00
Later than 1 year and no later than 5 year (4 x 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 chargeless the finance charge already expensed.

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12.4 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.

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 Year1 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 Year1	3,288
Total liability, end of Year 1	7,309

* N4,021 can be divided into N1,330 of interest payable and N2,691 of principal payable

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12.5 End of Chapter Questions and suggested solutions

12.5.1 Questions

Questions 1

Hyper Ltd entered into two lease arrangements during the financial year ended 30 September 20X4. On 1 October 20X3, it made the first of five equal annual payments of ₦90,000 under a lease agreement for plant, where the implicit interest rate is 10% and the present value of the lease at inception was ₦340,000. Additionally, on 1 January 20X4, Hyper paid ₦18,000 for a one-year lease of equipment.

Required
As a financial accountant, calculate and explain the **total amount to be charged to the statement of profit or loss** for the year ended 30 September 20X4 for both leases. Include the treatment of depreciation and interest.

Questions 2

On 1 November 20X2, Entity Z entered into a five-year lease agreement with annual lease payments of ₦10,975 starting on 31 October 20X3. The present value of the lease payments was determined to be ₦45,000, and the implicit interest rate in the lease was 7%.

Required
Calculate the amount that should be shown under **non-current liabilities** in the **statement of financial position** as at 31 October 20X3. Show workings and explain your treatment of the lease liability.

Questions 3

IFRS 16 *Leases* allows for exemptions from recognizing right-of-use assets in certain situations. Discuss the conditions under which a **leased asset** qualifies for such exemption. Use the following examples to support your explanation:

- A used vehicle with an original cost of ₦15,000 and current fair value of ₦700, leased for 24 months
- A new motor vehicle costing ₦15,000, leased for 24 months
- A motor vehicle leased for short-term daily rental business
- A 12-month lease of a ₦15,000 motor vehicle

Required:
Identify which lease(s), if any, are **exempt from recognition** under IFRS 16 and explain why.

Questions 4

On 1 January 20X3, Rabbit Ltd entered into a lease for a machine with a six-year useful life. The lease agreement included an immediate payment of ₦13,760, followed by five annual

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payments of ₦20,000. The present value of the lease payments (excluding the initial payment) was ₦86,240, and the implicit interest rate was 8%.

Required:
With reference to IFRS 16, compute and explain what should be reported in Rabbit Ltd's **statement of financial position as at 31 December 20X4** in respect of:

- Finance cost
- Non-current portion of lease liability
- Current portion of lease liability

Questions 5

Pigeon Ltd entered into a five-year lease agreement on 1 April 20X7 for a machine with an estimated useful life of seven years.

Required:
Discuss the accounting treatment and depreciation period for the leased asset under **IFRS 16**, indicating under which circumstances the machine should be depreciated over **seven years** rather than the lease term. Consider various options such as transfer of ownership, purchase options, and company policy in your discussion.

Questions 6

On 1 January 20X4, Badger Ltd leased a piece of machinery for four years with annual lease payments of ₦210,000 payable in arrears. The present value of lease payments was ₦635,000, and the implicit interest rate was 12.2%. Legal ownership will transfer to Badger at the end of the lease. However, in the financial statements for 31 December 20X4, Badger expensed the lease payment as an operating cost rather than capitalising it.

Required:
During 20X5, this accounting error was discovered. Explain the **adjustment that should be made to retained earnings** in the statement of changes in equity as at 31 December 20X5 due to this misstatement in 20X4.

Questions 7

Owl Ltd entered into a lease for an asset with a useful life of six years. The lease period is initially five years, with an option for an additional two years at a **nominal rental**. The present value of lease payments for the initial period is ₦87,000.

Required:
In accordance with **IFRS 16**, calculate and explain the **carrying amount of the right-of-use asset** in Owl's statement of financial position at the end of the **second year** of the lease.

Questions 8

On 1 January 20X6, Sideshow Ltd sold a property for its fair value of ₦2 million and leased it

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back under a five-year lease agreement, paying ₦150,000 annually. The present value of lease payments was ₦599,000. The carrying amount of the property before sale was ₦1.6 million and its remaining useful life was 20 years. The leaseback qualifies as a sale under **IFRS 16** and the interest rate implicit in the lease is 8%.

Required:
Using the information provided, calculate the **profit or loss on disposal**, **depreciation**, and **finance cost** that should be recognized in Sideshow's statement of profit or loss for the year ended 31 December 20X6. Justify each figure with calculations and reference to applicable IFRS 16 principles.

12.5.2 Suggested solution

Solutions 1

- Hyper Ltd should recognize expenses relating to both a finance lease and an operating lease during the year. For the finance lease, the depreciation of the right-of-use asset is calculated as ₦340,000 ÷ 5 years = **₦68,000**. The finance cost is based on the outstanding lease liability after the first payment of ₦90,000: (₦340,000 – ₦90,000) × 10% = **₦25,000**.

  Additionally, the one-year equipment lease of ₦18,000 (starting 1 January 20X4) qualifies as a short-term lease. Since the lease covers only 9 months in the financial year (January to September), the expense recognized is ₦18,000 × 9/12 = **₦13,500**.

  Total charge to profit or loss = ₦68,000 (depreciation) + ₦25,000 (finance cost) + ₦13,500 (operating lease) = **₦106,500**.

Solutions 2

Z Ltd entered into a 5-year lease on 1 November 20X2, with annual payments of ₦10,975 and a present value of ₦45,000 at an interest rate of 7%. Using an amortization table:

- **Year ending 31 October 20X3**:
  Opening balance: ₦45,000
  Interest (7%): ₦3,150
  Payment: (₦10,975)
  Closing balance: **₦37,175**
- **Year ending 31 October 20X4**:
  Opening balance: ₦37,175
  Interest (7%): ₦2,602
  Payment: (₦10,975)
  Closing balance: **₦28,802**

At 31 October 20X3, the **non-current liability** is the closing balance after the **next year's** payment, i.e., **₦28,802**. The current liability is the portion due within the next year, i.e., ₦37,175 – ₦28,802 = **₦8,373**.

Solutions 3

IFRS 16 permits lessees to exempt assets from right-of-use recognition when:

- The asset is of **low value** (typically below ₦5,000 when new), or

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- The **lease term is 12 months or less** (short-term leases), with no purchase option.

Applying this:

- A used vehicle with original cost ₦15,000: **Not exempt** (not low-value based on original cost).
- A new vehicle costing ₦15,000 for 24 months: **Not exempt** (exceeds low-value and exceeds 12-month limit).
- Vehicle leased for rental: **Still not exempt**, as use is irrelevant.
- A 12-month lease of a ₦15,000 vehicle: **Exempt**, based on short-term lease criterion.

Solutions 4

Rabbit Ltd's lease includes an initial payment of ₦13,760 and five additional payments of ₦20,000. The present value of future lease payments is ₦86,240 at 8%.
Using an amortisation schedule:

- **2023**: Opening = ₦86,240
  Payment = ₦20,000 → Balance = ₦66,240
  Interest (8%) = ₦5,299 → Closing = **₦71,539**
- **2024**: Opening = ₦71,539
  Payment = ₦20,000 → Balance = ₦51,539
  Interest (8%) = ₦4,123 → Closing = **₦55,662**

At 31 December 20X4:

- **Finance cost** = ₦4,123
- **Non-current liability** = balance after next payment = **₦35,662**
- **Current liability** = ₦55,662 – ₦35,662 = **₦20,000**

- Under IFRS 16, the depreciation period for a right-of-use asset is based on the **lease term**, unless **ownership transfers** to the lessee at the end of the lease or the lessee is reasonably certain to exercise a purchase option.
  In this case, Pigeon Ltd's lease agreement **transfers ownership** at the end of the lease. As such, the machine should be **depreciated over its full useful life of 7 years**, not just the 5-year lease term. Other options such as lease extensions or internal depreciation policy do not affect IFRS 16 treatment unless ownership transfer is involved or a purchase option is likely.

Solutions 6

Badger Ltd incorrectly treated a finance lease as an operating lease in 20X4. The necessary adjustments to correct the treatment in 20X5 are:

1. Reverse the incorrect operating expense:
   a. **Dr Lease liability ₦210,000**, **Cr Retained earnings ₦210,000**

2. Recognize depreciation of right-of-use asset:

- Lease value = ₦635,000
- Useful life = 5 years → Depreciation = ₦127,000

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- **Dr Retained earnings ₦127,000**, **Cr PPE ₦127,000**

3 Recognize finance cost:

- ₦635,000 × 12.2% = **₦77,470**
- **Dr Retained earnings ₦77,470**, **Cr Lease liability ₦77,470**

Net adjustment to retained earnings = ₦210,000 (reversed) – (₦127,000 + ₦77,470) = **₦5,530 credit**

Solutions 7

Owl Ltd leases an asset with a useful life of 6 years. The lease covers 5 years, with an optional 2-year extension at a **nominal rent**, making it **reasonably certain** that the option will be exercised.

Thus, depreciation is over the **full 6-year useful life**.
Initial capitalized amount = ₦87,000
Annual depreciation = ₦87,000 ÷ 6 = **₦14,500**
After two years, accumulated depreciation = ₦14,500 × 2 = **₦29,000**
Carrying amount = ₦87,000 – ₦29,000 = **₦58,000**

Solutions 8

Sideshow Ltd sold a property for ₦2 million and leased it back under IFRS 16. Since control passed to the buyer, this is a **sale and leaseback transaction**.

a. Present value of lease liability = **₦599,000**
b. Proportion of asset retained = (₦599,000 ÷ ₦2,000,000) × ₦1,600,000 = **₦479,200**
c. Depreciation (over 5 years) = ₦479,200 ÷ 5 = **₦95,840**
d. Finance cost = 8% × ₦599,000 = **₦47,920**
e. Total profit = Sale (₦2m) – Carrying amount (₦1.6m) = **₦400,000**
f. Recognized profit (portion not retained) = ₦400,000 × (₦2,000,000 – ₦599,000)/₦2,000,000 = **₦280,200**

Entries in profit or loss:

i. Profit on disposal: **₦280,200**
ii. Depreciation expense: **₦95,840**
iii. Finance cost: **₦47,920**

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Skills Level
Financial Reporting

CHAPTER 13

IAS 37: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

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13 Provisions, Contingent Liabilities and Contingent Assets

13.0 Learning objective

This chapter covers the treatment of provisions, contingent liabilities and contingent assets in financial statements.

13.1 Learning outcomes

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

a) define liability, provision, contingent liability and contingent asset;

b) distinguish between provisions, contingent liabilities or contingent assets;

c) understand and apply the recognition criteria for provisions under IFRS;

d) calculate/ measure provisions;

e) account for changes in provisions; and

f) report on provisions in final accounts.

13.2 Provisions: Recognition

13.2.1 Introduction

The first five sections of this chapter explain rules set out in *IAS 37: Provisions, contingent liabilities and contingent assets*.

Definitions

Provisions are liabilities of uncertain timing or amount.

A liability is 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.

An obligating event is 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 cashflows required to settle the liability.

Accruals are liabilities to pay for goods or services that have been received or supplied but have not yet been invoiced. There is often a degree of estimation in the measurement of accruals, but any inherent uncertainty is much less than for provisions.

IAS 37 applies to all provisions and contingencies apart from those covered by the specific requirements of other standards.

In some countries the term “provision” is also used to describe the reduction in the value of an asset. For example, accountants might talk of provision for depreciation, provision for doubtful debts and so on. These “provisions” are not covered by this standard which is only about provisions that are liabilities.

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Major accounting issues

There are three issues to address in accounting for provisions:

a. whether or not a provision should be recognised;

b. how to measure a provision that is recognised; and

c. what is the double entry on initial recognition of a provision and how is it remeasured on subsequent reporting dates.

13.2.2 Recognition criteria for provisions

A provision should be recognised when:

i. a company has a present obligation (legal or constructive) as a result of a past event.

ii. it is probable that an outflow of economic benefits will be required to settle the obligation; and

iii. 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.

13.2.3 Present obligation

An obligation must exist in order for a provision to be recognised. An

obligation may be legal or constructive.

a) A **legal obligation** is one arising from a contract, or some other aspect of the law.

b) A **constructive obligation** is one arising from the company's actions, whereby

c) through established past practice, published policies, or a specific current statement, the company has indicated to other parties that it will accept certain responsibilities; and

d) as a result, the company has created a valid expectation that it will discharge those responsibilities.

> **Example: Constructive obligation**
>
> A clothing retailer has a policy of taking back items of clothing that customers have purchased, and refunding the purchase price, simply because the purchaser has changed his or her mind about the item.
>
> The retailer does not have a legal obligation to do this under the consumer protection legislation that applies in the jurisdiction in which it operates.
>
> If this is the usual practice of a particular retailer, and the retailer's policy is well-known or has been made known to customers, then a constructive obligation exists whenever a sale is made.
>
> A provision would be recognised for sales returns subject to the other two criteria being satisfied.

In most cases it will be clear that a past event has given rise to a present obligation. However, in rare cases this may not be the case. In these cases, the past event is deemed to give rise to a present obligation if it is more likely than not that a present

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obligation exists at the end of the reporting period. This determination must be based on all available evidence.

13.2.4 Obligation arising out of a past event

A past event that leads to a present obligation is called an obligating event. For this to be the case it is necessary that the company has no realistic alternative to settling the obligation created by the event.

This is the case only:

a) where the settlement of the obligation can be enforced by law; or

b) in the case of a constructive obligation, where the event (which may be an action of the company) creates valid expectations in other parties that the company will discharge the obligation.

The event leading to the obligation must be **past** and must have occurred before the end of the reporting period when the provision is first recognised. No provision is made for costs that may be incurred in the future but where no obligation yet exists.

Illustration:

A company is planning a reorganisation. These plans are in an early stage.

There is no obligation (legal or constructive) to undertake the reorganisation. The company cannot create a provision for reorganisation costs.

Only obligations arising from past events that exist independently of a company's future actions are recognised as provisions.

Example:

Lagos Properties owns a series of high-rise modern office blocks in several major cities in Nigeria.

The government introduces legislation that requires toughened safety glass to be fitted in all windows on floors above the ground floor. The legislation only applies initially to new buildings, but all buildings will have to comply within 5 years.

Analysis:

There is no obligating event.

Even though Lagos Properties will have to comply within 5 years it can avoid the future expenditure by its future actions, for example by selling the buildings. There is no present obligation for that future expenditure, and no provision is recognised.

Example:

Aba Energy Company operates in a country where there is no environmental legislation. Its operations cause pollution in this country.

Aba Energy Company has a widely published policy in which it undertakes to clean up all contamination that it causes, and it has a record of honouring this published policy.

Analysis:

There is an obligating event. Aba Energy Company has a constructive obligation which will lead to an outflow of resources embodying economic benefits regardless of the future actions of the company. A provision would be recognised for the clean-up subject to the other two criteria being satisfied.

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An obligation always involves another party to whom the obligation is owed.

However, it is not necessary to know the identity of that party. It is perfectly possible to have an obligation to the public at large or to a

group of people.

Example:

Maiduguri Household Appliances Corporation gives warranties at the time of sale to purchasers of its products. Under the terms of the sale contract the company undertakes to make good any manufacturing defects that become apparent within three years from the date of sale.

In the period it has sold 250,000 appliances and estimates that about 2% will prove faulty.

Analysis:

There is an obligating event being the sale of an item with the promise to repair it as necessary. The fact that Maiduguri Household Appliances Corporation does not know which of its customers will seek repairs in the future is irrelevant to the existence of the obligation.

A provision would be recognised for the future repairs subject to the other two criteria being satisfied.

Note that the estimate that only 2% will be faulty is irrelevant in terms of recognizing a provision. However, it would be important when it came to

An obligation always involves a commitment to another party. Therefore, a management decision does not give rise to a constructive obligation unless it has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the company will discharge its responsibilities.

Example:

On13 December Jos Engineering decided to close a factory. The closure will lead to100 redundancies at a significant cost to the company.

At31December no new soft his plan had been communicated to the

workforce.

Analysis:

There is no obligating event. This will only come into existence when communication of the decision and its consequences are communicated to the workforce.

An event may not give rise to an obligation immediately but may do so at a later date due to a change in circumstances. These include:

changes in the law; or

where an act of the company (for example, a sufficiently specific public statement) gives rise to a constructive obligation.

If details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted.

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13.2.5 Probable outflow of economic benefits

The outflow of benefits must be probable. 'Probable' is defined by IAS 37 as 'more likely than not to occur'.

> **Illustration:**
> A company may have given a guarantee but may not expect to have to honour it.

More likely than not implies a greater than 50% chance but be careful to think about this in the right way.

Example:

Maiduguri Household Appliances Corporation gives warranties at the time of sale to purchasers of its products. Under the terms of the sale contract the company undertakes to make good any manufacturing defects that become apparent within three years from the date of sale.

In the period it has sold 250,000 appliances and estimates that about 2% will prove faulty.

Analysis:

The outflow of benefits is probable. It is more likely than not that 2% will be faulty. (In other words, there is more than a 50% chance that 2% of items will prove to be faulty).

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13.3 Provisions: Measurement

13.3.1 Introduction

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 the amount that the company would have to pay to settle the obligation at this date. It is the amount that the company would have to pay a third party to take the obligation off its hands.

The estimates of the outcome and financial effect of an obligation are made by management based on judgement and experience of similar transactions and perhaps reports from independent experts.

Risks and uncertainties should be taken into account in reaching the best estimate. Events after the reporting period will provide useful evidence. (Events after the reporting period are dealt with in more detail later.)

Uncertainties

Uncertainties about the amount to be recognised as a provision are dealt with by various means according to the circumstances.

In measuring a single obligation, the best estimate of the liability may be the most likely outcome. However, other possible outcomes should be considered. If there are other possibilities which are mostly higher or mostly lower than the most likely outcome, then the best estimate will be a higher or lower amount.

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Example:

Gombe Prefabricators Limited (GPL) has won a contract to provide temporary accommodation for workers involved in building a new airport. The contract involves the erection of accommodation blocks on a public park and two years later the removal of the blocks and there in statement of the site.

The blocks have been built, and it is now GPL's year-end.

GPL estimates that the task of removing the blocks and reinstating the park to its present condition might be complex, resulting in costs with a present value of ₦2,000,000, or straight forward, resulting in costs with a present value of ₦1,300,000.

GPL estimates that there is a 60% chance of the job being straight forward.

Should a provision be recognised and if so at what value?

Analysis

Should a provision be recognised?

Is there a present obligation as a result of a past event?	Yes. A present obligation arises due to the existence of a contractual term and the building of the block.
Is it probable that there will be an outflow of economic benefits to settle the obligation	Yes. This is certain.
Can a reliable estimate be made of the amount of the obligation?	Yes. Data is available.

A provision should be recognised.

How should the provision be measured? (What is the best estimate of expenditure required to settle the obligation?)

The most likely outcome is that the job will be straight forward. In this case the provision would be recognized at ₦1,300,000.

However, there is a significant chance that the job will be complex so perhaps GPL should measure the liability at the higher amount. This may sound a little vague but in practice this comes down to a matter of judgement.

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When there is a large population of potential obligations (for example, a provision for multiple claims under guarantees) the obligation should be estimated by calculating an expected value of the cost of the future obligations. This is done by weighting all possible outcomes by their associated probabilities.

Example:

Sokoto Manufacturing has sold ₦10,000 units in the year. Sales accrued evenly over the year.

It estimates that for every 100 items sold, 20 will require small repairs at a cost of ₦100,10 of the items will require substantial repairs at a cost of ₦400 each and 5 will require major repairs or replacement at a cost of ₦800 each.

On average the need for are pair becomes apparent 6 months after a sale. What is the closing provision?

A provision will be required for the sales in the second six months of the year as presumably the repairs necessary in respect of the sales in the first six months have been completed by the year end.

Sales accrue evenly, therefore, the sales in the second six months are 5,000 units ($^{6}/_{12}$ x 10,000).

Repair	Number	Cost per repair (₦)	Total (₦)
Small	20% x 5,000 = 1,000	100	100,000
Substantial	10% x 5,000 = 500	400	200,000
Major	5% x 5,000 = 250	800	200,000
Provision			500,000

Note that this would be reduced by their pairs already made by the year end

Time value

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.

The discount rate used should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

The need to discount is often found when accounting for decommissioning liabilities. These are discussed in section 2.4.

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Example:

Gombe Prefabricators Limited (GPL) has won a contract to provide temporary accommodation for workers involved in building a new airport. The contract involves the erection of accommodation blocks on a public park and two years later the removal of the blocks and the reinstatement of the site.

The blocks have been built, and it is now 31 December 20X8 (GPL's year-end).

GPL estimates that in two years it will have to pay ₦2,000,000 to remove the blocks and reinstate the site.

The pre-tax discount rate that reflects current market assessments of the time

The provision that should be recognized at 31 December 20X8 is as follows:

$$\text{Provision} = \frac{\text{Future Obligation}}{(1+r)^n}$$

Future events

Expected future events may be important in measuring provisions. For example, a company may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology.

The measurement of an obligation must take expected future changes into account where there is sufficient objective evidence that they will occur. In such cases the measurement of the provision should be based on the reasonable expectations of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up.

This means that a company might include expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out.

One future event might be the effect of possible new legislation.

The measurement process should take this into account when there is sufficient objective evidence that the legislation is virtually certain to be enacted.

In practice, the proceeds of the sale of an asset in the future might be used to pay for an event for which a provision is recognised today. However, gains from the expected disposal of assets must not be taken into account in measuring a provision.

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Reimbursements

In some cases, a part or all of a company's provision may be recoverable from a third party. For example, a company paying out to a customer under the terms of a guarantee may itself be able to claim money back from one of its own suppliers.

IAS 37 requires that such a reimbursement:

i. should only be recognised where receipt is virtually certain; and

ii. should be treated as a separate asset in the statement of financial position (i.e., not netted off against the provision) at an amount not greater than that of the provision.

However, IAS 37 allows the expense relating to a provision to be presented net of the amount recognised for a reimbursement in the statement of profit or loss.

13.4 Provisions: Double Entry And Disclosures

13.4.1 Introduction

IAS 37 is about the recognition and measurement of provisions which are of course a credit balance. It gives little guidance on the recognition of the debit entry on initial recognition of a provision saying that whether an expense or asset is recognised is left to guidance in other standards.

13.4.2 Measurement on initial recognition

In most cases the debit entry that arises when a provision is recognised is an expense. There is one important case where it is capitalised as an asset (on recognition of a decommissioning liability) and this is discussed later.

Illustration: Usual double entry on initial recognition of a provision

	Debit	Credit
Profit or loss (expense)	X	
Provision		X

13.4.3 Use of provisions

A provision is set up to recognise an expense (usually) that exists at the reporting date. When the expense is paid the following double entry is used:

Illustration: Using a provision.

	Debit	Credit
Provision	X	
Cash		X

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.

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If the provision is insufficient to settle the liability an extra expense is recognised.

IAS 37 also states that a provision may be used only for expenditures for which the provision was originally recognised.

Example: Use of provisions

A company has created a provision of ₦300,000 for the cost of warranties and guarantees.

The company now finds that it will probably has to pay ₦250,000 to settle a legal dispute.

It cannot use the warranties provision for the costs of the legal dispute. An extra ₦250,000 expense must be recognised.

13.4.4 Subsequent measurement

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.

Illustration: Subsequent re-measurement of provisions.

	Debit	Credit
Derecognition of a provision that is no longer needed.		
Provision	X	
Income statement		X
Increase in a provision:		
Profit or loss	X	
(expense)		X
Provision		
Decrease in a provision:	X	
Provision		X

Example: Subsequent measurement 31 December 20X7

A company was sued by a customer in the year ended 31 December 20X7.

Legal advice is that the customer is virtually certain to win the case as several similar cases have already been decided in the favour of the injured parties.

At 31 December 20X7, the company's lawyer was of the opinion that, the cost of the settlement would be ₦1,000,000.

A provision is recognized in the amount of ₦1,000,000 as follows (reducing profit for the year by that amount).

	Debit (₦)	Credit (₦)
Expenses	1,000,000	
Provision		1,000,000

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31 December 20X8

The claim has still not been settled. The lawyer now advises that the claim will probably be settled in the customer's favour at ₦1,200,000.

The provision is increased to ₦1,200,000 as follows.

	Debit (₦)	Credit (₦)
Expenses	200,000	
Provision		200,000

31 December 20X9

The claim has still not been settled. The lawyer now believes that the claim will be settled at ₦900,000.

The provision is reduced to ₦900,000 as follows.

	Debit(₦)	Credit (₦)
Provision	300,000	
Expenses		300,000

The reduction in the provision increases profit in the year and the provision in the statement of financial position is adjusted down to the revised estimate of ₦900,000.

31 December 20X9

The claim is settled for ₦950,000. On settlement, the double entry in the ledger accounts will be:

	Debit (₦)	Credit(₦)
Expenses	50,000	
Provision		
Cash	900,000	950,000

The charge against profit on settlement of the legal claim is ₦50,000.

The provision no longer exists. The total amount charged against profit over the four years was the final settlement figure of ₦950,000.

When a provision is included in the statement of financial position at a discounted value (at present value) the amount of the provision will increase over time, to reflect the passage of time. In other words, as time passes the amount of the discount gets smaller, so the reported provision increases. This increase in value is included in **borrowing costs** for the period.

13.4.5 Disclosures about provisions

IAS 37 requires the following disclosures about provisions in notes to the financial statements.

For each class of provision:

a) the opening and closing balances and movements in the provision during the year;

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b) a brief description of:

c) the nature of the obligation;

d) the expected timing of any settlement; and

e) an indication of the uncertainties surrounding the amount and timing of any settlement.

13.5 Guidance on Specific Provisions

IAS 37 explains how its rules apply in given circumstances. Some of the guidance is in the body of the standard and some in an appendix to the standard.

13.5.1 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).

Example: Onerous contract

On31December20X8, company His three years through a five-year contract to buy10,000 units of a component per annum at a price of ₦100 per unit.

The units are incorporated into a finished product that previously sold for ₦150 per unit. A substitute product for the finished good has recently entered the market. This product sells for ₦90 per unit and is superior to the original product.

Company H has decided to withdraw from this market but is still committed to the remaining two years of the supply contract.

The market price of the component has fallen to ₦75 per unit and it is probable that Company H could sell the components at this price.

Analysis

A present legal obligation exists as a result of a past event (the signing of the supply contract).

An outflow of resources is probable. (These are the payments to buy the components for the remainder of the term of the supply contract).

The amount can be measured reliably (10,000 units x 2years x ₦(100–75))= ₦500,000.

The discounted value of the future net payments for two years would be recognised as a provision.

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Example: Onerous contract

Ogbomosho Clothing has a contract to buy 300 metres of silk from a supplier each month for ₦3,000 per metre.

Ogbomosho Clothing had a contract with a Dubai retailer to sell each dress for ₦5,000 but this retailer has fallen into administration, and the administrator shave cancelled the contract as they were entitled to do under one of its clauses.

Ogbomosho Clothing cannot sell the dresses to any other customer.

The contract to buy the silk can be cancelled with three months'

notice. **Analysis**

The company can cancel the contract but must pay for the next three months deliveries:

Cost (300m × ₦3,000 × 3 months) ₦2,700,000 A provision should be recognised for this amount.

13.5.2 Future operating losses

A company may forecast that it will make a substantial operating loss in the next year or several years. If so, its directors might want to 'take all the bad news' immediately and create a provision for the future losses.

Provisions cannot be made for future operating losses. This is because they arise from future events, not past events.

13.5.3 Restructuring

A company may plan to restructure a significant part of its operations. Examples of restructuring are:

a) the sale or termination of a line of business

b) the closure of business operations in a country or geographical region, or relocation of operations from one region or country to another

c) major changes in management structure, such as the removal of an entire 'layer' of management from the management hierarchy

d) fundamental reorganisations changing the nature and focus of the company's operations.

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 identifying at least:

a) the business or part of a business concerned;

i. the principal locations affected;

ii. the location, function, and approximate number of employees who will be compensated for terminating their services;

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iii. the expenditures that will be undertaken; and

iv. when the plan will be implemented; and

b) 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.

A restructuring decision made before the end of the reporting period does not give rise to a constructive obligation unless the company has:

a) started to implement the plan; or

b) announced the main features of the plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the restructuring will occur.

A company might start to implement a restructuring plan, or announces its main features to those affected, after the reporting period but before the financial statements are authorised for issue.

Disclosure is required *under IAS 10 Events after the Reporting Period* if the restructuring is material.

A restructuring provision must only include the direct expenditures arising from the restructuring. These are those that are both:

a) necessarily entailed by the restructuring; and

b) not associated with the ongoing activities of the company.

A restructuring provision would not include costs that are associated with ongoing activities such as:

a) retraining or relocating continuing staff;

b) marketing; or

c) investment in new systems, etc.

13.5.4 Decommissioning liabilities and similar provisions

A company may be required to 'clean up' a location where it has been working when production ceases.

This is often the case in industries where companies are only granted licenses to operate on condition that they undertake to perform future clean-up operations.

Such industries include oil and gas, mining and nuclear power.

For example, a company that operates an oil rig may have to repair the damage it has caused to the seabed once the oil has all been extracted.

The normal rules apply for the recognition of a provision: a company recognises a provision only where it has an obligation to rectify environmental damage as a result of a past event.

A company has an obligation to 'clean-up' a site if:

a) it is required to do so by law (a legal obligation); or

b) its actions have created a constructive obligation to do so.

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A constructive obligation might exist if (for example) a company has actually promised to decontaminate a site or if it has adopted environmentally friendly policies and has made the public aware of this.

Accounting for a provision for a decommissioning liability

IAS 16 Property, plant and equipment identifies the initial estimate of the costs of dismantling and removing an item and restoring the site upon which it is located as part of the cost of an asset.

Future clean-up costs often occur many years in the future so any provision recognised is usually discounted to its present value.

Illustration: Initial recognition of a provision for a decommissioning liability

	Debit	Credit
Non-current asset	X	
Provision		X

The asset is depreciated over its useful life in the same way as other non-current assets.

The provision is remeasured at each reporting date. If there has been no change in the estimates (i.e. the future cash cost, the timing of the expenditure and the discount rate) the provision will increase each year because the payment of the cash becomes one year closer. This increase is described as being due to the unwinding of the discount.

The amount due to the unwinding of the discount must be expensed.

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Example: Deferred consideration

A company has constructed an oil rig which became operational on 1 January 20X8.

The company has contracted to remove the original associated infrastructure and to restore the site to repair any environmental damage to the site on completion of drilling activity. This is estimated to be at a cost of ₦8,000,000 in 10 years' time.

The pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability is 10%.

1 January 20X8 – Initial measurement

$$PV = \frac{8,000,000}{(1+0.10)^{10}} = 3,084,346$$

	Debit	Credit
Asset	3,084,346	
Provision		3,084,346

31 December 20X8

Ey The provision is remeasured as:

$$PV = \frac{8,000,000}{(1+0.10)^{10}} = 3,084,346$$

Provision:	₦
Balance b/f	3,084,346
Interest expense (the unwinding of the discount)	308,435
Balance c/f	3,392,781

The asset is depreciated (say on a straight line)

Asset:	₦
Cost	3,084,346
Depreciation (₦ 8,000,000/10years)	(308,435
Carrying amount	7,200,000

Double entry:

	Debit	**Credit**
Profit or loss (interest expense)	308,435	
Provision		308,435
Profit or loss (depreciation expense)	308,435	
Accumulated depreciation		308,435

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A provision for making good environmental damage might be recognised both on when an asset is installed and then increased as the asset is used.

Example:

A company is about to begin to operate a coal mine. At the end of the reporting period, the mineshaft has been prepared, and all the necessary equipment has been constructed and is in place, but no coal has yet been extracted.

Under local law, the company is obliged to rectify all damage to the site once the mining operation has been completed (this is expected to be several years from now).

Management estimates that 20% of the eventual costs of performing this work will relate to plugging the mine and removing the equipment and various buildings and the remaining 80% will relate to restoring the damage caused by the actual extraction of coal.

Analysis

The company has a legal obligation to rectify the environmental damage caused by the actual digging of the mineshaft and construction of the site. An outflow of economic benefits is probable.

Therefore, the company should recognise a provision for the best estimate of removing the equipment and rectifying other damage which has occurred to date. This is expected to be about 20% of the total cost of restoring the site.

Because no coal has yet been extracted, the company has no obligation to rectify any damage caused by mining. No provision can be recognised forth is part of the expenditure (estimate data bout 80% of the total).

13.4.5 Future repairs to assets

Some assets need to be repaired or to have parts replaced at intervals during their lives.

For example, suppose that a furnace has a lining that has to be replaced every five years. If the lining is not replaced, the furnace will break down.

Before IAS 37 was issued, companies would often recognise provisions for the cost of future repairs or replacement parts. These might be built up in instalments over the life of the asset or the relevant part of the asset.

IAS 37 effectively prohibits this treatment. The reasoning behind this is that a company almost always has an alternative to incurring the expenditure, even if it is required by law (for example, for safety reasons). For example, the company which has to replace the lining of its furnace could sell the furnace or stop using it, although this is unlikely in practice.

IAS 37 states that a provision cannot be recognised for the cost of future repairs or replacement parts unless the company has an obligation to incur the expenditure, which is unlikely. The obligating event is normally the actual repair or purchase of the replacement part.

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Instead of recognising a provision, a company should capitalise expenditure incurred on replacement of an asset and depreciate this cost over its useful life. This is the period until the part needs to be replaced again. For example, the cost of replacing the furnace lining should be capitalised, so that the furnace lining is a non-current asset; the cost should then be depreciated over five years. (Note: *IAS 16: Property, plant and equipment* states that where an asset has two or more parts with different useful lives, each part should be depreciated separately.)

Normal repair costs, however, are expenses that should be included in profit or loss as incurred.

13.6 Contingent Liabilities and Contingent Assets

13.6.1 Definitions

'Contingent' means 'dependent on something else happening.'

Contingent liability

A contingent liability is one that does not exist at the reporting date but may do so in the future or it is a liability that exists at the reporting date but cannot be recognised because it fails one of the IAS 37 recognition criteria.

> **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.

IAS 37 makes a distinction between:

a) provisions – which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

b) contingent liabilities – which are not recognised as liabilities because they are either:

i. possible obligations;

ii. present obligations that do not meet the recognition criteria for provisions because either;

iii. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

iv. a sufficiently reliable estimate of the amount of the obligation cannot be made).

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Example:

Company G is involved in a legal dispute with a customer, who is making a claim against Company G for losses it has suffered as a consequence of a breach of contract.

If Company G's lawyers believe that the likelihood of the claim succeeding is **possible** rather than probable, then the claim should be treated as a contingent liability and not as a provision.

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.

An example of a contingent asset might be a possible gain arising from an outstanding legal action against a third party. The existence of the asset (the money receivable) will only be confirmed by the outcome of the legal dispute.

Recognising contingent liabilities or contingent assets

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.

a) **Contingent liabilities** should be disclosed unless the possibility of any outflow in settlement is remote (the meaning of 'remote' is not defined in IAS 37).

b) **Contingent assets** should be **disclosed only if** an inflow in settlement is **probable**. 'Probable' is defined by IAS 37 as 'more likely than not'. (And if an inflow is certain, the item is an actual asset that should be recognised in the statement of financial position.)

Disclosures about contingent liabilities and contingent assets

Where disclosure of a contingent liability or a contingent asset is appropriate, the following disclosures are required:

a) a brief description of the nature of the contingent liability/asset;

b) where practicable;

c) an estimate of its financial effect;

d) an indication of the uncertainties; and

e) for contingent liabilities, the possibility of any reimbursement.

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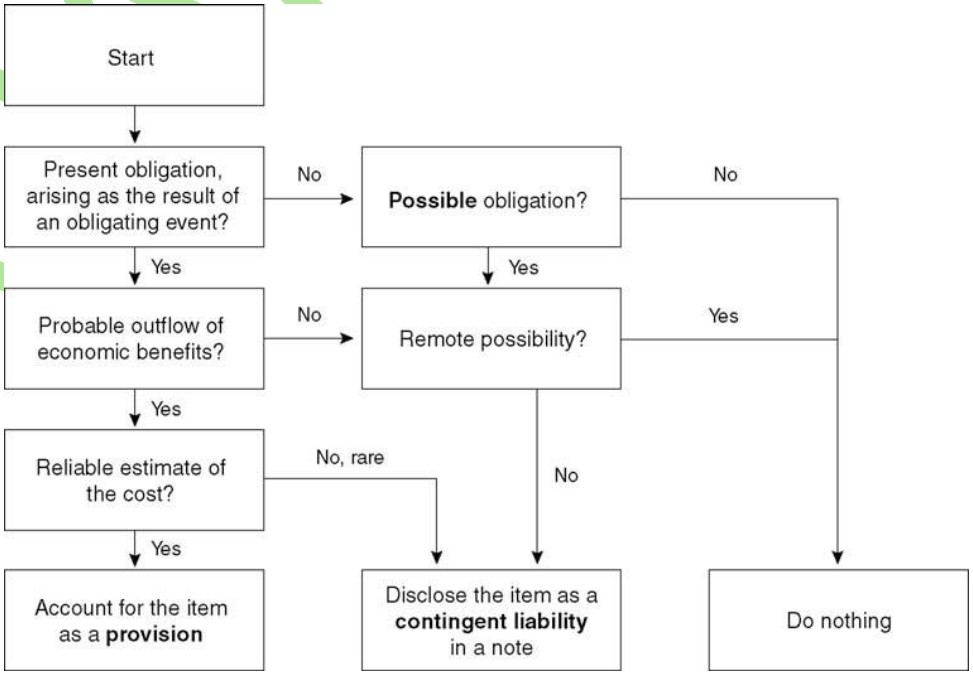
Summary: liabilities, provisions, contingent liabilities and contingent assets

The following table provides a summary of the rules about whether items should be treated as liabilities, 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 existence 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

Decision tree

An Appendix to IAS 37 includes a decision tree, showing the rules for deciding whether an item should be recognised as a provision, reported as a contingent liability, or not reported at all in the financial statements.



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Practice question 1

Sokoto Transformers Ltd (STL) is organised into several divisions.

The following events relate to the year ended 31 December 20X8.

i. A number of products are sold with a warranty. At the beginning of the year the provisions to date ₦750,000.

A number of claims have been settled during the period for ₦400,000.

As at the year-end there were unsettled claims from 150 customers. Experience is that 40% of the claims submitted do not fulfil warranty conditions and can be defended at no cost.

The average cost of settling the other claims will be ₦7,000 each.

ii. A transformer unit supplied to Rahim Yar Khan District Hospital exploded during the year.

The hospital has initiated legal proceedings for damages of ₦10 million against STL.

STL's legal advisors have warned that STL has only a 40% chance of defending the claim successfully. The present value of this claim has been estimated at ₦9million.

The explosion was due to faulty components supplied to STL for inclusion in the transformer. Legal proceedings have been started against the supplier. STL's legal advisors say that STL have a very good chance of winning the case and should receive 40% of the amount that they have to pay to the hospital.

iii. On1July 20X8 STL entered into a two-year, fixed price contract to supply a customer 100 units per month.

Therefore, cast profit per unit was ₦1,600 but, due to unforeseen cost increases and production problems, each unit is anticipated to make a loss of ₦800.

iv. On1July 20X7 one of STL's divisions has commenced the extraction of minerals in an overseas country. The extraction process causes pollution progressively as theories extracted.

There is no environmental clean-up law enacted in the country.

STL made public statements during the licence negotiations that as a responsible company it would restore the environment at the end of the licence.

STL has a license to operate for 5 years. At the end of five years the cost of cleaning (on the basis of the planned extraction) will be:
₦5,000,000.

Extraction commenced on1July 20X8 and is currently at planned levels.

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Required:

Prepare the provisions and contingencies notes for the financial statements for the year ended 31December 20X8, including narrative commentary.

13.7 Chapter review

Chapter review

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

(a) define liability, provision, contingent liability and contingent asset;

(b) distinguish between provisions, contingent liabilities or contingent assets;

(c) understand and apply the recognition criteria for provisions under IFRS;

(d) calculate/ measure provisions;

(e) account for changes in provisions; and

(f) report provisions in final accounts.

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Solution to Practice Question

Solution: Provisions and contingencies 1

	Warranty	Legal claim	Onerous contract	Clean-up costs	Total
	₦000	₦000	₦000	₦000	₦000
At 1 January 20X8	750	nil	nil	500	1,250
Used in the year	(400)				(400)
Statement of profit or loss (balance)	280	9,000	1,440	1,000	11,720
At31 December 20X8	630 W1	9,000	1,440 W2	1,500 W3	12,570 W4

Warranty: The company grants warranties on certain categories of goods. The measurement of the provision is on the company's experience of the likelihood and cost of paying out under the warranty.

Legal claim: The legal claim provision is in respect of a claim made by a customer for damages as a result of faulty equipment supplied by the company. It represents the present value of the amount at which the company's legal advisors believe the claim is likely to be settled.

Onerous contract: The provision for the onerous contract is in respect of a two-year fixed-price contract which the company entered into on 1 July 20X8. Due to unforeseen cost increases and production problems, a lessor this contract is now anticipated. The provision is based on the amount of this loss up to the end of the contract.

Clean-up costs: The provision for clean-up costs is in respect of the company's overseas mineral extraction operations.

The company is 18 months into a five-year operating licence. The estimated cost of cleaning up the site at the end of the five years is ₦5,000,000. A provision of ₦1,000,000 per annum is recognised.

Contingent asset: The company is making a claim against a supplier of components. These components led in part to the legal claim against the company for which a provision has been made above. Legal advice is that this claim is likely to succeed and should amount to around 40% of the total damages (₦3.6 million).

W1 Warranty provision:150 x ₦7,000 x 60% = ₦30,000.

W2 Onerous contract:18months x100 units x ₦800 = ₦1,440,000.

W3 Clean up costs: ₦1,000,000 per annum as it is the extraction that causes the cost.

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13.8 End of chapter questions and suggested solutions

13.8.1 Questions

Question 1

You are the financial reporting officer for ABC Ltd. The company is finalising its financial statements for the year ended 31 December 20X4. Several events during the year raise concerns over the appropriate recognition of provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. You are required to provide professional advice on the following issues:

a. ABC Ltd has received legal claims from multiple customers regarding a faulty product. The total claim is ₦3.5 million. Based on legal advice, there is an 80% chance of the customers being successful.

b. On 15 December 20X4, the board publicly announced the closure of an operating unit, which will lead to employee redundancies and reassignments. The associated costs are as follows:

   i. Redundancy: ₦800,000
   ii. Lease termination: ₦200,000
   iii. Relocation of continuing employees: ₦400,000
   iv. Retraining of continuing employees: ₦300,000

c. ABC is also considering the recognition of a warranty provision. The company sold 100,000 units of a product during the year. Historical trends show:

   i. 6% of products require repairs costing ₦100 per unit
   ii. 8% require minor services costing ₦30 per unit

d. Outline the criteria required under IAS 37 for recognising a provision. Provide examples from the scenarios above to support your explanation.

Question 2

Promoil Ltd is preparing its financial statements for the year ended 30 September 20X8. The statements were authorised for issue on 6 November 20X8. You are required to assess and advise on the following issues:

a. On 1 October 20X7, Promoil acquired an oil platform at a cost of ₦30 million. There is **no legal requirement** to dismantle the platform after use. However, Promoil has a **published environmental policy** and a consistent history of decommissioning similar platforms. The estimated decommissioning cost in 10 years is ₦15 million. The present value factor at 8% for 10 years is 0.46.

b. On 12 October 20X8, a fire destroyed the company's warehouse with a carrying amount of ₦10 million. Insurance recovery of ₦9 million is expected. The fire occurred after the reporting date.

c. The company forecasts an operating loss of ₦4 million for the year ending 31 December 20X5. Should any provision be recognised?

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d. A provision for a workplace accident is estimated at ₦2 million. What principles should be applied to determine the amount to be recognised?

13.8.2 Suggested solutions

Solution 1:

a) **Legal claim for faulty products**
IAS 37 requires recognition of a provision where:

i. A present obligation exists from a past event.
ii. There is a probable outflow of resources.
iii. The amount can be reliably estimated.

Here, the faulty product sale is a past event, the 80% chance meets the "probable" threshold, and the claim is measurable.

Provision to recognise = ₦3,500,000

b) **Restructuring provision**
Only costs directly resulting from the restructuring should be provided for. According to IAS 37:

i. Redundancy (₦800k) and lease termination (₦200k) are obligations.
ii. Relocation and retraining relate to ongoing operations and should not be included.

Total provision = ₦800,000 + ₦200,000 = ₦1,000,000

c) **Warranty provision calculation**
IAS 37 requires using expected values for obligations involving a large population.

i. Repair cost = 100,000 × 6% × ₦100 = ₦600,000
ii. Service cost = 100,000 × 8% × ₦30 = ₦240,000

Warranty provision = ₦840,000

d) **Criteria for recognising a provision under IAS 37:**

i. **Present obligation** from past event (e.g., faulty product sale)
ii. **Probable outflow** of economic resources (e.g., 80% probability)
iii. **Reliable estimate** of the obligation (e.g., ₦3.5 million legal claim, calculated warranty)

All scenarios above satisfy IAS 37 recognition rules.

Solution 2:

a) **Decommissioning provision for oil platform**
IAS 37 recognises both **legal and constructive obligations**. Although there is

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no legal obligation, the published environmental policy and history of decommissioning give rise to a **constructive obligation**.

i. Initial provision = ₦15m × 0.46 = ₦6.9 million
ii. After unwinding one year of 8% discount: ₦6.9m × 1.08 = ₦7.452 million

Provision to recognise at 30 Sept 20X8 = ₦7,452,000

b) **Warehouse fire (event after reporting date)**
The fire occurred on **12 October**, **after the reporting date** (30 September), but **before the financial statements were authorised**.

Per IAS 10 *Events after the Reporting Period*, this is a **non-adjusting event** since it occurred **after year-end** and does **not relate to conditions existing at reporting date**.

Disclose in notes; **no adjustment** to 30 Sept 20X8 financials.

c) Forecast future operating loss
IAS 37 prohibits recognising provisions for **future operating losses** since they do not relate to present obligations or past events.

No provision to be recognised.

d) Workplace accident provision
IAS 37 requires that a **provision for a single obligation** be recognised at the **most likely amount**, not an expected value (used for large populations).

Provision = ₦2 million (most probable value)

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Skills Level
Financial Reporting

CHAPTER 14

IAS 12: INCOME TAXES

Contents

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14.5 Recognition of deferred tax: basic approach
14.6 Recognition and measurement rules
14.7 Presentation and disclosure
14.8 Chapter review
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14 Income Taxes

14.0 Learning objective

This chapter covers the treatment of income taxes in financial statements.

14.1 Learning outcomes

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

(a) account for current tax;

(b) define temporary differences;

(c) identify temporary differences that cause deferred tax liabilities and deferred tax assets;

(d) determine the amount of deferred tax to be recognised in respect of temporary differences identified; and

(e) apply the disclosure requirements of ias12.

14.2 Accounting for Taxation

14.2.1 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:

a) Adding back inadmissible deductions (accounting expenses which are not allowed as a deduction against taxable profit).

b) Deducting admissible deductions which include:

i. expenses that are allowable as a deduction against taxable profit, but which have not been recognised in the financial statements.

ii. Income recognised in the financial statements, but which is not taxed.

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***.

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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: In admissible deductions	X
Less: Admissible deductions	(X)
Taxable profit	X
Tax rate	x%
Tax payable (current tax)	X

Example: Taxation computation

Enugu Traders Ltd had an accounting profit of ₦89,000 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 capitalized in accordance with IAS 23.

At1January 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.

Accounting depreciation is not allowable for tax purposes.

Capital allowance is 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 in admissible deductions:		
Accounting depreciation	70,000	
Fine paid	125,000	
		195,000
Less: Admissible deductions		
Tax depreciation (15% x 120,000 + 10% x 600,000)	78,000	
Capital gain	97,000	
Borrowing cost capitalised	10,000	
		(185,000)
Taxable profit		799,000

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Tax rate	30%
Tax payable	239,700

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 depreciation 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.

14.2.2 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 profit or loss 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 sometime 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.

(a) an under-estimated of tax on the previous year's profits is added to the tax charge for the current year.

(b) an over-estimated of tax on the previous year's profits is deducted from the tax charge for the current year.

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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

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

14.2.3 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

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14.3 Deferred Tax: Introduction

14.3.1 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:

a) one set constructed following IFRS rules; and,

b) 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 1January 20X1 for ₦9,000. This asset is to be depreciated on a straight-line basis over 3 years.

	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

Accounting depreciation is not allowed as a taxable deduction in the jurisdiction in which the company operates. Instead, tax allowable depreciation (capital allowance) is available as shown in the following tax computations:

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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 profit or loss 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 x 30% = 45,000).

This is not the case in each separate year.

This is because the tax rate is not applied to the accounting profit before tax but to that figure after adjustments.

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 profit or loss. (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 profit or loss 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.

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14.3.2 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) a statement of profit or loss (income and expenses) perspective:

i. 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;

ii. the approach identifies the deferred tax expense or credit recognised in the statement of profit or loss for the period (with the other side of the entry recognised as a liability or asset); or

(b) a statement of financial position (assets and liabilities) perspective:

i. 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;

ii. x 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 profit or loss).

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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 at31/12/X3	–	–	–	–

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Statement of profit or loss perspective

Example continued: Statement of profit or loss perspective 20X1:

₦3,000 is disallowed but ₦4,500 is allowed instead.

taxable expense is ₦1,500 greater than the accounting expense.

tax able 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 recognized to restore the balance (Dr: Tax expense/Cr: Deferred taxation liability).

20X2:

₦3,000 is disallowed but ₦2,500 is allowed instead.

(a) taxable expense is ₦500 less than the accounting expense.

(b) taxable profit is ₦500 more than accounting profit.

(c) current tax is increased by 30% of ₦500 (₦150).

(d) deferred tax credit of ₦150 must be recognized to restore the balance (Dr: Deferred taxation liability/Cr: Tax expense).

20X3:

₦3,000 is disallowed but ₦2,000 is allowed instead.

(a) taxable expense is ₦1,000 less than the accounting expense.

(b) Taxable profit is ₦1,000more than accounting profit.

(c) current tax is increased by 30% of ₦1,000 (₦300).

(d) deferred tax credit of ₦300 must be recognised to restore the balance (Dr: Deferred taxation liability / Cr: Tax expense).

The statement of profit or loss 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

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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 taxbase.

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.

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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.

14.3.2 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.

14.4 Recognition of Deferred Tax: Basic Approach

14.3.1 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. Tax able 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 tax able 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

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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.

14.4.2 Taxable and deductible temporary differences

Temporary differences may be either taxable temporary differences or deductible temporary differences.

Taxable temporary differences

A temporary taxable 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.

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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 basis.

If an item is taxed on cash basis the tax base would be zero as no receivable would be recognized under the tax rules.

Note 2:

The credit balance in the financial statements is ₦1,000 and the tax base is accredited 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.

IAS12 rationalises the approach as follows (using then on-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.

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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 then on-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.

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14.4.3 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 but the deferred tax consequences of these is outside your syllabus).

Approach

The calculation of the balance to be recognised in the statement of financial position is quite straight forward.

Step 1:

Identify the temporary differences (this should always involve a column are 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 at a x base of ₦140,000.

It has recognised a receivable of ₦I0,000. This relates to income which is taxed on 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.

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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

14.4.4 Sources of temporary differences

Circumstances under which temporary differences arise include:

1. 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:
   - **(a)** items which are taxed on a cash basis but which will be accounted for on an accrual basis; and
   - **(b)** situations where the accounting depreciation does not equal tax allowable depreciation (capital allowance).
2. Revaluation of assets where the tax authorities do not amend the tax base when the asset is revalued.

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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 recognizes 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

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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 31December 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.

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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 31December 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

14.5 Recognition and Measurement Rules

14.5.1 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:

a) the initial recognition of goodwill; or

b) the initial recognition of an asset or liability in a transaction which:

   i. is not a business combination; and

   ii. 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 but that is outside the scope of your syllabus.

14.5.2 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

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Example: Goodwill

In the year ended 31 December 20X8, A Plc acquired 80% of another company 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	nil	100,000
Deferred tax (due to the exception)			nil

The exception refers to the initial recognition of good will. 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 goodwill if ₦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 effects either accounting profit or taxable profit the exception does not apply, and deferred tax is recognised on initial recognition.

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Example: Goodwill

In the year ended 31December 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
	₦	₦	₦
Goodwill	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.

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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 them 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

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14.5.3 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:

a) is not a business combination; and

b) at the time of the transaction, it affects neither accounting profit nor taxable profit (tax loss).

There is further guidance on the recognition of deferred tax assets 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:

a) liabilities are always recognised in full (subject to certain exemptions beyond the scope of your syllabus); but

b) 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 to be used in the future. Any such reduction might be reversed in the future if circumstances change again.

14.5.4 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.

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Example: Permanent difference.

E Plc has recognized ₦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
₦	₦	₦
100,000	nil	100,000

Receivable

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:

(a) 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.

(b) 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.

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Returning to the above example:

Example: Permanent difference.

E Plc has recognised100,000 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
₦	₦	₦
100,000	100,000	nil

Receivable

The item is not taxable its tax base is set to be the same as its carrying amount.

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 u the accounting profit before tax.

This will not be the case if there are permanent differences.

14.5.5 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.

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14.6 Presentation and Disclosure

14.6.1 Presentation

IAS 12: Income taxes contain rules on when current tax liabilities may be offset against current tax assets

Offset of current tax liabilities and assets

A company must offset current tax assets and current tax liabilities if, and only if, it:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) 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:

(a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

(b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:

i. the same taxable entity; or

ii. 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.

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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

	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 recognized if the entity believes it is probable that it will be recovered in the foreseeable future.

14.6.2 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);

(a) any adjustments recognised in the period for current tax of prior periods;

(b) the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;

(c) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;

(d) 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;

(e) deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset;

(f) the amount of tax expense (income) relating to those changes in

Illustration: Note to the statement of profit or loss

Taxation expense	₦
Current tax	129,000
Adjustment for overestimate 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

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accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

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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

	₦
Deferred taxation b/f	30,000
Statement of profit or loss: Rate change (5/30 x 30,000)	(5,000)
Deferred taxation b/f restated	25,000
Statement of profit or loss (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:

a. an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

   i. 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

   ii. 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;

b. an explanation of changes in the applicable tax rate(s) compared to the previous accounting period;

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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 u 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.

B Plc's taxation computation is as follows:	**₦**
Accounting profit	500,000
Add back inadmissible deductions	
Depreciation	100,000
Deduct admissible deduction:	
Tax allowable depreciation	150,000
Income not taxed	20,000
	(170,000)
Taxable profit	430,000
Tax at 30%	129,000

Tax expense	**₦**
Current tax	129,000
Deferred taxation (30% x ₦50,000)	15,000
Tax expense	144,000

Tax reconciliation (in absolute numbers)	**₦**
Accounting profit	500,000
Applicable tax rate	30%
Accounting profit x the applicable tax rate	150,000
Tax effect of untaxed income (30% x ₦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%

Accounting depreciation in the year was ₦100,000 and tax allowable depreciation was ₦150,000. This means that a temporary difference of N50,000 originated in the year.

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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:

(a) the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and

(b) the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

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Practice questions 1

XYZ Limited had an accounting profit before tax of ₦90,000 for the year ended 31st December 20X8. The tax rate is 30%.

The following balances and information are relevant as at 31st December 20X8.

Non-current assets	₦	₦	
Property	63,000		1
Plant and machinery	100,000	90,000	2
Receivables:			
Trade receivables	73,000		3
Interest receivable	1,000		4
Payables			
Fine	10,000		
Interest payable	3,300		4

Note1: 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.

Note2: 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.

Note3: 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.

Note4: Interest income is taxed and interest expense is allowable on a cash basis. There were no opening balances on interest receivable and interest payable.

1. Prepare a tax computation and calculate the current tax expense.
2. Calculate the deferred tax liability required as at 31December 20X8.
3. Show the movement on the deferred tax account for the year ended 31 December 20X8 given that the opening balance was ₦3,600 Cr.
4. Prepare a note showing the components of the tax expense for the period.
5. Prepare a reconciliation between the tax expense and the product of the accounting profit multiplied by the applicable rate.

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14.7 Chapter review

Chapter review

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

(a) account for current tax;

(b) define temporary differences;

(c) identify temporary differences that cause deferred tax liabilities and deferred tax assets;

(d) determine the amount of deferred tax to be recognised in respect of temporary differences identified; and

(e) apply the disclosure requirements of IAS 12.

Solutions to Practice Questions

Solution: Tax computation for the year ended 31December 20X8 **1a**

	₦	₦
Accounting profit		90,000
Add back inadmissible expenses		
Depreciation on property	7,000	
Depreciation of plant and machinery	12,000	
Increase in provision for doubtful debts	7,000	
Interest payable accrual	3,300	
Fine	10,000	39,300
Less admissible deductions		
Interest income	1,000	
Tax allowable depreciation on property	42,000	
Tax allowable depreciation on plant and machinery	10,000	(53,000)
		76,300
Tax 30%		22,890

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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
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)
			35,700
Deferred tax @ 30%			10,710

	Temporary differences	Deferred tax @ 30%
Deferred tax liabilities	46,000	13,800
Deferred tax assets	(10,300)	(3,090)
		10,710

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Solution: Movement on the deferred tax account for the year ended 31December 20X8. **1c**

	₦
Deferred tax as at 1st January 20X9	3,600
Statement of profit or loss (balancing figure)	7,110
Deferred tax as at 31stDecember 20X9	10,710

Solution: Components of tax expense for the year ended 31December 20X8. **1d**

	₦
Current tax expense (see part a)	22,890
Deferred tax (see part c)	7,110
Tax expense	30,000

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

Solutions: Tax reconciliation for the year ended 31 December 20X8.

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14.8 End of chapter questions and suggested solutions

14.8.1 Questions

QUESTION 1

• In accordance with IAS 12 on Income Tax, the income tax expense in statement of profit or loss is composed of two tax components:
(i) Current tax; and

(ii) Deferred tax

Required:

Explain these TWO tax components.

• Dan Ruwa Nigeria Limited is a company that is based in the North-western part of Nigeria and specialises in the production of bottled and sachets water.

The company was incorporated on January 1, 2018.

The summarised financial statements of the company for the year ended December 31, 2018 is as follows:

Extract of Statements of profit or loss for the year ended December 31, 2018

	₦'000
Revenue	270,000
Administrative and other allowable expenses	(138,000)
Accounting depreciation	(11,000)
Net profit before taxation	121,000

Extracts of statement of financial position as at December 31, 2018

Assets (Non-current assets)	₦'000
Property, plant & equipment	48,000
Motor vehicle	12,000
Less:	
Depreciation	(11,000)
Carrying amount December 31, 2018	49,000

	₦'000
Ordinary share capital	17,000
Retained earnings	12,000
Other liabilities	20,000
	49,000

The Federal Inland Revenue Service (FIRS) granted the company a capital allowance on its non-current assets, which amounted to N15,000,000 and company income tax rate is 30%.

Required:

i. Calculate the current income tax expense and the deferred tax liability balance that should be disclosed in the statement of financial position of the company as at December 31, 2018.

ii. Prepare the statement of profit or loss of Dan Ruwa Nigeria Limited incorporating the tax expense for the year ended December 31, 2018.

QUESTION 2

Babanriga Nigeria Limited acquired a factory machine for N10million on January 1, 2019. The machine had estimated life and residual value of 10 years and N2million respectively. It is depreciated on a straight-line basis. In lieu of depreciation, the tax authority allows a tax expense of 40% of the cost of this type of machine to be claimed against income tax in the year of purchase and 25% per annum of its tax base subsequently on reducing balance basis. The prevailing company income tax rate is 30%.

Required:

Calculate the deferred tax charge or credit which will be recorded in Babanriga Nigeria Limited Statements of profit or loss and other comprehensive income for the year ended December 31, 2021 and the deferred tax balance in the statement of financial position at that date.

QUESTION 3

a. Accounting for deferred tax is based on the identification of the temporary differences.

Required:

a. Explain the term "Temporary difference" and discuss the **TWO** different types.
b. State and briefly explain FIVE components of tax expense or income.
c. Buga Nigeria Limited had an accounting profit before taxation of N196,800,000 for the year ended September 30, 2022. The following balances were extracted from the company's books as at September 30, 2022.

Non-current assets	**₦'000**	**₦'000**
Freehold property		236,700
Office equipment	205,000	
Tax allowed depreciation	(22,500)	182,000
Current assets		
Trade receivables	174, 250	
Interest receivables	3,250	
Current liabilities		
Fine payable	32, 500	
Interest payable	10,850	

Other information

(i) Interest income is taxed while interest expense is allowable on a cash basis. There were no opening balances on interest receivable and interest payable.

(ii) The trade receivables above is shown net of an allowance for doubtful balances of N16,750,000. This is the first year that such an allowance has been recognised. A deduction for debts is only allowed for tax purposes when the debtors is in the process of winding-up.

(iii) The balances in respect of office equipment are after charging accounting depreciation of N28,250,000 and tax allowable depreciation of N22,500,000 respectively.

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(iv) The freehold property was purchased on October 1, 2021 for N263,000,000 and is being depreciated for accounting purposes on a 10% per annum. Buga Nigeria Limited is in a position to claim N94,600,000 as accelerated depreciation on cost as taxable expense in this year's tax computation.

Required:
i. Prepare a tax computation and calculate the current tax expense.

ii. Calculate the deferred tax liability as at September 30, 2022.

iii. Show the movement on the deferred tax account for the year ended September 30, 2022 given that the opening balance was N8,100,000.

14.8.2 Suggested solutions

Solution 1

(a) (i) CURRENT TAX

• Current tax is the amount of income tax payable or recoverable in respect of the taxable profit or loss for a period. At the end of a reporting period, an estimated amount usually by applying the corporate tax rate in force to accrue for the amount of tax payable based on the year profit. The tax charged is accounted for as follows:

Dr - Profit or loss account

Cr - Tax payable

• It is the amount payable to the tax authority in relation to the trading activities.

(ii) DEFERRED TAX

• Deferred tax is the tax consequence of future recovery/settlement of the carrying amount of assets/liabilities that are recognized in an entity statement of financial position.

• Deferred tax is not a current liability or an asset. Deferred tax arises because profit before taxation for accounting purposes is not the same amount as taxable profit for taxation purpose. That is a temporary difference.

• It is also an accounting measure used to match the tax effect of transactions with their accounting impact.

It is calculated as: temporary difference x tax rate

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(b) (i) Current income tax for the year end December 31, 2018

	₦'000
Profit per a/c	121,000
Add: depreciation	11,000
	132,000
Less:	
Capital allowance	(15,000)
Taxable profit	117,000
Current tax payable @ 30%	35,100
Deferred tax as at December 31, 2018	
	₦'000
Carrying amount	49,000
Tax base (60,000 – 15,000)	(45,000)
Temporary difference	4,000
Deferred tax liability (30% x 4,000)	1,200

ii. DANRUWA NIG. LTD

Statement of profit or loss for the year ended December 31, 2018

	₦'000	₦'000
Revenue		270,000
Less:		
Admin expenses and other expenses	138,000	
Depreciation	11,000	
		149,000
Net profit before taxation		121,000
Income tax expenses - current	35,100	
- Deferred tax	1,200	(36,300)
Profit for the year		84,700

SOLUTION 2

Babanriga Nigeria Limited

Computation of deferred tax charge/credit for the year ended December 31, 2021

Date	Details	Carrying amount	Tax base	Temporary difference	Tax rate	Deferred tax
		₦'000	₦'000	₦'000	%	₦'000
1/1/2019	Cost	10,000	10,000	-	30%	-
31/12/2019	Depreciation	(800)	(4,000)	3,200	30%	960
31/12/2019	Tax base	9,200	6,000	3,200	30%	960
31/12/2020	Depreciation	(800)	(1,500)	700	30%	210
31/12/2020	Tax base	8,400	4,500	3,900	30%	1,170
31/12/2021	Depreciation	(800)	(1,125)	325	30%	98
31/12/2021	Tax base	7,600	3,375	4,225	30%	1,268

In Summary:

The deferred tax charges to be recognised in the statement of profit or loss and other comprehensive income will be ₦98,000.

The deferred tax balance to be shown in the statement of financial position will be ₦1,268,000.

SOLUTION 3

(a) 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:
i. 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
ii. 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.

(b) The major components of tax expense or income to be disclosed may include:
i. Current tax expense or income;
ii. Any adjustments recognised in the period for current tax of prior periods;
iii. The amount of deferred tax expense or income relating to the origination and reversal of temporary differences;

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iv. The amount of deferred tax expense or income relating to changes in tax rates or the imposition of new taxes;
v. The amount of the benefit from a previously unrecognised tax loss, tax credit; or temporary difference of a prior period that is used to reduce deferred tax expense;
vi. Deferred tax expense arising from the write-down, or reversal of a previous write-down of a deferred tax asset; and
vii. The amount of tax expense or 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.

c. i) **Bugo Nigeria Limited**

Tax computation and current tax expense for the year September 30, 2022

	₦'000	₦'000
Accounting profit before taxation		196,800
Add:		
Depreciation on freehold property	26,300	
Depreciation of office equipment	28,250	
Increase in provision for doubtful debts	16,750	
Accrued interest	10,850	
Fine payable	32,500	114,650
Less:		
Interest income	3,250	
Tax allowable depreciation on freehold proper	94,600	
Tax allowable depreciation on office equipment	22,500	(120,350)
Taxable Profit		191,100
Tax at 30%		57,330

(ii) **Deferred tax liability as at September 30, 2022**

	Carrying amount ₦'000	Tax base ₦'000	Temporary difference ₦'000
Freehold property	236,700	168,400	68,300
Office equipment	205,000	182,500	22,500
Trade receivables	174,250	191,000	(16,750)
Interest receivables	3,250	-	3,250
Fines payable	(32,500)	(32,500)	-
Interest payables	(10,850)	-	(10,850)
			66,450
Deferred tax at 30%			19,935

	Temporary difference	Deferred tax at 30%
Deferred tax liabilities	94,050	28,215
Deferred tax assets	(27,600)	(8,280)
Deferred tax	66,450	19,935

(iii) Movement on the deferred tax account for the year ended Sept. 30, 2022

	₦'000
Deferred tax as at October 1, 2021	8,100
Statement of profit or loss (balancing figure)	11,835
Deferred tax as at September 30, 2022	19,935

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Skills Level
Financial Reporting

CHAPTER 15

IFRS 13: FAIR VALUE MEASUREMENT

Contents

15.0 Learning objectives
15.1 Learning outcomes
15.2 Introduction to IFRS 13
15.3 Measurement
15.4 Valuation techniques
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15 Fair Value Measurement

15.0 Learning objective

This chapter covers the use of fair value measurement in estimating assets and liabilities.

15.1 Learning outcomes

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

a) define fair value;

b) measure fair value in situations involving a principal or most advantageous market and situations involving the highest and best use of assets;

c) explain different techniques that might be used to arrive at fair value; and

d) describe the fair value hierarchy set out in the standard.

15.2 Introduction to IFRS 13

15.2.1 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.
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

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	(with some exceptions) of the assets acquired and liabilities assumed in a transaction in which control is achieved.
	Other standards require the use of measures which incorporate fair value.
IAS 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:

(a) define fair value;

(b) set out a single framework for measuring fair value; and

(c) 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:

(a) share based payment transactions within the scope of IFRS 2; or

(b) 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:

(a) plan assets measured at fair value (*IAS 19: Employee benefits*);

(b) retirement benefit plan investments measured at fair value (*IAS 26: Accounting and reporting by retirement benefit plans*); and

(c) assets for which recoverable amount is fair value less costs of disposal in accordance with IAS36.

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15.2.2 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.

15.2.3 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:

(a) the condition and location of the asset; and

(b) restrictions, if any, on the sale or use of the asset.

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15.2.4 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:

(a) They are independent of each other.

(b) 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.

(c) They are able to enter into a transaction for the asset or liability.

(d) 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.

15.3 Measurement

15.3.1 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) 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.

(b) 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.

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15.3.2 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 maximizes 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:

(a) fair value is not "net realisable value" or "fair value less costs of disposal"; and

(b) 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.

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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 maximizes 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).

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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.

15.2.3 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 an on-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:

(a) Physically possible;

(b) legally permissible; and

(c) 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.

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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 ₦10million (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 – ₦10million)	52

Conclusion: The fair value of the land is ₦52million.

15.4 Valuation Techniques

15.4.1 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:

a) market approach – uses prices and other relevant information from market transactions involving identical or similar assets and liabilities;

b) cost approach – the amount required to replace the service capacity of an asset (also known as the current replacement cost); and

c) 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.

15.4.2 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

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.

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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.

15.4.3 Fair value hierarchy

IFRS 13 establishes a fair value hierarchy to categorise inputs to valuation techniques into three levels.

	Definition	Examples
Level1	Quoted prices inactive markets for identical assets or liabilities that the entity can access at the measurement date	Share price quoted on the Nigerian Stock Exchange
Level2	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.
Level3	Unobservable inputs for the asset or liability.	Cash flow projections.

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15.4.4 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.

(a) 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).

(b) 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.

15.5 Disclosure

15.5.1 Recurring and non-recurring fair value measurement

The fair value measurement of assets and liabilities might be recurring or non-recurring:

a) 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 issued); and

b) 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.

15.5.2 Overall disclosure objective

Information must be disclosed to help users assess both of the following:

a) the valuation techniques and inputs used to measure the fair value assets and liabilities on a recurring or non-recurring basis;

b) the effect on profit or loss or other comprehensive income for the period of recurring fair value measurements using significant unobservable inputs (Level3).

All of the following must be considered to meet the above objectives:

a) the level of detail necessary to satisfy the disclosure requirements;

b) how much emphasis to place on each of the various requirements;

c) how much aggregation or disaggregation to undertake; and

d) the need for additional information.

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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:

(a) the nature, characteristics and risks of the asset or liability; and

(b) the level of the fair value hierarchy within which the fair value measurement is 484ategorized.

15.5.3 Specific 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 484ategorized in their entirety (Level 1, 2 or 3).

For fair value measurements 484ategorized within Level 2 and Level 3 of the fair value hierarchy:

(a) a description of the valuation technique(s) and the inputs used in the fair value measurement for;

(b) 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 484ategorized within Level 3 of the fair value hierarchy.

A description of the valuation processes used for fair value measurements 484ategorized 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 484ategorized within Level 3 of the fair value hierarchy:

(a) a reconciliation of opening balances to closing balances, disclosing separately changes during the period attributable to the following:

i. total gains or losses recognised in profit or loss (and the line items in which they are recognised);

ii. categorise amounts included in the above;

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iii. total gains or losses recognised in other comprehensive income (and the line item in which they are recognised);

iv. purchases, sales, issues and settlements; and

v. details of transfers into or out of Level 3 of the fair value hierarchy.

(b) for recurring fair value measurements categorised within Level 3 of the fair value hierarchy:

i. a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs;

ii. 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.

Other

If financial assets and financial liabilities are managed on a net basis and the fair value of the net position is measured that fact must be disclosed.

15.6 Chapter review

Chapter review

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

(a) define fair value;

(b) measure fair value in situations involving a principal or most advantageous market and situations involving the highest and best use of assets;

(c) explain different techniques that might be used to arrive at fair value; and

(d) describe the fair value hierarchy set out in the standard.

15.7 End of chapter questions and suggested solutions

15.7.1 Questions

Question 1

(a) Discuss the hierarchy of inputs used in fair value measurement under IFRS 13. Clearly distinguish between Level 1, Level 2, and Level 3 inputs, giving one practical example for each category.

(b) Critically evaluate the reliability and limitations of Level 3 inputs when used for measuring the fair value of non-financial assets. In your response, include an explanation of when Level 3 inputs may still be considered acceptable under IFRS 13.

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(c) At 31 March 20X6, the management of Schrute Ltd received a valuation report from an independent expert regarding its farmland property. The valuation was based on recent market prices of similar farmland in the region. The valuer concluded that the comparative sales prices per square metre were appropriate for valuing Schrute's farm without adjustment.

Required:

(a) Identify which level of input under IFRS 13 this valuation approach falls under and justify your answer.

(b) Evaluate the appropriateness of this method if material differences exist between the comparative properties and Schrute's farmland (e.g., access roads, soil type, irrigation systems).

Question 2

You are the financial reporting manager of Alpha Group. The group prepares its consolidated financial statements in accordance with International Financial Reporting Standards (IFRS).

In light of the group's recent fair value-based transactions and reporting requirements, the Board has requested clarification on the application and implications of **IFRS 13: Fair Value Measurement**.

Required:

You are to prepare a report to the Board that addresses the following:

(a) Clearly explain the **objective and scope** of IFRS 13. Your explanation should highlight when and how IFRS 13 applies to assets, liabilities, and equity instruments. *(4 marks)*

(b) IFRS 13 sets out a fair value hierarchy consisting of three levels of inputs

i. Define **Level 1, Level 2, and Level 3 inputs**, with clear distinctions and examples for each.

ii. Evaluate the relative reliability and risks of using Level 2 and Level 3 inputs in measuring the fair value of non-financial assets such as land and buildings

(c) During the current reporting period, the Group received a valuation of one of its investment properties from an external expert. The valuation was based on market prices of similar properties in nearby locations, with **no significant adjustments** made. The directors wish to know how to classify the valuation input and whether additional disclosures are required.

i. Identify the **appropriate level in the fair value hierarchy** this valuation

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belongs to and justify your classification.

ii. Outline the **key disclosure requirements** under IFRS 13 related to fair value measurements using Level 2 or Level 3 inputs. *(5 marks)*

(d) Discuss the **potential ethical and financial reporting implications** of classifying an input as Level 2 when in substance it involves unobservable estimates characteristic of Level 3. *(3 marks)*

15.7.2 Suggested solutions

Solution 1

1. Explanation of the fair value hierarchy

•Level 1 Inputs

Quoted prices (unadjusted) in active markets for identical assets or liabilities at the measurement date.

Example: Listed equity shares on a stock exchange.

•Level 2 Inputs

Inputs other than quoted prices included in Level 1, that are observable for the asset/liability, either directly or indirectly.

Example: Market prices for similar real estate properties with slight differences (e.g., location or condition).

•Level 3 Inputs

Unobservable inputs for the asset or liability, based on the entity's own assumptions.

Example: Valuation of a privately held company using a discounted cash flow model.

•Purpose of hierarchy

To prioritise the use of observable, verifiable market data over internal estimates.

2. Evaluation of Level 3 inputs

•Reliability concerns

Based on significant management assumptions; may lack objectivity or comparability.

•Acceptability under IFRS 13

Allowed when observable inputs are not available; must reflect assumptions market participants would use.

•Mitigation strategies

Use of independent valuers, sensitivity analysis, and detailed disclosures increase credibility.

3. Application to Schrute Ltd

(i) Input classification

•The valuation uses Level 2 inputs, because it is based on observable prices for similar assets (i.e., farmland in the same region), not identical.

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•No adjustments were made, so the data is still considered observable and not internal or subjective.

(ii) Appropriateness evaluation

•If material differences exist between the properties and no adjustments are made, the valuation may no longer qualify as Level 2 and should be reassessed as Level 3, as unobservable adjustments would be necessary.
•IFRS 13 requires fair value to reflect the asset's specific characteristics, so ignoring unique features could undermine faithful representation.

Solution 2

Objective and Scope of IFRS 13
a)

- **Objective**:
  The objective of IFRS 13 is to define *fair value*, set out a framework for measuring fair value, and specify the disclosures about fair value measurements.
- **Scope**:
  IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value (e.g., IAS 16, IAS 38, IFRS 9, IFRS 3).
  It does **not** apply to share-based payments (IFRS 2), lease transactions (IFRS 16), or measurements that are similar to, but not fair value (e.g., value in use).
- **Application to items**:
  Fair value can apply to *assets*, *liabilities*, and *an entity's own equity instruments*.
  Fair value must reflect the price that would be received or paid in an orderly transaction between market participants on the measurement date.

b) i. Fair Value Hierarchy – Definitions and Examples

- **Level 1 Inputs**
  Quoted prices (unadjusted) in *active markets* for *identical assets or liabilities* available at the measurement date.
  Example: Quoted price of equity shares listed on a stock exchange.
- **Level 2 Inputs**
  Inputs other than Level 1 that are *observable*, either directly or indirectly, for *similar* assets or liabilities.
  Example: Prices for similar properties or interest rate curves.
- **Level 3 Inputs**
  Unobservable inputs reflecting the entity's own assumptions about market participant assumptions. Used when observable inputs are not available.
  Example: Valuation of a private company using discounted cash flows.
- **Purpose of hierarchy**
  The hierarchy prioritises the use of market-based (observable) data over internally developed (subjective) estimates to improve reliability and comparability.

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b(ii) Evaluation of Reliability: Level 2 vs Level 3 Inputs

Level 2

a. Generally reliable due to observable data, but adjustments may introduce estimation risk.
b. Risk arises if adjustments are significant, which might push the input classification to Level 3.
c. **Level 3**
d. Least reliable due to subjectivity and absence of observable data.
e. Higher risk of **bias**, **manipulation**, or **management override**.
f. Requires significant disclosures to enhance transparency and auditability
g. **Acceptability of Level 3**
h. Acceptable when no market data is available and measurement reflects assumptions market participants would use.

c)i Classification of Valuation Input

a. The valuation is based on observable prices of **similar assets**, without material adjustments.
b. Therefore, this qualifies as a **Level 2 input** under IFRS 13.
c. If significant adjustments were required, the input would be reclassified as Level 3.

(ii) Disclosure Requirements under IFRS 13

Entities must disclose the following for **Level 2 and Level 3** fair value measurements:

- **Valuation techniques and inputs used** (including the basis of input classification).
- **Sensitivity analysis** for Level 3 inputs (how changes in assumptions affect fair value).
- **Transfers between levels** and rationale for reclassification.

For recurring and non-recurring fair value measurements, the **highest and best use** assumption must also be disclosed for non-financial assets.

d) Ethical and Financial Reporting Implications

- **Misclassification Risk**:
  Misstating Level 3 inputs as Level 2 misleads stakeholders and overstates the reliability of reported figures.
- **Financial Reporting Consequence**:
  May result in *material misstatements* and weaken audit assurance if disclosures are insufficient.

Ethical Responsibility:
Management has a duty to present fair and faithful representations. Intentionally misclassifying inputs could breach **IFAC Code of Ethics**, undermining professional integrity and objectivity.

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Skills Level
Financial Reporting

CHAPTER 16

IFRS 9: FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

Contents

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16 Financial Instruments: Recognition and Measurement

16.0 Learning objective

This chapter covers the use of the provisions of IFRS 9: Financial Instrument: Recognition and Measurement in measuring financial assets and liabilities in financial statements.

16.1 Learning outcomes

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

a. define financial asset and financial liability;

b. explain fair value and amortised cost;

c. apply the correct accounting treatment for the different categories of financial asset identified by IFRS 9;

d. account for financial liabilities in accordance with IFRS 9; and

e. account for simple impairment under IFRS 9.

16.2 GAAP for financial instruments

16.2.1 Background

The rules on financial instruments are set out in three accounting standards:

a) IAS 32: Financial instruments: Presentation

b) IFRS 7: Financial instruments: Disclosure

c) IFRS 9: Financial Instruments

16.2.2 Definitions

A **financial instrument** is a contract that gives rise to both:

a) a financial asset in one entity, and

b) a financial liability or equity instrument in another entity.

A **financial asset** is any asset that is:

a) cash;

b) an equity instrument of another entity; and

c) a contractual right:

   i. to receive cash or another financial asset from another entity; or

   ii. to exchange financial assets or financial liabilities with another entity

A **financial liability** is any liability that is a contractual obligation:

a) to deliver cash or another financial asset to another entity; or

b) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

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Financial instruments include:

a) cash;

b) shares;

c) loans; and

d) accounts receivable or accounts payable.

16.2.3 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 described in the IASB's Conceptual Framework which 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 ₦1million at 0% repayable in12months.

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= ₦1mu0.909090 = ₦909,091.

The double entry on initial recognition should be:

Dr	Financial asset	₦909,091
Dr	PorL(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.

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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.

16.2.4 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

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.

a) Have the contractual rights to cash flows of the financial asset expired?
   i. If the answer is "yes" – derecognise the financial asset; and
   ii. If the answer is "no" – ask the next question.

b) Has the asset been transferred to another party?
   i. If the answer is "no" – the asset is retained (not derecognised); and
   ii. If the answer is "yes" – ask the next question.

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c) Have substantially all of the risks and rewards of ownership passed?
   i. If the answer is "yes" – derecognise the financial asset;
   ii. If the answer is "no" – the asset is retained (not derecognised); and
   iii. 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.

d) 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:

   i. If the answer is "yes" – derecognise the financial asset; and

   ii. 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:

   i. The contractual rights to the cashflows from the financial asset expire; or

   ii. The financial asset is transferred and substantially all of the risks and rewards of ownership pass to the transferee; or

   iii. 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.

a) Transactions where the asset is derecognised may lead to the recognition of a profit or loss on disposal.

b) 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 cashflows of the financial asset expired? **Yes** – Derecognise the asset

Dr	Cash	₦10,000	
Cr	Receivable		₦10,000

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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?
2. **No** – ask the next question
3. Has the asset been transferred to another party? **Yes** (for 80% of it)
4. Have substantially all of the risks and rewards of ownership passed?

   The receivables are factored without recourses of ABC as 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 or L	₦8,000	
Cr	Receivables		₦8,000

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Example: Derecognition (III)

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

a. Have the contractual rights to cash flows of the financial asset expired?

No – ask the next question

b. Has the asset been transferred to another party? Yes (for 80% of it)

c. Have substantially all of the risks and rewards of owner ship passed?

The debt is factored with recourses of the bad debt risk stays with ABC. In addition, ABC as access to future rewards as further sums are receivable if the customers pay on time.

As ABC as 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	Receivables		₦X

In addition, ABC has given part of the receivable to the factor as a fee:

Dr	Por L		₦8,000	
	Cr	Receivables		₦8,000

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16.3 Measurement Methods

16.3.1 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 cashflows 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.

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.

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Example: Amortised cost

A bond has an issue value of ₦1million 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 after four years.

The effective rate for this bond is 5.942%

The amortised cost at the end of each year over the life of the bond is as follows:

Amortised cost

Year	brought forward ₦	Interest at 5.942%	Cashflows ₦	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 as 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).

Tutorial note: 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)

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16.3.2 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

	Amortised cost brought at forward	Interest 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:

	Statement of profit or loss interest expense	Financial liability in statement of financial position ₦
	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

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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:		
		Interest income	Gross carrying amount	Loss allowance (say)	Net (amortised cost)
	r-end	₦ ₦	₦	₦	
Yea	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	

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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
P**lus:** Interest recognised as income at the effective rate:	X	**Plus:** Interest recognised as expense at the effective rate:	X
Less: receipts	(X)	L**ess:** 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

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16.3.3 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.

Fair value
Fair value measurement looks at the asset (liability) from the point of view of a market participant. This was discussed in the previous chapter.

> **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 a next price).

16.4 Classification and Measurement of Financial Assets

16.4.1 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:

a) financial assets at amortised cost;

b) financial assets at fair value with gains and losses recognised in other comprehensive income (described as fair value through OCI or FVOCI); or

c) financial assets at fair value with gains and losses recognised in profit or loss (described as fair value through P or 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.

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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.

16.4.2 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:

a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cashflows; and

b) 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:

a) 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

b) 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 or L (FVPL)

All other financial assets must be measured at fair value through P or 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 or 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 or 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.

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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 cashflows 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 criterion as a company might convert it into equity. In that case the amounts 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 confirm that this is correct Equity that has been designated into this category on initial recognition
Fair value through profit or loss (FVPL)	Equity investments 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 in consistency

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16.4.3 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 20 X 5 and classified it as measured at Amortised cost.

Terms:

Nominal value	₦50million
Coupon rate	10%
Term to maturity	3years
Purchase price	₦48million
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 a teach date would be more correctly described as "gross carrying amount of the financial asset").

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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 or 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 cashflow 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).

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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):

a) 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

b) 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	₦ 50million
Coupon rate	10%
Term to maturity	3years
Purchase price	₦48million
Effective rate	11.67%

Fair values at each year end to maturity areas follows

31 December 20X5	₦49.2 million
31 December20X6	₦49.5 million
31 December20X7	₦50.0 million

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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 ₦m	Interest at 11.67% ₦m	Cash receipt ₦m	AC c/f ₦m	Fair value (given) ₦m	Cumulative fair value adjustment ₦m
20X5	48.00	5.60	(5)	48.60	49.20	0.60
20X6	48.60	5.65	(5)	49.25	49.50	0.25
20X7	49.25	5.75	(55)	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 or L in the usual way).

The following table summarises the necessary double entries. Credit entries are shown as figures in brackets

	Cash ₦	Financial asset ₦m	OCI ₦m	P or 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 assets are at fair value.

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16.4.4 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 or 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 ₦m	Interest at 11.67% ₦m	Cash receipt ₦m	AC c/f ₦m	Fair value (given) ₦m	Cumulative fair value adjustment ₦m
20X5	48.00	5.60	(5)	48.60	49.20	0.60
20X6	48.60	5.65	(5)	49.25	49.50	0.25

X sold the asset for ₦50m on 10 January 20X7.

The journal entry to record the disposal is as follows:

		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 recognized on disposal is ₦0.75m (₦0.5m + ₦0.25m).

This is the amount that would have been recognized on disposal of the asset if it had been measured at amortised cost. (₦50m - ₦49.25m= ₦0.75m).

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16.4.5 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 1January 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.

On11December 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

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Example: Transaction costs

An equity investment is purchased for ₦30,000 plus 1% transaction costs on1 January 20X6.

The company made an irrevocable decision to design at ethe 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.

On11December 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.

31December 20X6 The investment is revalued to its fair value of ₦40,000. There is again of ₦9,700 (₦40,000 – ₦30,300). This gain of ₦9,700 is included in other 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 or L		10,000

Amounts previously recognized in OCI in respect of equity instruments for which an irrevocable designation has been made must **not** be reclassified to P or L.

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16.5 Classification and Measurement of Financial Liabilities

16.5.1 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:

(a) it eliminates or significantly reduces a measurement or recognition inconsistency; or

(b) 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.

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Example: Changes in own credit risk

A company y issues a bond (borrows) for ₦1million.

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: Por L ₦0.1million
Cr: Liability ₦0.1million

In other words, the improvement in the company's economic situation would result in the recognition of an expense in its P or 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 or L ₦0.1million

In other words, the deterioration in the company's economic situation would result in the recognition of a gain in the P or L account.

he 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.

16.5.2 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**.

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Example: Financial liability

X issued a loan on 1 January 20X5 and classified it as measured at amortised cost.

Terms:

Nominal value	
	₦50million
Coupon rate	10%
Term to maturity	3years
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 ₦m	Interest at 11.67% ₦m	Cash payments ₦m	Amortised cost c/f ₦m
20X5	48.00	5.60	(5)	48.60
20X6	48.60	5.65	(5)	49.25
20X7	49.25	5.75	(55)	nil

This is the same as the table from the lender's viewpoint except the interest is an expense rather than income and the cashflows

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Example (continued): Financial liability

The following table summarises the necessary double entries. Credit entries are shown as figures in brackets.

	Cash	Financial liability	P or L
	₦m	₦m	₦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	

Practice question **1**

A company issues ₦10million of 6% bonds at a price of ₦100.50 for each ₦100 nominal value with issue costs of ₦50,000.

The bonds are redeemable after four years for ₦10,444,000.

The effective annual interest rate for this financial instrument is 7%.

Calculate the amortised cost of the bond and show the interest income for each year to maturity.

16.5.3 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

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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

16.6 Impairment of Financial Assets

16.6.1 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 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).

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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 is possible within the 12 months after the reporting date.

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 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.

a) 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.

b) 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.

The two bullets simply differ in terms of how the expected loss is measured.

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There is no difference between the necessary double entry in each case.
Accounting for the loss allowance: financial assets at amortised cost

(a) The movement on the loss allowance is recognised in profit or loss.

(b) 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 as measure data amortised cost.
Terms:

Nominal value	₦50million
Coupon rate	10%
Term to maturity	3years
Purchase price	₦48million
Effective rate	11.67%

Loss allowances (estimated in accordance with IFRS 9):

1January 20X5	₦1million
31 December 20X5	₦1.5million
31 December 20X6	₦1.2million
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 assets are not affected by the existence of the loss allowance.

Accounting for the loss allowances its 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 ₦m	Interest at 11.67% ₦m	Cash receipts ₦m	Amortised cost c/f ₦m
20X5	48.00	5.60	(5)	48.60
20X6	48.60	5.65	(5)	49.25
20X7	49.25	5.75	(55)	nil

(The amortised cost at each date would be more correctly described

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as “gross carrying amount of the financial

	Cash ₦m	Financial asset ₦m	Loss allowance ₦m	P or L ₦m
20X5				
Initial recognition of:				
Financial asset(48.00) loss allowance		48.00	(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	

The amortised cost of the financial asset at each year-end is as follows:

	20X5	20X6	20X7
Gross carrying amount	48.60	49.25	nil
Loss allowance	(1.50)	(1.20)	nil
	47.10	48.05	nil

Simplified approach

This applies to trade receivables and contract assets. 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.

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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.

1 April 20X6: Initial recognition	Dr(₦)	Cr(₦)
Statement of profit or loss	2,000	
Loss allowance (2% of 500,0000) ₦8,000)		2,000

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.

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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	1to30	31to60	61to90	More than 90
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

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).

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Chapter review

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

a) define financial asset and financial liability;

b) explain fair value and amortised cost;

c) apply the correct accounting treatment for the different categories of financial asset identified by IFRS 9;

d) account for financial liabilities in accordance with IFRS 9; and

e) account for simple impairment under IFRS 9.

Solutions to Practice Questions

Solution **1**

The initial liability is (₦10million × 100.50/100)–

	Liability at start of year ₦	Finance charge at7% ₦	Interest paid ₦	Liability at end of year
Year 1	10,000,000	700,000	(600,000)	10,100,000
Year 2	10,100,000	707,000	(600,000)	10,207,000
Year 3	10,207,000	714,490	(600,000)	10,321,490
Year 4	10,321,490	722,510	(600,000)	10,444,000
		2,844,000	2,400,000	

The final interest payment of ₦722,510 contains a rounding adjustment of ₦6.

Note that the difference between the interest charged and the interest paid is because the final payment of the redemption proceeds has not been shown. This contains a redemption premium of ₦444,000 which has already been recognised as an expense by the year end.

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16.8 End of chapter questions and suggested solutions

16.8.1 Questions

Question 1

IFRS is published subject to the appropriate level of IASB approval. This also includes the opinions of any dissenting IASB members and basis of IASB conclusions.

IFRS 9 - Financial Instruments, prescribes principles for reporting, recognising and de-recognising financial instruments in the financial statements of an entity.

Required:
Explain TWO classes of financial instruments in accordance with IFRS 9.

Question 2
On January 1, 2020, an entity bought Lagos State Government Bond in the capital market for N575,000,000. The principal amount of the bond is N500,000,000 and it is redeemable at par on December 31, 2025. The bond has a stated interest rate of 15% payable annually and an effective interest rate of 12%.
Draft an amortisation schedule to indicate the amortised cost at the end of each year and the journal entries at the end of December 31, 2025.

Question 3

One of the basic elements of IFRS 9 is the Business Model test, which ensures that financial assets are accounted for in a manner that reflects the way they are managed, and generate cash flows. Understanding and applying this test is essential for preparers of financial statements, aiming to achieve faithful representation and compliance.

Required:

Explain **THREE** basic steps in the application of Business Model test in IFRS 9.

16.8.2 Suggested solutions

Solution 1
Classifications of Financial Instruments in accordance with IFRS 9

- A Financial asset is measured at amortised cost if:
  - **(a)** The financial asset is held within a business model in which the intention is to hold financial asset to collect contractual cash flows;
  - **(b)** Each group or portfolio is being classified as held to collect and or to sell or other; and
  - **(c)** Assets are classified as being held to collect, if it evaluates the appropriateness of the classification through testing against past activities.

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- Fair value through other comprehensive income
  Within a business financial model, a financial asset is measured at fair value through other comprehensive income if:
  - The assets are held when the objective of business model is achieved by collecting contractual cash flows and selling financial assets; and
  - The terms of the contractual agreement of the financial assets give rise to cash flows on a specified date that is wholly for payments of principal and interest outstanding on the principal.
- Fair Value through profit or loss
  - It is the normal default classification for financial assets, which are applicable to all financial assets except they are to be measured at amortised cost or fair value through other comprehensive income; and
  - This classification includes financial assets held for trading purposes and derivatives unless they are properly designated for hedging arrangements.

Solution 2

Amortisation Schedule

Amortisation schedule indicating amortised cost at the end of each year

Year Ended	Amortised cost brought forward	Effective Interest at 12%	Cash received	Amortised cost carried forward
	₦	₦	₦	₦
2020	575,000,000	69,000,000	75,000,000	569,000,000
2021	569,000,000	68,280,000	75,000,000	562,280,000
2022	562,280,000	67,473,600	75,000,000	554,753,600
2023	554,753,600	66,570,432	75,000,000	546,324,032
2024	546,324,032	65,558,884	75,000,000	536,882,916
2025	536,882,916	64,425,950	575,000,000	26,308,866

The journal entries at the end of December 31, 2025 will be as follows:

	Dr.	Cr.
	₦	₦
Cash	575,000,000	
Balance as per amortisation table	26,308,866	
Investment in Lagos State Government Bond		536,882,916
Investment income		64,425,950
Being entries on amortisation of Lagos State Government bond		

Solution 3

Basics Steps in the Application of Business Model Test in IFRS 9

The steps in the application of business model tests under IFRS 9 are as follows:

(a) Sub-dividing where necessary loans and receivables into different groups or portfolios based on the way they are managed;

(b) Objective identification of the entity, which is used in the course of its business to manage each group or portfolio;

(c) Classification for each group or portfolio of financial assets as being held to collect, and held to sell; and

(d) The appropriateness of the classification will be evaluated through back-testing of past activities, for the assets classified as held to collect.

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Skills Level
Financial Reporting

CHAPTER 17

IAS 32 and IFRS 7: FINANCIAL INSTRUMENTS: PRESENTATION AND DISCLOSURE

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17.1 Leaning outcomes
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17 Financial Instruments: Presentation and Disclosure

17.0 Learning objective

This chapter covers the presentation and disclosure of financial instruments in financial statements in accordance with IAS 32 and IFRS 7.

17.1 Learning outcomes

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

a) distinguish between debt and equity;

b) apply split accounting in the books of the issue on the initial recognition of a convertible bond; and

c) explain the IFRS 7 disclosures in respect of financial instruments in overview.

17.2 IAS 32: Presentation

17.2.1 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:

(a) to deliver cash or another financial asset to another entity, or

(b) 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.

17.2.2 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.

(a) Interest expense, dividend payments, gains and losses relating to a **financial liability** is recognised in the **statement of profit or loss**.

(b) Distributions to equity holders are debited to equity and shown in the statement of changes inequity.

Illustration: Classification

Preference shares must be classified as either equity or debt, according to their substance. Most preference shares are closer in substance to debt as they have the following characteristics:

(a) a fixed dividend

(b) no rights to participate in any surplus on winding up the entity.

The return on a preference share must be classified as dividends or interest in accordance with the classification of the instrument. Hence the dividend payments on most preference shares will be disclosed as interest expense in profit and loss.

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17.2.3 Compound instruments

A compound instrument is a financial instrument issued that cannot be classified as simply a liability or as equity by the issuing company 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 two component parts, equity and liability.

To do this, the following steps are necessary:

Step 1: Derive the fair value of liability

Step 2: Calculate the equity component as the difference between the total amount for the instrument and the fair value of the liability.

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 9%.

Example: Convertible bond

A company issues a convertible bond. The details are as follows:

Number of bonds issued	2,000 Nominal value
per unit	₦1,000 Annual
interest rate	5% Market rate at
date of issue	9%
Issue date	1st January 20X5
Redemption dates	31st December 20X7
Terms of conversion	Six ₦1 shares per ₦10 nominal value of bond

The cash proceeds of the issue are ₦2million. (So, debit Cash ₦2 million.)

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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 of9%.

31 December	Cash flow	DF (9%)	₦
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
Value of debt element			1,797,496

Step2: Compare the value of the debt element to the cash raised. The difference is the equity element.

Total proceeds	2,000,000
Value of equity element (residual)	202,504

The initial double entry to recognise the bond is as follows:

	Dr	Cr
Cash	2,000,000	
Liability		1,797,496
Equity		202,504

The financial liability is measured at amortised cost in the accounts of the issuing company (the borrower).

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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

	Brought forward	9%effective interest	Interest: cash payment	Carried forward
	₦	₦	₦	₦
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

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 20X7 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	2,000,000	
Cash		2,000,000
and:		
Equity component	202,504	
Retained earnings		202,504

If the bond is converted 1,200,000 new shares will be issued (₦2,000,000 nominal value of the bonds × 6 shares per ₦10 of bonds)

	Dr	Cr
Liability	2,000,000	
Share capital		1,200,000
Share premium		800,000
and:		
Equity component	202,504	
Retained earnings		202,504

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Practice question **1**

A company issued a convertible bond for ₦2,000,000 on 1January 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

1. Calculate the liability and equity components of the bond on initial recognition.
2. Construct the necessary journal on initial recognition.
3. Construct an amortisation table to show how the liability component would be measured over the life of the bond.
4. Construct the journal to reflect the possible conversion of the bonds to shares on 31 December 20X7.

17.2.4 Transactions in own equity

When a company whose shares are traded on the stock market buys back some of its shares, they 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 such transactions are other comprehensive income and should be taken directly to equity, and should not be reported in profit and loss.

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.

17.2.5 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.

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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:

(a) currently has a legal right to set off the amounts; and

(b) 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 and must be. Furthermore, it must be legally enforceable in all of the following circumstances:

(a) the normal course of business;

(b) the event of default;

(c) 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.

17.3 Accounting for share issues

17.3.1 Issue of equity shares

This topic is not covered by the rules on financial instruments but is dealt with by company law. It is included in this chapter for convenience.

When an entity issues new ordinary shares:

a) The issued shares become a part of equity, and

b) The entity receives cash from the issue, or possibly assets other than cash (for which a carrying value is determined).

The issue price of new equity shares is usually higher than their face value or nominal value. The difference between the nominal value of the shares and their issue price is accounted for as share premium and credited to a share premium reserve. (This reserve is a part of equity).

Illustration: Share issue double

	Debit	Credit
Bank (cash received)	X	
Share capital (nominal value of shares issued)		X
Share premium (with the excess of the issue price of the shares over the nominal value)		X

Transaction costs of issuing new equity shares for cash should be debited directly to equity.

The costs of the issue, net of related tax benefit, are set against the share premium account. (If there is no share premium on the issue of the new

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shares, issue costs should be deducted from retained earnings).

Example: Share issue

A company issues 200,000 shares of ₦ 25 each at a price of ₦250 per share. Issue costs are ₦3,000,000.

The share issue would be accounted for as follows:

	Dr (₦ 000)	Cr (₦ 000)
Cash (200,000 × 250)	50,000	
Share capital (200,000 × 25)		5,000
Share premium (200,000 × 250 – 25)		45,000
Share premium Cash	3,000	
		3,000

Bonus Issues

When an entity issues new ordinary 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 an equity balance from the statement of financial position into ordinary share capital.

Illustration: Share issue double entry

	Debit	Credit
Equity reserve	X	
Share capital (nominal value of shares issued)		X

17.4 IFRS 7: Disclosure

17.4.1 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: Financial risks

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.

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There are several financial risks that this company faces with respect to this investment.

(a) It is a floating rate bond. So, if market interest rates for bonds decrease, the interest income from the bonds will fall.

(b) 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.

(c) A bonus is linked to movements in the price of silver. So, there is exposure to changes in the price of silver.

(d) 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) A section on the disclosure of 'the significance of financial instruments' for the entity's financial position and financial performance

(b) A section on disclosures of the nature and extent of risks arising from financial instruments.

17.4.2 Significance of Financial Instruments for Financial Position and Performance

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:

a) financial assets at fair value through profit or loss;

b) financial assets at amortised cost;

c) financial assets at fair value through other comprehensive income;

d) financial liabilities at fair value through profit or loss; and

e) financial liabilities measured at amortised cost.

Other disclosures relating to the statement of financial position are also required. These include the following:

i. **Collateral**. A note should disclose the amount of financial assets that the entity has pledged as collateral for liabilities or contingent liabilities.

ii. **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.

iii. **Defaults and breaches**. For loans **payable**, the entity should disclose

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details of any defaults during the period in the loan payments, or any other breaches in the loan conditions.

17.4.3 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:

a) net gains or losses on financial assets or financial liabilities at fair value through profit or loss;

b) net gains or losses on financial liabilities measured at amortised cost;

c) net gains or losses on financial assets at fair value through other comprehensive income;

d) net gains or losses on investments in equity instruments designated at fair value through other comprehensive income;

e) 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;

f) fee income and expenses arising from financial assets or liabilities that are not at fair value through profit or loss; and

g) the amount of any impairment loss for each class of financial asset.

17.3.4 Other disclosures

IFRS 7 also requires other disclosures. These include the following:

a) 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.

b) 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.)

Nature and extent of risks arising from financial instruments

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 are typically included, but are not restricted to:

a) credit risk;

b) liquidity risk; and

c) market risk.

For each category of risk, the entity should provide both quantitative and

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qualitative information about the risks.

a) **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.

b) **Quantitative disclosures**. For each type of risk, the entity should also disclose a summary of 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.

17.4.5 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) 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.

b) For each class of financial assets, a disclosure of assets where payment is 'past due' or the asset has been impaired.

17.4.6 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) A maturity analysis for financial liabilities, showing when the contractual liabilities fall due for payment; and

b) A description of how the entity manages the liquidity risk that arises from this maturity profile of payments.

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17.4.7 Market Risk

Market risk is the risk of losses that might occur from changes in the value of financial instruments due to changes in:

(a) Exchange rates,

(b) interest rates, or

(c) 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.

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Chapter review

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

a) distinguish between debt and equity;

b) apply split accounting in the books of the issue on the initial recognition of a convertible bond; and

c) 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

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17.6 End of chapter questions and suggested solutions

17.6.1 Questions

Question 1

Akwa Nig. Limited is a private limited company planning to be registered with the Nigeria Exchange Limited (NGX). The company is engaged in the conversion of petrol engine into compressed gas engine.

The following are the transaction of the company in respect of its debts and equity instruments.

Transaction 1

Akwa Nig. Limited issued 40million non-redeemable N1 preference share at par value. Under the terms relating to the preference shares, a dividend is payable on the preference shares only if Akwa Nig. Limited also pays a dividend on its ordinary shares for the same period.

Transaction 2

Akwa Nig. Limited entered into a contract with a supplier to buy a significant item of equipment. Under the terms of the agreement the supplier will receive ordinary shares with an equivalent value of N5million one year after the equipment is delivered.

Transaction 3

The directors of Akwa Nig. Limited on becoming director are required to invest a fixed agreed sum of money in a special class of N1 ordinary shares that only directors hold. Dividend payments on the shares are discretionary and are ratified at the Annual General Meeting (AGM) of the company. When a director's service contract expires, Akwa Nig. Limited is required to repurchase the shares at their nominal value.

A senior accountant in your company (Akwa Nig. Limited) has asked for your advise on how the above transactions should be treated in the financial statements of your company in accordance with IAS 32 – Financial Instruments: Presentation.

Required:

Write a memo on the above request, discussing and justifying how each of the transactions should be treated in the financial statements, in accordance with IAS 32– Financial Instruments: Presentation.

Question 2:

Accounting for Compound Financial Instruments and Fair Value through Profit or Loss Investments

Sachi Co issued ₦2 million 6% convertible loan notes on 1 April 20X2. These loan notes are redeemable on 31 March 20X5 at par for cash or are convertible into equity shares at that date. Similar loan notes without the conversion option carry an annual interest rate of 9%. The present value of ₦1 receivable at the end of each year for three years, discounted at both 6%

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and 9%, is as follows:

Year	6%	9%
1	0.943	0.917
2	0.890	0.842
3	0.840	0.772

On 1 April 20X3, Sachi Co also purchased 50,000 equity shares in Speedi Co at ₦4 per share, incurring transaction costs of ₦4,000. These shares were designated as held for trading under IFRS 9. As of 31 March 20X4, the shares were trading at ₦7 each. A dividend was also received on the investment during the year.

Required:

a) In accordance with IAS 32, distinguish between a financial liability and an equity instrument. Provide an explanation of why a convertible loan note is treated as a compound instrument.
b) Compute the value of the debt component of the convertible loan note as at 1 April 20X2. Also, determine the amount to be recognised in equity.
c) *E*xplain how the Speedi Co investment should be accounted for under IFRS 9, including how the transaction costs and fair value gains/losses should be treated.
d) Show the value of the investment in Speedi Co to be reported in the financial statements of Sachi Co as at 31 March 20X4.
e) State where the dividend income and the gain on revaluation of the shares should be reported in the financial statements for the year ended 31 March 20X4. Justify your treatment.

Question 3:
Financial Instruments, Inventory Adjustments, and Factoring Arrangements

The trial balance of Diaz Co as at 31 December 20X8 includes the following:

a) Inventory: ₦8.6m
b) Trade receivables: ₦6.2m
c) 5% loan notes: ₦9.0m

During the year-end procedures, two inventory-related issues were noted:

i. Items with a sales value of ₦0.6m were excluded from the count.
ii. Damaged items costing ₦0.2m were included in the count but could only be sold for 50% of normal price. Diaz applies a mark-up of 50%.

Diaz Co entered a factoring agreement with Finaid Co on 31 December 20X8, selling receivables worth ₦6.2m for ₦6.0m. Unpaid debts will be returned to Diaz after 6 months, and a 5% monthly fee is charged on uncollected balances.

Additionally, the 5% loan notes were issued on 1 July 20X8 at ₦9m. Diaz incurred ₦0.5m

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issue costs, which were immediately expensed. The loan notes carry an effective interest rate of 8% and are repayable at a premium. Interest is payable annually on 30 June.

Required:

a) With reference to IAS 32, explain what qualifies as a financial instrument and assess which of the items in the trial balance meet the definition.

b) Determine the appropriate adjustments to the inventory figure as at 31 December 20X8 and justify your treatment of both the omitted and damaged items.

c) Evaluate whether the factoring arrangement should be treated as a sale or a secured borrowing under IFRS 9. Justify your conclusion.

d) Discuss the accounting treatment of the 5% loan notes using the effective interest method. Calculate the initial liability to be recognised and describe how issue costs should be accounted for.

17.6.2 Suggested solutions

Solution 1

MEMO

From: Accountant

To: Senior Accountant

Subject: Treatment of financial Instruments in accordance with IAS 32

Transaction 1

(a) IAS 32 requires a financial instrument to be classified as a liability if there is a contractual obligation to deliver cash or another financial asset to another entity.

(b) In the case of the preference shares as they are non-redeemable, there is no obligation to repay the principal.

(c) In the case of the dividends, because of the condition that preference dividend will only be paid if ordinary dividends are paid in relation to the same period, the preference shareholders have no contractual right to a dividend. Instead, the distributions to holders of the preference shares are at the discretion of the issuer as Akwa Nig. Ltd. can choose whether or not to pay an ordinary dividend and therefore a preference dividend. Therefore, there is no contractual obligation in relation to the dividend.

(d) As there is no contractual obligation in relation to either dividend or principal, the definition of a financial liability has not been met and the preference shares should be treated as equity and initially recorded at fair value of ₦40million.

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(e) The treatment of dividends should be consistent with the classification of the shares and should be charged directly to retained earnings in the statement of changes in equity.

Transaction 2

(a) The price of the equipment, a non-current asset is fixed at ₦5million one year after delivery. In terms of recognition and measurement of the equipment, the N5million price would be discounted back one year to its present value.

(b) The company is paying for the equipment by issuing shares. However, this is outside the scope of IFRS 2-Share Based Payments because the payment is not dependent on the value of its shares, it is fixed at ₦5million.

(c) This is an example of a contract that will be settled in an equity instruments and is non-derivative for which the entity is or may be obliged to deliver a variable number of equity's own equity instrument i.e. it is a Financial Liability.

(d) Therefore, it is a financial liability and initially measured at the present value of the ₦5million.

(e) Subsequently, as it is not measured at fair value through profit or loss (as it is not held for a short-term profit making or a derivative) it should be measured at amortise cost.

(f) As a result, interest will be applied to the discounted amount over the period until payment are recognised in statement of profit or loss with corresponding increase in the financial liability.

Transaction 3

(a) Most ordinary shares are treated as equity as they do not contain contractual obligation to deliver cash.

(b) However, in the case of the directors' shares, a contractual obligation to deliver cash exists on specific date as the shares are redeemable at the end of service contract of the directors.

(c) The redemption is not discretionary and Akwa LTD has no right to avoid it. The mandatory of the repayment makes the capital a Financial Liability.

(d) The dividend payments are discretionary as they must be ratified at the Annual General Meeting (AGM). Therefore, no liability should be recognised for any dividend until it is ratified. When recognised the classification of the dividend should be consistent with that of the shares and therefore, the dividends should be classified as a finance cost rather than as a deduction from retained earnings

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hence the dividend should be charged to the statement of profit or loss as finance cost.

Conclusion

Hope the above explanation is clear. If you need further explanation do not hesitate to contact me.

Thank you.
Accountant

Solution 2

a. Financial Liability vs Equity Instrument and Treatment of Convertible Loan Notes.

According to **IAS 32**, a **financial liability** is a **contractual obligation** to:

(a) Deliver cash or another financial asset to another entity; or
(b) Exchange financial assets or liabilities under conditions that are potentially unfavourable.

An **equity instrument** is any contract that **evidences a residual interest** in the assets of an entity after deducting all its liabilities. It does **not** contain an obligation to deliver cash or another financial asset.

A **convertible loan note** is classified as a **compound financial instrument** because it contains:

(a) A **debt component**: the obligation to pay interest and principal in cash.
(b) An **equity component**: the option to convert the liability into equity shares of the issuer, which meets the definition of an equity instrument.

Therefore, **split accounting** is required to separately recognise the **liability** (at fair value) and the **equity** (residual) components on initial recognition.

b) Computation of Debt and Equity Components

The **cash flows** associated with the convertible note are:

- Annual interest: 6% × ₦2,000,000 = ₦120,000
- Principal repayment at end of Year 3: ₦2,000,000

Discount these cash flows at **9%**, the market rate for a similar non-convertible instrument:

Year	Cash Flow	Discount Factor (9%)	Present Value (₦)
1	120,000	0.917	110,040
2	120,000	0.842	101,040
3	2,120,000	0.772	1,636,640

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Total Present Value (Debt Component) =
110,040 + 101,040 + 1,636,640 = **₦1,847,720 ≈ ₦1,848,000**

Equity Component = Issue Proceeds – Debt Component
= **₦**2,000,000 – **₦**1,848,000 = **₦152,000**

c) Accounting for Investment in Speedi Co under IFRS 9

The shares in **Speedi Co** are designated as **held for trading**, which means they fall under the **Fair Value Through Profit or Loss (FVTPL)** category in IFRS 9.

- **Initial Recognition**: Measured at **fair value**, which is **₦**4 × 50,000 = **₦**200,000.
- **Transaction costs** of **₦**4,000 are **expensed immediately** to profit or loss under FVTPL.
- **Subsequent Measurement**: At fair value, with changes in fair value recognised in **profit or loss**.

Thus:

i. The investment is revalued at each reporting date.
ii. **Gains or losses** from fair value changes go to the **profit or loss statement**.

d) Investment Value as at 31 March 20X4

- **50,000 shares × ₦7 (fair value)** = **₦350,000**

This is the amount reported in the **statement of financial position** under **financial assets at FVTPL** as at 31 March 20X4.

e) Reporting of Dividend and Fair Value Gain

Under IFRS 9:

i. **Fair value gain** = **₦**350,000 (closing FV) – **₦**200,000 (initial FV) = **₦150,000**
ii. This gain is recognised in the **statement of profit or loss**.
iii. The **dividend income** received is also recognised in the **statement of profit or loss** when the entity becomes entitled to it.

Justification:
Since the investment is classified as FVTPL, both:

- The dividend income, and
- The fair value gain

must be recognised in **profit or loss**, not in other comprehensive income (OCI).

Solution 3
a) Financial Instruments under IAS 32

Under **IAS 32**, a **financial instrument** is any contract that gives rise to:

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(a) A **financial asset** of one entity, and
(b) A **financial liability or equity instrument** of another entity.

Assessment of items:

i. **Inventory**: Not a financial instrument. It is a physical asset held for sale or consumption.
ii. **Trade receivables**: Yes, it is a **financial asset**. It represents a contractual right to receive cash.
iii. **5% loan notes**: Yes, these are **financial liabilities**. They represent a contractual obligation to deliver cash (repay principal + interest).

Conclusion: Only **trade receivables** and **5% loan notes** are financial instruments.

b) Inventory Adjustments at 31 December 20X8 (5 marks)

(i) Omitted Inventory – Sales Value ₦0.6m

(a) The **sales value** is ₦0.6m. Given a **mark-up of 50%**, the **cost** is:

Cost = 0.6m/ 1.5 = 0.4m

(b) This was **omitted** from the count. Inventory should be **increased by ₦0.4m**.

(ii) Damaged Items – Cost ₦0.2m

(a) These were **included**, but are damaged and will sell at **50% of normal price**.
(b) Normal selling price = ₦0.2m × 1.5 = ₦0.3m
Damaged sale price = ₦0.3m × 50% = ₦0.15m
(c) **Net realisable value (NRV)** = ₦0.15m, which is **less than cost (₦0.2m)**, so inventory should be **written down to NRV**.
(d) Adjustment = ₦0.2m – ₦0.15m = **₦0.05m write-down**

Net Adjustment to Inventory:

(a) Increase: ₦0.4m (omitted)
(b) Decrease: ₦0.05m (write-down)
(c) Revised Inventory = ₦8.6m + ₦0.4m – ₦0.05m = **₦8.95m**

c) Factoring Agreement Analysis

Under **IFRS 9**, a company must assess whether:

- **Substantially all risks and rewards** of ownership have been transferred.
- If not, the transfer is treated as a **secured borrowing** (not a sale).

Assessment:

i. **Diaz sold receivables for ₦6.0m**, below their carrying amount of ₦6.2m.
ii. **Unpaid debts are returned** after 6 months → *retains credit risk*.

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iii. **5% fee monthly on uncollected debts** → implies continuing involvement and risk.

Conclusion:

i. Risks and rewards have **not been substantially transferred**.
ii. This is a **secured borrowing**, not a derecognition.
iii. Diaz should **recognise a liability** of ₦6.0m and **retain the receivables** on its statement of financial position.

d) Accounting for 5% Loan Notes

Initial Issue Details:

i. Issued: ₦9.0m on 1 July 20X8
ii. Issue costs: ₦0.5m (incorrectly expensed)
iii. Effective interest rate: 8%

i. Initial Liability

(a) Under **IFRS 9**, loan notes should be measured at **amortised cost** using the **effective interest method**.
(b) **Initial liability** = Issue proceeds – issue costs =

9.0m – 0.5m = 8.5 million

ii. Interest Expense for the Year

(a) Loan issued on **1 July 20X8**, so **6 months** to 31 December 20X8.
(b) Effective interest = 8% × ₦8.5m × 6/12 = **₦340,000**

iii. Issue Cost Treatment

(a) The **₦0.5m** issue cost should not be expensed.
(b) It should be **deducted from the initial liability** and **amortised** over the life of the loan using the effective interest rate.

Summary:

i. Recognise liability at **₦8.5m**.
ii. Apply the **effective interest method** to accrue interest.
iii. Adjust prior misclassification of issue costs (reclassify from expense to liability).

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Skills Level
Financial Reporting

CHAPTER 18

CONSOLIDATED ACCOUNTS: STATEMENT OF FINANCIAL POSITION– BASIC APPROACH

Contents

18.0	Learning objective
18.1	Learning outcomes
18.2	The nature of a group and consolidated accounts
18.3	Consolidated statement of financial position
18.4	IFRS 3: Business combinations
18.5	Consolidation double entry
18.6	Chapter review
18.7	End of chapter questions and suggested solutions

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18 Consolidated Accounts: Statement of financial position–Basic approach

18.0 Learning objective

This chapter covers the basic approach to preparing the statement of financial position in a consolidated account for a group.

18.1 Learning outcomes

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

(a) describe the concept of a group as a single economic unit;

(b) define using simple examples subsidiary, parent and control;

(c) describe situations when control is presumed to exist;

(d) identify and describe the circumstances in which an entity is required to prepare and present consolidated financial statements; and

(e) prepare basic a consolidated statement of financial position including the calculation of goodwill, non-controlling interest and consolidated post-acquisition reserves.

18.2 The Nature of a Group and Consolidated Accounts

18.2.1 Group as a single economic entity

Illustration: Single economic entity

A Limited (a car manufacturer) buys 100% of B Limited (an automotive parts manufacturer).

The 100% ownership gives A Limited complete control over B

Limited. A Limited's Business has changed as a result of buying B

Limited.

It was a car manufacturer. Now it is a car manufacturer and a manufacturer of automotive parts.

The two parts of the business are operated by two separate legal entities (A Limited and B Limited). However, the two parts of the business are controlled by the management of A Limited.

In substance, the two separate legal entities are a single economic entity.

IFRS contains rules that require the preparation of a special form of financial statements (consolidated financial statements also known as group accounts) in circumstances like the one described above.

This chapter explains some of the rules contained in the following standards:

a) *IFRS 10: Consolidated financial statements*

b) *IFRS 3: Business combinations*.

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18.2.2 A group of companies: parent and subsidiaries

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**.

18.2.3 Control

An entity is a subsidiary of another entity if it is controlled by that other entity.

Definition: Control

An investor controls an investee when:

25 it is exposed, or has rights, to variable returns from its involvement with the investee; and

26 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:

a) power over the investee;

b) exposure, or rights, to variable returns from its involvement with the investee; and

c) ability to use its power over the investee to affect the amount of its returns.

Situations where control exists

The above definition of control is quite complicated.

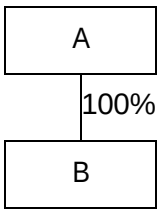
In practice, the vast majority of cases involve a company achieving control of another through buying a controlling interest in its shares.

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.

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Illustration: Wholly owned subsidiary

A owns 100% of B's voting share capital.



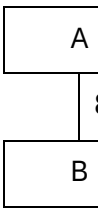
This 100% holding is described as a controlling interest and gives A complete control of B.

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.

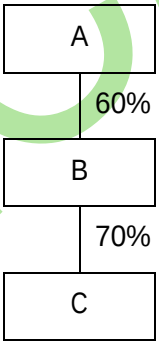
Other parties own the remaining 20% of the shares. They have an ownership interest in B but do not have control.

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, directly or indirectly, 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.

Consolidation of sub-subsidiaries is not in this syllabus.

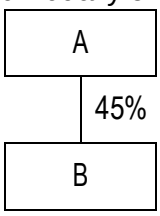
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In certain circumstances, a company might control another company even if it owns shares which give it less than half of the voting rights. Such a company is said to have ***de facto*** control over the other company. (***De facto*** is a Latin phrase 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.

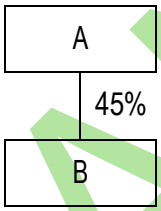
It would be unlikely that a sufficient number of the other shareholders would vote together to stop A directing the company as it wishes.

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 further10% 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 bank's 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.

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18.2.4 Purpose and nature of consolidated financial statements

An investment in a company is usually included in the statement of financial position of the parent at cost. This does not reflect the substance of the situation. The directors have control of the net assets of the subsidiary and use these to generate profit.

To solve this problem IFRS requires that where a company holds a subsidiary it must prepare group accounts in addition to its own accounts.

The type of group accounts specified by IFRS are called consolidations.

The purpose of consolidated financial statements 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**.

In preparing consolidated financial statements:

(a) the assets and liabilities of the parent and its subsidiaries are combined in a single consolidated statement of financial position.

(b) the profits of the parent and its subsidiaries, and their other comprehensive income, are combined into a single in a consolidated statement of comprehensive income

In other words, a lot of the numbers in the consolidated financial statements are constructed as a simple cross cast of the balance in the financial statements of the parent and its subsidiary (or subsidiaries).

Example: Consolidated figures

	Parent		Subsidiary		Consolidated
Property, plant and equipment	1,000	+	500	=	1,500
Inventory	500	+	800	=	1,300

It is not always as straightforward as this. Sometimes there is a need for adjustments in the cross cast. This will be explained later.

Note that the share capital and reserves for the consolidated balance sheet **are not** calculated simply by adding the capital and reserves of all the companies in the group!). This is explained later.

18.2.5 The requirement to prepare consolidated accounts

IFRS 10 states that, with certain exceptions, a parent must present consolidated financial statements in which it consolidates its investments in subsidiaries. In other words, a parent must prepare consolidated financial statements for the group as a whole.

Exception to this rule

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There is an exception to this rule. This allows a parent that is itself a subsidiary not to prepare consolidated financial statements.

A parent need not present consolidated financial statements if (and only if) **all** the following conditions apply:

(a) 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.

(b) The parent's debt or equity instruments are not traded in a public market.

(c) The parent does not file its financial statements with a securities commission for the purpose of issuing financial instruments in a public market.

(d) 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 IFRS.

18.2.5 All subsidiaries

Consolidated financial statements must include **all** the subsidiaries of the parent (IFRS 10). There are no grounds for excluding a subsidiary from consolidation.

Sundry accounting issues

18.2.6 Common Reporting Date

IFRS 10 requires that the financial statements of the parent and its subsidiaries that are used to prepare the consolidated financial statements should all be prepared with the same reporting date (the same financial year-end date), unless it is impracticable to do so.

If it is impracticable for a subsidiary to prepare its financial statements with the same reporting date as its parent, adjustments must be made for the effects of significant transactions or events that occur between the dates of the subsidiary's and the parent's financial statements. In addition, the reporting date of the parent and the subsidiary must not differ by more than three months.

18.2.7 Uniform Accounting Policies

Since the consolidated accounts combine the assets, liabilities, income and expenses of all the entities in the group, it is important that the methods used for recognition and measurement of all these items should be the same for all the entities in the group.

IFRS 10 therefore states that consolidated financial statements must be prepared using uniform accounting policies. The policies used to prepare the financial statements in all the entities in the group must be the same.

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18.3 Consolidated Statement of Financial Position

18.3.1 The basic approach

> **Definition**
>
> Consolidated financial statements: The financial statements of a group presented as those of a single economic entity.

The technique of consolidation involves combining the financial statements of the parent and its subsidiaries. We will first explain how to consolidate the statement of financial position. Consolidation of the statement of comprehensive income will be covered in chapter 19.

18.3.2 Question structure

There are often two major stages in answering consolidation questions:

(a) **Stage 1** involves making adjustments to the financial statements of the parent and subsidiary to take account of information provided. This might involve correcting an accounting treatment that has been used in preparing the individual company accounts.

(b) **Stage 2** involves consolidating the correct figures that you have produced.

The early examples used to demonstrate the consolidation technique look only at step 2. It is assumed that the financial statements provided for the parent and its subsidiary are correct.

183.3 Approach in this section

This section will demonstrate the techniques used to consolidate the statements of financial position using a series of examples introducing complications one at a time.

The examples will be solved using an approach that you might safely use to answer exam questions. This approach is quick but it does not show how the double entry works. The double entry will be covered in section 3 of this chapter so that you are able to understand the flow of numbers in the consolidation and able to prepare journal entries if asked to do so.

Note the following features in following examples:

(a) The asset in the parent's statement of financial position representing the cost of investment in the subsidiary disappears in the consolidation.

(b) Each consolidated asset and liability is constructed by adding together the balances from the statements of financial position of the parent and the subsidiary.

(c) The share capital (and share premium) in the consolidated statement of financial position is always just the share capital (and share premium) of the parent. That of the subsidiary disappears in the consolidation process.

Major workings

There are three major calculations to perform in preparing a consolidated

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statement of financial position:

a) Calculation of goodwill

b) Calculation of consolidated retained earnings

c) Calculation of non-controlling interest

In order to calculate the above figures (all of which will be explained in the following pages) information about the net assets of the subsidiary at the date of acquisition and at the date of consolidation is needed.

This is constructed using facts about the equity balances (as net assets = equity).

Illustration: Net assets summary of the subsidiary

	At date of consolidation	At date of acquisition
Share capital Share	X	X
premium Retained	X	X
earnings*	X	X
Net assets	X	X

*Retained earnings are also known as unappropriated profits or accumulated profits.

You are not yet in a position to fully understand this, but all will be explained in the following pages.

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Example1-To illustrate the basics

Example: Very basic example

P acquired 100% of the equity shares of S on incorporation of S (i.e., when S was first established as a company).

The date of this transaction was 31 December 20X1 (this known as the date of acquisition).

The cost of this investment was ₦ 120,000.

S had net assets (total assets minus total liabilities) when it was first set up of ₦ 120,000.

The statements of financial position P and S as at 31 December 20X1 (the date of acquisition) were as follows.

	P	S
	₦	₦
Non-current assets:		
Property, plant and equipment	640,000	125,000
Investment in S	120,000	-
Current assets	140,000	20,000
	900,000	145,000
Equity		
Share capital	200,000	80,000
Share premium	250,000	40,000
Retained earnings	350,000	–
	800,000	120,000
Current liabilities	100,000	25,000
	900,000	145,000

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

P Group: Consolidated statement of financial position as 31 December 20X1

Non-current assets:		
Property, plant and equipment	(640,000 + 125,000)	765,000
Current assets	(140,000 + 20,000)	160,000
		925,000
Equity		
Share capital	(parent company only)	200,000
Share premium	(parent company only)	250,000
Retained earnings		350,000
		800,000
Current liabilities	(100,000 + 25,000)	125,000
		925,000

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Note: In practice, there is no reason to prepare a consolidated statement of financial position when a subsidiary is acquired. However, it is used here to illustrate the basic principles of consolidation, before going on to consider what happens after the subsidiary has been acquired.

Observations

The asset in the parent's statement of financial position representing the cost of investment in the subsidiary disappears in the consolidation.

Each consolidated asset and liability are constructed by adding together the balances from the statements of financial position of the parent and the subsidiary.

The share capital (and share premium) in the consolidated statement of financial position is always just the share capital (and share premium) of the parent. That of the subsidiary disappears in the consolidation process.

Closing comment

The cost of investment was the same as the net assets acquired (₦120,000). This is very rarely the case. Usually there is a difference. This difference is called goodwill. It will be explained later.

18.3.4 Pre-acquisition and post-acquisition profits

Subsidiaries are usually acquired after they have been in business for some time rather than when they were incorporated.

This means that the acquired subsidiary will have retained earnings at the date of the acquisition. These are called pre-acquisition profits.

Only profits earned by the subsidiary since the date of acquisition are included as retained earnings in the consolidated financial statements. These are called post- acquisition retained earnings.

Pre-acquisition profits of a subsidiary are not included as retained earnings in the consolidated financial statements.

The working for the consolidated retained earnings balance is as follows:

Illustration: Consolidated retained earnings

	₦
All of P's retained earnings	X
P's share of the post-acquisition retained earnings of S	X
Consolidated retained earnings	X

Other reserves

Sometimes a subsidiary has reserves other than retained earnings. The same basic rules apply.

Only that part of a subsidiary's reserve that arose after the acquisition date is included in the group accounts (and then only the parent's share of it).

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Example: Consolidated statement of financial position with share of post-acquisition profits of subsidiary

P acquired 100% of the share capital of Son1January 20 X 1 for = ₦ 200,000.

The balance on the retained earnings account of S was ₦80,000 at this date.

The statements of financial position P and S as at 31 December 20X1 were as follows.

	P	S
	₦	₦
Non-current assets:		
Property, plant and equipment	680,000	245,000
Investment in S	200,000	-
Current assets	175,000	90,000
	1,055,000	335,000
Equity		
Share capital	150,000	30,000
Share premium	280,000	90,000
Retained earnings	470,000	140,000
	900,000	260,000
Current liabilities	155,000	75,000
	1,055,000	335,000

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

		₦
Non-current assets:		
Property, plant and equipment	(680,000 + 245,000)	925,000
Current assets	(175,000 + 90,000)	265,000
		1,190,000
Equity		
Share capital	(parent company only)	150,000
Share premium	(parent company only)	280,000
Consolidated retained earnings	**(see working)**	530,000
		960,000
Current liabilities	(155,000 + 75,000)	230,000
		1,190,000

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Example (continued): Workings

Net assets summary of S:

	At date of consolidation	At date of acquisition	Post acqn
Share capital	30,000	30,000	
Share premium	90,000	90,000	
Retained earnings	140,000	80,000	**60,000**
Net assets	140,000	200,000	

Consolidated retained profits:	₦
All of P's retained earnings	470,000
P's share of the post-acquisition retained earnings of S (100% of **60,000** (see above))	60,000
	530,000

Observations

The asset in the parent's statement of financial position representing the cost of investment in the subsidiary disappears in the consolidation.

Each consolidated asset and liability is constructed by adding together the balances from the statements of financial position of the parent and the subsidiary.

The share capital (and share premium) in the consolidated statement of financial position is always just the share capital (and share premium) of the parent. That of the subsidiary disappears in the consolidation process.

The consolidated retained profits is made up of the parent's retained profits plus the parent's share of the growth in the subsidiary's retained profits since the date of acquisition.

Closing comment

The cost of investment was the same as the net assets acquired (₦120,000). This is very rarely the case. Usually there is a difference. This difference is called goodwill. It will be explained later.

Goodwill

In each of the two previous examples the cost of investment was the same as the net assets of the subsidiary at the date of acquisition.

In effect what has happened in both examples is the cost of investment has been replaced by the net assets of the subsidiary as at the date of acquisition.

The net assets have grown since acquisition to become the net assets at consolidation. These have been included as part of the net assets of the group but remember that the consolidated retained earnings includes the parent's share of post-acquisition retained

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earnings so everything balances.

Do not worry if this is not obvious to you. The double entry is explained in section 3 of this chapter.

In almost all cases the cost of investment will be different to the net assets purchased. The difference is called 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.

When a parent buys a subsidiary the price it pays is not just for the assets in the statement of financial position. It will pay more than the value of the assets because it is buying the potential of the business to make profit.

The amount it pays in excess of the value of the assets is for the goodwill.

IFRS 3 Business combinations, sets out the calculation of goodwill as follows:

Illustration: Goodwill

N.B. All balances areas 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 IFRS3)	X
Goodwill recognised	X

The above calculation compares the total value of the company represented by what the parent has paid for it and the non-controlling interest to the net assets acquired at the date of acquisition.

The guidance requires the ***net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3***). This will be explained later.

The guidance also refers to non-controlling interest. This will be explained later but first we will present an example where there is no non-controlling interest.

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Example: Consolidated statement of financial position with share of post-acquisition profits and goodwill

P acquired 100% of Son 1 January 20 X 1 for ₦ 230,000. The retained earnings of S were 100,000 at that date.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P	S
	₦	₦
Assets:		
Investment in S, at cost	230,000	-
Other assets	570,000	240,000
	800,000	240,000
Equity		
Share capital	200,000	50,000
Share premium	100,000	20,000
Retained earnings	440,000	125,000
	740,000	195,000
Current liabilities	60,000	45,000
	800,000	240,000

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 20 X 1

Assets	₦
Goodwill (see working)	60,000
Other assets (570 + 240)	810,000
Total assets	870,000
Equity	
Share capital (P only)	200,000
Share premium (P only)	100,000
Consolidated retained earnings (see working)	465,000
	765,000
Current liabilities (60 + 40)	105,000
Total equity and liabilities	870,000

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Example (continued): Net assets summary of

	At date of consolidation	At date of acquisition	Post acqn
Share capital	50,000	50,000	
Share premium	20,000	20,000	
Retained earnings	125,000	100,000	25,000
Net assets	195,000	170,000*	

Goodwill	₦
Cost of investment	230,000
Non-controlling interest	nil
	230,000
Net assets at acquisition 100% of 170,000* (see above)	(170,000)
	60,000

Consolidated retained profits:	₦
All of P's retained earnings	440,000
P's share of the post-acquisition retained earnings of S (100% of 25,000(see above))	25,000
	465,000

Observations

The asset in the parent's statement of financial position representing the cost of investment in the subsidiary disappears in the consolidation. It is taken into the goodwill calculation.

Each consolidated asset and liability is constructed by adding together the balances from the statements of financial position of the parent and the subsidiary.

The share capital (and share premium) in the consolidated statement of financial position is always just the share capital (and share premium) of the parent. That of the subsidiary disappears in the consolidation process.

The consolidated retained profits is made up of the parent's retained profits plus the parent's share of the growth in the subsidiary's retained profits since the date of acquisition.

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Accounting for goodwill

Goodwill is recognised as an asset in the consolidated financial statements. It is not amortised but is tested for impairment on an annual basis.

Practice question **1**

Calculate the goodwill arising on acquisition in each of the following cases on the assumption that it is the parent company's policy to measure non-controlling interest at acquisition as a proportionate share of net assets.

(a) A Ltd bought 60% of B Limited on 1 January 2005 for ₦766,000. At this date B limited had net assets of ₦800,000.

(b) C Ltd bought 55% of D Limited several years ago for
(c) 1,000,000.

At this date D limited had share capital of ₦500,000 and retained earnings of ₦ 750,000.

(d) E Ltd bought 90% of F Limited several years ago for ₦1,750,000.

At this date F limited had share capital of ₦100,000, share premium of ₦48,000, are valuation reserve of ₦120,000 and retained earnings of ₦250,000.

(e) G Ltd bought 40% of H Limited several years ago for ₦1,000,000. Circumstances are such that this holding gives G Ltd defacto control of H Limited.

At this date H limited had share capital of ₦500,000 and retained earnings of ₦750,000.

18.3.5 Non-controlling interest

When a parent entity acquires less than 100% of the equity shares in a subsidiary, the remainder of the shares in the subsidiary are held by other shareholders. These are called the non-controlling interest (NCI) in the subsidiary. The abbreviation ***NCI*** is used for non-controlling interests.

For example, P might acquire 60% of the shares in S.

(a) It has acquired 60% of the 'equity' ownership of S.

(b) The remaining 40% of the equity in S is owned by the non-controlling interest.

Non-controlling interest (NCI) is defined by IFRS 10 as: 'the equity in a subsidiary not attributable, directly or indirectly, to a parent.'

All of the assets and liabilities of S are consolidated just as before. However, part of the net assets that have been consolidated belongs to the NCI. A figure for the NCI is recognised in equity to show their ownership interest in the net assets.

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18.3.5 Measuring the NCI

The NCI at the reporting date made up as follows:

Illustration: Consolidated retained earnings

	₦
NCI at the date of acquisition	X
NCI's share of the post-acquisition retained earnings of S NCI's	X
share of each other post-acquisition reserves of S (if any)	X
Consolidated retained earnings	X

There are two ways of measuring the NCI at the date of acquisition.

(a) As a percentage of the net assets of the subsidiary at the date of acquisition; or

(b) At fair value as at the date of acquisition.

The first technique is the easier of the two because it allows for the use of a short cut. Also, it is far the more common in practice.

The different approaches will obviously result in a different figure for NCI but remember that the NCI at acquisition is also used in the goodwill calculation.

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This is affected also.

Example: Consolidated statement of financial position with share of post- acquisition profits, goodwill and NCI

P acquired 80% of Son 1 January 20 X 1 for ₦230,000. The retained

earnings of S were 100,000 at that date.

It is P's policy to recognize 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
A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

	P	S
	₦	₦
Assets:		
Investment in S, at cost	230,000	-
Other assets	570,000	240,000
	800,000	240,000
Equity		
Share capital	200,000	50,000
Share premium	100,000	20,000
Retained earnings	440,000	125,000
	740,000	195,000
Current liabilities	60,000	45,000
	800,000	240,000
Goodwill (see working)		94,000
Other assets (570 + 240)		810,000
Total assets		904,000
Equity		
Share capital (P only)		200,000
Share premium (P only)		100,000
Consolidated retained earnings (see working)		460,000
		760,000
Non-controlling interest (see working)		39,000
		799,000
Current liabilities (60 + 40)		105,000
Total equity and liabilities		904,000

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Example (continued): Net assets summary of

	At date of consolidation	At date of acquisition	Post acqn
Share capital	50,000	50,000	
Share premium	20,000	20,000	
Retained earnings	125,000	100,000	25,000
Net assets	195,000*	170,000	

Non-controlling interest	₦
NCI's share of net assets at the date of acquisition (20% u170,000)	34,000
NCI's share of the post- acquisition retained earnings of S (20% of 25,000 (see above))	5,000
NCI's share of net assets at the date of consolidation	39,000

Goodwill	₦
Cost of investment	230,000
Non-controlling interest at acquisition	34,000
	264,000
Net assets at acquisition (see above)	(170,000)
	94,000

Consolidated retained profits:	₦
All of P's retained earnings	440,000
P's share of the post-acquisition retained earnings of S (80% of 25,000 (see above))	20,000
	460,000

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The NCI at the date of consolidation has been calculated as NCI share of net assets at acquisition plus the NCI share of profit since the date of acquisition.

NCI share of profit since the date of acquisition is the same as the NCI share of net assets since the date of acquisition.

Therefore, the NCI at the date of consolidation is simply the NCI share of net assets at the date of consolidation.

Example (continued): Net assets summary of

	At date of consolidation	At date of acquisition	Post acqn
Share capital	50,000	50,000	
Share premium	20,000	20,000	
Retained earnings	125,000	100,000	25,000
Net assets	195,000*	170,000	

This short cut is not available if the NCI at acquisition is measured at fair value.

Non-controlling interest	₦
NCI's share of net assets at the date of consolidation (20% x 195,000*)	39,000

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NCI at fair value at the date of acquisition

Example: NCI at date of acquisition measured at fair value

Continuing the earlier example with the extra information that the fair value of the NCI at acquisition was 40,000.

Net assets summary of S

	At date of consolidation	At date of acquisition	Post acqn
Share capital	50,000	50,000	
Share premium	20,000	20,000	
Retained earnings	125,000	100,000	25,000
Net assets	195,000	170,000	

Figures under both methods are shown so that you can see the difference between the two.

	NCI at fair value	share of net assets
Non-controlling interest	₦	₦
NCI at the date of acquisition		
at fair value	40,000	
share of net assets (20% u170,000)		34,000
NCI's share of the post-acquisition retained earnings of S (20% of 25,000 (see above))	5,000	5,000
NCI's share of net assets at the date of consolidation	45,000	39,000
Goodwill	₦	₦
Cost of investment	230,000	230,000
Non-controlling interest at acquisition	40,000	34,000
	270,000	264,000
Net assets at acquisition (see above)	(170,000)	(170,000)
	100,000	94,000

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Practice question **2**

Calculate the goodwill arising on acquisition in each of the following cases on the assumption that it is the parent company's policy to measure non-controlling interest at acquisition at its fair value.

(a) A Ltd bought 60% of B Limited on 1 January 2005 for ₦766,000.

At this date B limited had net assets of ₦800,000 and the fair value of Its non-controlling interest was ₦350,000.

(b) C Ltd bought 55% of D Limited several years ago for ₦1,000,000.

At this date D limited had share capital of ₦500,000 and retained earnings of ₦750,000 and the fair value of its non-controlling interest was ₦600,000.

(c) E Ltd bought 90% of F Limited several years ago for ₦1,750,000.

At this date F limited had share capital of ₦100,000, share premium of ₦ 48,000, are valuation reserve of ₦120,000 and retained earnings of ₦ 250,000 and the fair value of its non-controlling interest was ₦ 60,000.

18.3.6 Suggested step by step approach

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

Step 5.
Calculate the goodwill

Step 6.
Calculate the non-controlling interest.

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Step 7.
Calculate consolidated retained earnings.

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Practice question **3**

P acquired 70% of Son1January 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	x	350,000

Prepare a consolidated statement of financial position as at 31 December 20X1.

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Practice question **4**

P acquired 70% of Son1January 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

Prepare a consolidated statement of financial position as at 31 December 20X1.

18.4 IFRS 3: Business Combinations

18.4.1 Introduction to IFRS 3

18.4.2 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:

a) the recognition and measurement of identifiable assets acquired, liabilities assumed and non-controlling interest in the acquiree;

b) the recognition and measurement of goodwill (or a gain from a bargain purchase); and

c) disclosures that enable users to evaluate the nature and financial effects of a business combination.

18.4.3 Acquisition method

All business combinations are accounted for by the acquisition method which

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involves:

a) identifying the acquirer.

b) determining the acquisition date.

c) recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

d) recognising and measuring goodwill or a gain from a bargain purchase

18.4.4 Identifying the acquirer

It might be difficult to identify an acquirer:

a. The acquirer is usually the combining entity whose relative size is significantly greater than that of the other(s).

b. 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.

c. In a business combinations affected by exchange of equity interests the acquirer is usually the entity that issues equity.

Also note that the acquirer is usually the entity:

(a) whose owners have the largest portion of the voting rights in the combined entity;

(b) whose owners have the ability determine the composition of the governing body of the combined entity;

(c) whose (former) management dominates the management of the combined entity; and

(d) that pays a premium over the pre-combination fair value of the equity interests of the others.

18.4.6 Determining the acquisition date

Acquisition date is the date on which the acquirer effectively obtains control of the acquiree.

This is 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.

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18.4.7 Goodwill

Goodwill was defined in an earlier section which explained that it is measured as follows:

Illustration: Goodwill

N.B. All balances are as at the date of

	₦
Consideration transferred (cost of the business combination)	X
	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in Accordance with IFRS 3)	X
Good will recognised	X

The section also explained that the non-controlling interest may be stated as either:

(a) a proportionate share of the identifiable assets acquired and liabilities assumed; or

(b) at fair value as at the date of acquisition

18.4.7 Issues to address

IFRS 3 gives guidance on:

(a) cost of a business combination;

(b) recognition and measurement of identifiable assets and liabilities assumed; and

(c) accounting for goodwill.

i. Cost (consideration transferred)

Consideration transferred is measured at fair value which is the sum of acquisition-date fair values of:

(a) assets transferred by the acquirer;

(b) liabilities incurred by the acquirer to former owners of the acquiree; and

(c) equity interests issued by the acquirer (except for share-based payment awards exchanged for those held by the acquiree's employees – IFRS 2 applies)

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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:

a) recognised at acquisition-date fair value; and

b) 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.

Acquisition-related costs

Acquisition-related costs (costs the acquirer incurs to effect a business combination) are recognised as expenses in the periods in which the costs are incurred and the services are received.

Costs of issuing debt or equity (perhaps to pay for the business combination) are not acquisition costs. These costs are accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

Acquisition date amounts of assets acquired, and liabilities assumed

The way that the following rules impact consolidation is shown in the next chapter.

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 3 sets out:

a) a recognition principle;

b) classification guidance; with

c) 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***

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as at the acquisition date.

This might result in recognition of assets and liabilities not previously recognised by the acquiree.

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:

a) classification of a lease contract in accordance with ***IFRS 16:*** *Leases*; and

b) classification of a contract as an insurance contract in accordance with IFRS 16.

18.4.8 IFRS 4: *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.

Measurement principle

Identifiable assets acquired and the liabilities assumed are measured 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.

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18.4.9 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:

a) the identifiable assets acquired and liabilities assumed;

b) the non-controlling interest in the acquiree (if any); and

c) the consideration transferred.

Any amount remaining after applying the above requirements is recognised as a gain in profit or loss on the acquisition date.

18.5 Consolidation Double Entry

18.5.1 Introductory comment

This section has been prepared for your wider professional education rather than for the exam. Treat it as a reference section that shows how the double entry of consolidation works.

We recommend that you do not answer questions using "T accounts" as shown in this section but use schedules as shown in the earlier sections

Usually, journals are prepared to process changes in the general ledger. This is not the case of the journals in this section. There is no general ledger for the group accounts. Consolidated financial statements are prepared from independent sets of financial statements which are extracted from separate general ledgers. Information from these independent financial statements is transferred to working papers where the consolidation is performed.

The journals described in this refer to adjustments made to numbers in those working papers.

The example used earlier at paragraph 2.5 of this chapter will be used to illustrate the double entry.

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18.5.2 Calculating goodwill

The cost of an investment account is renamed the cost of control account. This is the account used to calculate goodwill. P's share of net assets is compared with the cost of investment in this account by transferring in P's share of each of S's equity balances at the date of acquisition.

Illustration: Double entry to calculate goodwill

	Debit	Credit
Share capital of S	40,000	
Cost of control (80% of 50,000)		40,000
Share premium of S	16,000	
Cost of control (80% of 20,000)		16,000
Retained earnings of S	80,000	
Cost of control (80% of 100,000)		80,000

Being: Transfer of P's share of S's share capital, share premium and retained earnings to cost of control account as at the date of acquisition.

The balance on the cost of control account is the goodwill figure.

Example (continued): Cost of control account

Cost of control (goodwill)

	₦		₦
Cost of investment	230,000	1) P's share of S's capital	40,000
		(a) P's share of S's share	16,000
			80,000
		pre	94,000
	230,000		230,000
Balance b/d	94,000		

This is only shown for background information. Do not use a "T account" but use a schedule as previously shown.

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18.5.3 Calculating NCI

The NCI's share of net assets of S is constructed by transferring in their share of each of S's equity balances at the date of consolidation into an NCI account.

Illustration: Double entry to calculate NCI

	Debit	Credit
Share capital of S	10,000	
Non-controlling interest		10,000
Share premium of S	4,000	
Non-controlling interest		4,000
Retained earnings of S	25,000	
Non-controlling interest (20% of 125,000)		25,000

Being: Transfer of NCI's share of S's share capital, share premium and retained earnings to the non-controlling interest account

The balance on this account is the non-controlling interest

Example (continued): NCI account

Non-controlling interest

	₦		₦
		4) NCI's share of S's share capital (20% of 50,000)	10,000
		5) NCI's share of S's share premium (20% of 20,000)	4,000
	39,000	6)NCI's share of S's retained earnings (20% of125,000)	25,000
Balance b/d			
	39,000		39,000
		Balance b/d	39,000

This is only shown for background information. Do not use a "T account" but use a schedule as previously shown.

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18.5.4 Calculating Consolidated Retained Earnings

P's share of S's retained earnings since the date of acquisition is credited to the P's retained earnings account.

Illustration: Double entry to calculate consolidated retained earnings

	Debit	Credit
Retained earnings of S	20,000	
P's retained earnings		20,000
Being: Transfer of P's share of post-acquisition profits of S into retained earnings. (80% of (125,000 –100,000))		

The balance on this account is the consolidated retained earnings.

Example (continued): Consolidated retained earnings account

Retained earnings

	₦		₦
		P's balance	440,000
		P's share of S's	20,000
Balance b/d	460,000		
	460,000		460,000
		Balance b/d	460,000

This is only shown for background information. Do not use a "T account" but use a schedule as previously shown.

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18.5.5 Tutorial note

The balances on S's share capital, share premium and retained earnings have all been removed elsewhere.

Example (continued): Other accounts

Share capital (of S)

	₦		₦
P's share at acquisition (to cost of control)	40,000	Balance b/d	50,000
S's share (to NCI)	10,000		
	50,000		50,000

Share premium (of S)

	₦		₦
P's share at acquisition (to cost of control)	16,000	Balance b/d	20,000
S's share (to NCI)	4,000		
	20,000		20,000

Retained earnings (of S)

	₦		₦
P's share at acquisition (to cost of control)	80,000	Balance b/d	125,000
P's share since acquisition (consolidated retained profits)	20,000		
S's share (to NCI)	25,000		
	125,000		125,000

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Chapter review

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

a) describe the concept of a group as a single economic unit;

b) define using simple examples subsidiary, parent and control;

c) describe situations when control is presumed to exist;

d) identify and describe the circumstances in which an entity is required to prepare and present consolidated financial statements; and

e) prepare basic a consolidated statement of financial position including the calculation of goodwill, non-controlling interest and consolidated post-acquisition reserves.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

a) **Goodwill**

	₦
Cost of investment	766,000
Non-controlling interest at acquisition (40 % of 800,000)	320,000
	1,086,000
Net assets at acquisition	(800,000)
	286,000

b) **Net assets summary**

	At date of acquisition
Share capital	500,000
Retained earnings	750,000
Net assets	1,250,000

Goodwill

	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (45 % of 1,250,000)	562,500
	1,562,500
Net assets at acquisition	(1,250,000)
	312,500

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C) **Net assets summary**

	At date of acquisition
Share capital	100,000
Share premium	48,000
Revaluation reserve	120,000
Retained earnings	250,000
Net assets	518,000

Goodwill	₦
Cost of investment	1,750,000
Non-controlling interest at acquisition (10 % of 518,000)	51,800
	1,801,800
Net assets at acquisition	(518,000)
	1,283,800

Solution (continued) **1**

d) **Net assets summary**

	At date of acquisition
Share capital	500,000
Retained earnings	750,000
Net assets	1,250,000

Goodwill	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (60 % of 1,250,000)	750,000
	1,750,000
Net assets at acquisition	(1,250,000)
	500,000

Solutions **2**

a) **Goodwill**

	₦
Cost of investment	766,000
Non-controlling interest at acquisition (given)	350,000
	1,116,000
Net assets at acquisition	(800,000)
	316,000

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b) **Net assets summary**

	At date of acquisition
Share capital	500,000
Retained earnings	750,000
Net assets	1,250,000

Goodwill	**₦**
Cost of investment	1,000,000
Non-controlling interest at acquisition (given)	600,000
	1,600,000
Net assets at acquisition	(1,250,000)
	350,000

Solutions (continued) **2**

c) **Net assets summary**

	At date of acquisition
Share capital	100,000
Share premium	48,000
Revaluation reserve	120,000
Retained earnings	250,000
Net assets	518,000

Goodwill	**₦**
Cost of investment	1,750,000
Non-controlling interest at acquisition (given)	60,000
	1,810,000
Net assets at acquisition	(518,000)
	1,292,000

Solution **3**

P Group: Consolidated statement of financial position at 31 December 20X1

Assets	**₦**
Goodwill (W3)	345,000
Other assets (500 + 350)	850,000
Total assets	1,195,000

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Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	685,000
	785,000
Non-controlling interest (W2)	60,000
	845,000
Current liabilities (200 + 150)	350,000
Total equity and liabilities	1,195,000

Solution (continued) **3**

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

	₦
NCI's share of net assets at the date of acquisition (30% x150,000 (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% x 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

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Solution 4

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

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Solution (continued) **4**

		₦
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

18.7 End of chapter questions and suggested solutions

18.7.1 Questions

QUESTION 1

When a parent Company elects not to prepare consolidated financial statements and instead prepares separate financial statements; what are the disclosure requirements stipulated in IAS 27 on Separate Financial Statements?

Question 2

Kerewanta Plc. acquired 60% of the equity shares of Orijinmi Plc. by means of share exchange of three shares in Kerewanta Plc. for four shares in Orijinmi Plc.

The market value of the shares of Kerewanta Plc. at the date of acquisition, which is 1 April, 2013 was N10 per share.

Kerewanta Plc. would make a deferred cash payment of 70k per acquired share on 1 April 2014. Kerewanta Plc. cost of capital is 12% per annum. None of the considerations have been recorded in the books of Kerewanta Plc. The following information was extracted from the financial statements of the two companies as at 31 March 2014.

	Kerewanta Plc. ₦'m	Orijinmi Plc. ₦'m
Equity shares of ₦1 each	60,000	20,000
Share premium	15,000	NIL
Retained earnings 1 April, 2013	20,500	11,600
Retained earnings for the year ended 31 March, 2014	9,800	6,700
Property, plant and equipment	50,400	22,900

The following is the additional relevant information:

i. An equipment had a fair value of N360,000,000 above its carrying amount. At the date of acquisition of Orijinmi Plc. the asset had a remaining life of four years. It is the group's policy to depreciate such asset using the straight-line method.

ii. Orijinmi Plc. had deferred tax liability of N10,000,000 as at 31 March 2014 which had not been recorded. The company's goodwill is not impaired.

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iii. Non-controlling interests are to be valued at fair value at the date of acquisition of Orijinmi Plc. The fair value of the shares of Orijinmi Plc. held by non-controlling interests at the date of acquisition is N6 per share.

Required:
Calculate the following as at 31 March 2014:

a) Equity

b) Non-controlling interests

c) Consolidated goodwill

d) Property, plant and equipment

18.7.2 Suggested solutions

Solution 1
DISCLOSURE REQUIREMENTS STIPULATED IN IAS 27 WHERE A COMPANY ELECTS NOT TO PREPARE CONSOLIDATED FINANCIAL STATEMENTS

When a parent company elects not to prepare consolidated financial statements and instead prepares separate financial statements, IAS 27 on Consolidated and
Separate Financial Statements state that it shall be disclosed in those separate financials.

(a) The fact that financial statements are separate financial statements.

(b) A list of significant investments in subsidiaries, joint ventures and associates including:
- **i.** The name of those investees
- **ii.** The principal place of business (and country of incorporation, if different) of those investees
- **iii.** Its proportion of ownership interest (and its proportion of the voting rights, if different) held in those investees.

(c) A description of the method used to account for the investment listed under (b) above.

Solution 2

(i) Equity as at 31 March, 2014

	₦'m
Share capital of Kerewanta Plc.	69,000
Share premium	96,000
Retained earnings (Wk 1)	33,360
	198,360

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(ii) Non-controlling interests as at 31 March, 2014

	₦'m
Added on acquisition at 1 April, 2013	48,000
40% post acquisition on profit (40% x ₦6,700)	2,680
Deferred tax expenses (₦10million x 40%)	(4)
Additional depreciation (1/4 year x ₦360 x 40%)	(36)
	50,640

(iii) Consolidated Goodwill as at 31 March, 2014

Purchase consideration of Kerewanta Plc.	₦'m	
Share consideration		90,000
Deferred consideration		7,500
		97,500
Non- controlling interest		48,000
Cost of business combination		145,500

Fair value of identifiable net asset at 1 April, 2013

	₦'m	
Share capital	20,000	
Pre-acquisition reserves	11,600	
Fair value adjustments	360	(31,976)
Full goodwill		113,540

(iv) Property, plant and equipment as at 31 March, 2014

	₦'m
Kerewanta Plc.	50,400
Orijinmi Plc.	22,900
Fair value Adjustment	360
Less: Additional depreciation (1/4 years x ₦360million)	(90)
	73,570

Workings:

Wk 1 Retained earnings as at 31 March, 2014

	₦'m
Kerewanta Plc. retained earnings (₦20,500 + ₦9,800)	30,300
60% post-acquisition profit (60% x ₦6,700)	4,020
Finance cost (12% x ₦7,500million)	(900)
Deferred tax expense (₦10million x 60%)	(6)
Additional depreciation (1/4 years x ₦360million x 60%)	(54)
	33,360

Skills Level
Financial Reporting

CHAPTER 19

CONSOLIDATED ACCOUNTS: STATEMENT OF FINANCIAL POSITION-COMPLICATIONS

Contents

19.0 Learning objective
19.1 Learning outcomes
19.2 Possible complications: Before consolidation
19.3 Possible complications: During consolidation
19.4 Possible complications: After consolidation
19.5 Chapter review
19.6 End of chapter question and suggested solution

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19 Consolidated Accounts: Statement of Financial Position Complications

19.0 Learning objective

This chapter covers treatment of complications in preparing statement of financial position in consolidated accounts of a group.

19.1 Learning outcomes

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

a) account for acquisition related costs;

b) incorporate straightforward fair value adjustments into a consolidation;

c) account for a mid-year acquisition of a subsidiary;

d) eliminate unrealised profit on transactions between a parent company and its subsidiary;

e) account for goodwill; and

f) account for gain on a bargain purchase (negative goodwill).

19.2 Possible Complications: Before Consolidation

19.2.1 Acquisition-related costs

Acquisition-related costs are costs the acquirer incurs to effect a business combination. They include advisory, legal, accounting, valuation and other professional or consulting fees.

These costs are not capitalised as part of the cost of acquisition but expensed in the periods in which they are incurred. (This is different rule to that which applies to the purchase of property, plant and equipment or intangibles).

A question may incorrectly capitalise the costs. You would have to correct this before consolidating.

19.2.2 Acquired intangible assets

A question might provide information about an unrecognised asset of the subsidiary. You would have to include the asset in the subsidiary's financial statements before consolidating them.

Reason

Goodwill is recognised by the acquirer as an asset from the acquisition date. It is initially measured as the difference between:

a) the cost of the acquisition plus the non-controlling interest; and

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

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

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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: Fair value adjustment

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.

Example: Fair value adjustment (non-depreciable asset)

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 recognized 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

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

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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

Example (continued):

Net assets summary of S

	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 brand (100,000 × 2 years/20 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% of 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

Goodwill	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (20% u800,000)	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

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	3,212,000

Brand	₦
On initial recognition	100,000
Depreciation since acquisition (100,000 × 2 years/20 years)	(10,000)
	90,000

19.2.3 Fair Value Exercise at Acquisition

A question might provide information about the fair value of a subsidiary's assets at the date of acquisition. You might have to revalue the assets in the subsidiary's financial statements before consolidating them.

Reason

Goodwill is recognised by the acquirer as an asset from the acquisition date. It is initially measured as the difference between:

a) the cost of the acquisition plus the non-controlling interest; and

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

IFRS 3 requires that most assets and liabilities be measured at their fair value.

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.

IFRS 13 para 9

In every example so far it has been assumed that the fair value of the assets and liabilities of the subsidiary were the same as their book value as at the date of acquisition. In practice this will not be the case.

In other cases, a question will include information about the fair value of an asset or assets as at the date of acquisition.

The net assets of a newly acquired business are subject to a fair valuation exercise.

Where the subsidiary has not reflected fair values at acquisition in its accounts, this must be done before consolidating. Note that this is almost always the case

19.2.4 Revaluation upwards:

The asset is revalued in the consolidation working papers (not in the general ledger of the subsidiary). The other side of the entry is taken to a fair value reserve as at the date of acquisition. This will appear in the net assets working and therefore become part of the goodwill calculation.

The reserve is also included in the net assets working at the reporting date if the asset is still owned by the subsidiary.

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If a depreciable asset is revalued the post-acquisition depreciation must be adjusted to take account of the change in the value of the asset being depreciated.

19.2.5 Revaluation downwards

Write off the amount to retained earnings in the net assets working (book value less fair value of net assets at acquisition) at acquisition and at the reporting date if the asset is still owned.

Example: Fair value adjustment (depreciable asset)

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

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	
Goodwill (see working)	200,000
PP & 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 (200,000 + 200,000)	400,000

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Total equity and liabilities	3,940,000

Example (continued):

Net assets summary of S

	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% of 1,000,000)	200,000
NCI's share of the post-acquisition retained earnings of S (20% of 340,000 (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% 0f 1,000,000)	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 340,000 (see above))	272,000
	3,172,000

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	P(₦)	S(₦)

Example (continued): Net assets summary of S

Property plant and equipment	₦'000
Parent's	1,800
Subsidiary's	
Given in question	1,000
Fair value adjustment	300
Extra depreciation on fair value adjustment (300 × $^{2\ years}/_{10years}$)	(60)
	1,240
To statement of financial position	3,040

19.2.6 Explanation of Extra Depreciation

If a depreciable asset is revalued (which is usually the case) the post-acquisition depreciation must be adjusted to take account of the change in the value of the asset being depreciated.

In this example, two years ago the subsidiary had an asset which had a fair value ₦300,000 greater than its book value. This valuation was not recorded in the financial statements of the subsidiary, so the subsidiary's figures need to be retrospectively adjusted, for the purposes of consolidation, at each yearend.

Depreciation of an asset is based on its carrying amount. Depreciation of an asset increases when it is revalued. Therefore, the extra depreciation necessary as a result of the fair value adjustment is ₦ 30,000 per annum (₦ $^{00,000}/_{10years}$)

The acquisition was 2years ago so extra depreciation of ₦60,000(₦30,000 x 2 years) must be recognised retrospectively.

Practice question

P acquired 70% of Son 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 recognize 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:

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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

19.3 Possible complications: during consolidation

19.3.1 Mid-year Acquisitions

Goodwill is measured at the date of acquisition of the subsidiary.

He may not acquire S at the start or end of a year. If S is acquired mid-year, it is necessary to calculate the net assets at date of acquisition in order to calculate goodwill, non-controlling interest and consolidated retained earnings.

This usually involves calculating the subsidiary's retained earnings at the date of acquisition. The profits of the subsidiary are assumed to accrue evenly over time unless there is information to the contrary.

Illustration: Retained earnings at the date of

	₦
Retained earnings at the start of the year	X
Retained earnings for the year up to the date of acquisition	X
Retained earnings at the date of acquisition	X

Example: Mid-year acquisition

P bought 70% of S on 31st March this year. S's

profit for the year was ₦12,000

The statements of financial position P and S as at 31 December 20X1 were as follows:

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	P	S
	₦	₦
PP & E	100,000	20,000
Investment in S	50,000	
Other assets	30,000	12,000
	180,000	32,000
Share capital	10,000	1,000
Retained earnings	160,000	30,000
Liabilities	10,000	1,000
	180,000	32,000

Goodwill (see working)	34,600
PP & E (100,000 + 20,000)	120,000
Other assets (30,000 + 12,000)	42,000
Total assets	196,600
Equity	
Share capital (P only)	10,000
Consolidated retained earnings (see working)	166,300
	176,300
Non-controlling interest	9,300
	185,600
Current liabilities (10,000 + 1,000)	11,000
Total equity and liabilities	196,600

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Example (continued):

Net assets summary of S

	At date of consolidation	At date of acquisition	Post acqn
Share capital	1,000	1,000	
Retained earnings			
Given in the question	30,000		
See working below		21,000	
	30,000	21,000	9,000
Net assets	31,000	22,000	

Retained earnings of the subsidiary as at the date of acquisition

	₦
Retained earnings at the start of the year	
Retained earnings at the end of the year	30,000)
Less: profit for the year	(12,000)
	18,000
Profit from the start of the year to the date of acquisition (3/12 x 12,000)	3,000
NCI's share of net assets at the date of consolidation	21,000

Non-controlling interest	₦
NCI's share of net assets at the date of acquisition (30% of 22,000)	6,600
NCI's share of the post-acquisition retained earnings of S (30% of 9,000 (see above))	2,700
NCI's share of net assets at the date of consolidation	9,300

Goodwill	₦
Cost of investment	50,000
Non-controlling interest at acquisition (30% of 22,000)	6,600
	56,600
Net assets at acquisition (see above)	(22,000)
	34,600

Consolidated retained profits:	₦
All of P's retained earnings	160,000
P's share of the post-acquisition retained earnings of S (70% of 9,000 (see above))	6,300
	166,300

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19.3.2 Types of Intra-Group Transaction

In many groups, business and financial transactions take place between entities within the group. These 'intra-group' transactions might be:

a) the sale of goods or services between the parent and a subsidiary, or between two subsidiaries in the group;

b) transfers of non-current assets between the parent and a subsidiary, or between two subsidiaries in the group;

c) the payment of dividends by a subsidiary to the parent (or by one subsidiary to another subsidiary); and

d) loans by one entity in the group to another, and the payment of interest on intra-group loans.

19.3.3 The need to eliminate intra-group transactions on consolidation

Intra-group transactions should be eliminated on consolidation. In other words, the effects of intra-group transactions must be removed from the financial statements on consolidation.

The purpose of consolidated accounts is to show the financial position and the financial performance of the group as a whole, as if it is a single operating unit. If intra-group transactions are included in the consolidated financial statements, the statements will show too many assets, liabilities, income and expenses for the group as a single operating unit.

The consolidated financial statements represent the financial position and performance of a group of companies as if they are a single economic entity. A single economic entity cannot owe itself money!

IFRS 10 therefore requires that:

(a) Intra-group balances and transactions, including income, expenses and dividends, must be eliminated in full.

(b) Profits or losses resulting from intra-group transactions that are recognised in inventory or non-current assets must be eliminated in full.

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Illustration: Unrealised profit double entry

Example: Elimination of intra-group transactions on consolidation

H owns 80% of S. H sells goods to S.

	P	S	Adjustment Dr	Adjustment Cr	Consolidated statement of financial position
Receivables:					
From S	1,000			1,000	–
Payables:					
To H		1,000	1,000		–

The above adjustment is simply a cancellation of the inter-company receivable in one group member's statement of financial position against the inter-company payable in another group member's statement of financial position.

Items in transit

At the year-end current accounts may not agree, owing to the existence of in- transit items such as goods or cash.

The usual convention followed is to follow the item through to its ultimate destination and adjust the books of the ultimate recipient.

19.3.3 Unrealised profit – Inventory

Inter-company balances are cancelled on consolidation. The main reason for this arising is inter company (or intra group) trading. The other example you will come across is inter-company transfers of non-current assets.

If a member of a group sells inventory to another member of the group and that inventory is still held by the buying company at the year-end:

(a) The company that made the sale will show profit in its own accounts.

(b) This is fine from the individual company's viewpoint but the profit has not been realised by the group.

(c) The company that made the purchase will record the inventory at cost to itself.

(d) This is fine from the individual company's view but consolidation of this value will result in the inclusion in the financial statements of a figure which is not at cost to the group.

IFRS 10 requires that the unrealised profit be removed in full from the closing inventory valuation. It gives no further guidance on how this should be done.

This is an inventory valuation adjustment and can be processed in the consolidated financial statements.

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	Debit	Credit
Closing inventory – Statement of comprehensive income	X	
Closing inventory – Statement of financial position		X

There is a complication to think about. If S is the selling company the purpose of the above adjustment is to reduce the profit of the subsidiary because there is unrealised profit on the inter-company transaction and reduce the inventory held by P as it is not at cost to the group.

If the profit of the subsidiary is being reduced then NCI should share in that reduction. This implies a second journal as follows:

Illustration: Unrealised profit double entry

	Debit	Credit
NCI in the statement of financial position	X	
NCI in the statement of comprehensive income		X
With their share of the adjustment		

The two journals can be combined as follows to produce a composite adjustment in questions which only require the preparation of the statement of financial position.

Illustration: Unrealised profit double entry

	Debit	Credit
Consolidated retained earnings	X	
NCI in the statement of financial position	X	
Closing inventory – Statement of financial position		X

Example: Unrealised profit

P bought 80% of S, 2 years ago. At the date of acquisition S's retained earnings stood at ₦16,000.

During the year S sold goods to H for ₦20,000 which gave S, a profit of ₦ 8,000.

H still held 40% of these goods at the year end.

The statements of financial position P and S as at 31 December 20X1 were as follows:

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	P	S
	₦	₦
PP & E	100,000	41,000
Investment in S	50,000	
Other assets	110,000	50,000
	260,000	91,000
Share capital	50,000	30,000
Retained earnings	200,000	56,000
Liabilities	10,000	5,000
	260,000	91,000

Assets	₦
Goodwill (see working)	13,200
PP & E (100,000 + 41,000)	141,000
Other assets (see working)	156,800
Total assets	311,000
Equity	
Share capital (P only)	50,000
Consolidated retained earnings (see working)	229,440
	279,440
Non-controlling interest	16,560
	296,000
Current liabilities (10,000 + 5,000)	15,000
Total equity and liabilities	311,000

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Example (continued):

Net assets summary of S

	At date of consolidation	At date of acquisition	Post acqn
Share capital	30,000	30,000	
Retained earnings			
Given in the question	56,000	16,000	40,000
Net assets	82,800	46,000	

Unrealised profit

	₦
Total profit on transaction	8,000
Inventory held at year end (therefore the profit on this is unrealised by the group)	40%
Adjustment	3,200

Double entry in consolidated financial statements	Dr	Cr
Consolidated retained earnings (80% of 3,200)	2,560	
NCI – Statement of financial position (20% of 3,200)	640	
Closing inventory – Statement of financial position		3,200

Non-controlling interest	₦
NCI's share of net assets at the date of acquisition (20% of 46,000)	9,200
NCI's share of the post-acquisition retained earnings of S (20% of 40,000 (see above))	8,000
NCI share of unrealised profit adjustment	(640)
NCI's share of net assets at the date of consolidation	16,560

Goodwill	₦
Cost of investment	50,000
Non-controlling interest at acquisition (20% of 46,000)	9,200
	59,200
Net assets at acquisition (see above)	(46,000)
Recoverable amount of goodwill (given)	13,200

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Example (continued)

Consolidated retained profits:	₦
All of P's retained earnings	200,000
P's share of the post-acquisition retained earnings of S (80% of 40,000 (see above))	32,000
Unrealised profit adjustment	(2,560)
	229,440

Practice question **2**

P acquired 60% of Son 1 January 20X1 for ₦2,000,000

The retained earnings of S were ₦785,000 at that date and S held land which had a fair value of ₦500,000 more than its carrying value.

It is P's policy to recognise non-controlling interest at the date of acquisition as a proportionate share of net assets.

During the period P had sold goods to S for ₦50,000 at a mark-up of 25% on cost. S had sold some of this inventory to third parties but still held inventory bought from P for ₦12,500 at 31 December 20X1.

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	2,000,000	-
Other non-current assets	650,000	826,000
Current assets		
Inventory	100,000	80,000
Amount owed by S	6,000	na
Other current assets	374,000	320,000
	480,000	400,000
	3,130,000	1,226,000
Equity		
Share capital	100,000	50,000
Retained earnings	2,590,000	1,050,000
Current liabilities		
Amount owed to P	na	6,000
Other current liabilities	240,000	120,000
	440,000	126,000
	3,130,000	1,226,000

Prepare a consolidated statement of financial position as at 31 December 20X1.

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19.3.4 Unrealised profit–Transfers of non-current assets

One member of a group may sell a non-current asset to another member of the group.

The company making the sale will recognise a profit or loss on disposal.

The company buying the asset will include the asset at purchase cost in its own accounts and depreciation will be based on that amount. This cost will be different to cost to the group.

As far as the group is concerned no transfer has occurred. The group accounts must reflect non-current assets at the amount they would have been stated at had the transfer not been made.

Summary of adjustments:

(a) Remove profit from the financial statements of the company that made the sale; and

(b) Correct the depreciation charge in the financial statements of the company that made the purchase.

These two adjustments establish the transferred asset at its cost less accumulated depreciation to the group.

The double entry is shared to the NCI as appropriate in the consolidated statement of financial position.

(a) If the sale was to S the NCI would share the depreciation adjustment.

(b) If the sale was from S to H the NCI would share the profit adjustment. This is best seen with an illustration.

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Example: Unrealised profit on transfer of non-current assets

H owns 80% of S.

There was a transfer of an asset within the group for ₦15,000 on1 January 20X3.

The original cost to H was ₦20,000 and the accumulated depreciation at the date of transfer was ₦8,000.

Both companies depreciate such assets at 20% per year on cost to the company, recognising a full year's depreciation in the year of purchase and none in the year of sale.

	Figures in the accounts	Figures if no transfer had been made	Adjustment required
Against S's figures:			
Cost	15,000	20,000	5,000 Dr
Accumulated depreciation	(3,000)	(12,000)	9,000 Cr
	12,000	8,000	4,000 Cr
Charge for the year	3,000	4,000	1,000 Dr
Against P's figures:			
Profit on disposal			
Proceeds	15,000		
Carrying amount at disposal (20,000 – 8,000)	(12,000)		
	3,000	nil	

If the transfer was from H to S–Full journal

Consolidated financial statements	Dr	Cr
Income statement (profit on disposal)	3,000	
Income statement (depreciation)	1,000	
Non-current asset		4,000
NCI in the statement of financial position	200	
NCI in the statement of comprehensive income		200
Being the NCI share of the depreciation adjustment (20% of 1,000)		

Composite journal if just preparing the consolidated statement of financial position	Dr	Cr
Consolidated retained earnings	3,800	
Non-current asset		4,000
NCI in the statement of financial position	200	

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If the transfer was from S to H – Full journal

Consolidated financial statements	Dr	Cr
Income statement (profit on disposal)	3,000	
Income statement (depreciation)	1,000	
Non-current asset		4,000

Composite journal if just preparing the consolidated statement of financial position	Dr	Cr
Consolidated retained earnings	3,400	
Non-current asset		4,000
NCI in the statement of financial position		600

19.4 Possible Complications: After Consolidation

19.4.1 Accounting for goodwill

Goodwill is carried as an asset. It is not depreciated or amortised but instead it is subject to an annual impairment review.

This means that the recoverable amount of goodwill must be estimated on an annual basis. If the recoverable amount is less than the carrying amount, the goodwill is written down to the recoverable amount.

The amount of the impairment is included as a charge against profit in the consolidated statement of comprehensive income.

Example: Goodwill impairment

P acquired 80% of S when the retained earnings of S were ₦20,000.

The values for assets and liabilities in the statement of financial position for S represent fair values.

A review of goodwill at 31 December 20X1 found that goodwill had been impaired, and was now valued at ₦55,000.

The statements of financial position of a parent company P and its subsidiary Sat 31 December 20X1 are as follows:

	P(₦)	S(₦)
Non-current assets:		
Property, plant and equipment	408,000	100,000
Investment in S	142,000	-
Current assets	120,000	40,000
	670,000	140,000
Equity		
Share capital	100,000	20,000
Share premium	100,000	50,000
Retained earnings	400,000	60,000
	600,000	130,000
Bank loan	70,000	10,000

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	670,000	140,000

Example (continued):

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

P Group: Consolidated statement of financial position at 31December 20X1

Assets	
Goodwill (see working)	55,000
Property, plant and equipment (508 + 100)	508,000
Current assets (120,000 + 40,000)	160,000
Total assets	723,000
Equity	
Share capital (P only)	100,000
Share premium (P only)	100,000
Consolidated retained earnings (see working)	417,000
	617,000
Non-controlling interest	26,000
	643,000
Current liabilities (70,000 + 10,000)	80,000
Total equity and liabilities	723,000

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Example (continued):

Net assets summary S

of P

	At date of Consolidation	At date of Acquisition	Post acqn
Share capital	20,000	20,000	
Share premium	50,000	50,000	
Retained earnings	60,000	20,000	40,000
Net assets	130,000	90,000	

Non-controlling interest	₦
NCI's share of net assets at the date of acquisition (20% of 90,000)	18,000
NCI's share of the post-acquisition retained earnings of S (20% of 40,000 (see above))	8,000
NCI's share of net assets at the date of consolidation	26,000

Goodwill	₦
Cost of investment	142,000
Non-controlling interest at acquisition (20% of 90,000)	18,000
	160,000
Net assets at acquisition (see above)	(90,000)
	70,000
Write down of goodwill (balancing figure)	(15,000)
Recoverable amount of goodwill (given)	55,000

Consolidated retained profits:	₦
All of P's retained earnings	400,000
P's share of the post-acquisition retained earnings of S (80% of 40,000 (see above))	32,000
Write down of goodwill (see goodwill working)	(15,000)
	417,000

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19.4.2 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:

a) the identifiable assets acquired and liabilities assumed;

b) the non-controlling interest in the acquiree (if any); and

c) the consideration transferred.

Any amount remaining after applying the above requirements is recognised as a gain in profit or loss on the acquisition date.

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.

19.5 Chapter review

Chapter review

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

a) account for acquisition related costs;

b) incorporate straightforward fair value adjustments into a consolidation;

c) account for a mid-year acquisition of a subsidiary;

d) eliminate unrealised profit on transactions between a parent company and its subsidiary;

e) account for goodwill; and

f) account for gain on a bargain purchase (negative goodwill).

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Solutions To Practice Questions

Solution 1

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

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post acqn
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% of 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

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Solution (continued) **1**

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

Solution **2**

P Group: Consolidated statement of financial position at 31 December 20X1

Assets	**₦**
Goodwill (W3)	1,199,000
Other non-current assets (650 + (826 + 500)	1,976,000
Current assets:	
Inventory (100 + 80 –2.5)	177,500
Other current assets (374 + 320)	694,000
Total assets	4,046,500
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	2,746,500
	2,846,500
Non-controlling interest (W2)	640,000
	3,486,500
Current liabilities (440 + 120)	560,000
Total equity and liabilities	4,046,500

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Solution (continued) **2**

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post acqn
Share capital	50,000	50,000	
Retained earnings	1,050,000	785,000	265,000
Fair value reserve	500,000	500,000	
Net assets	1,600,000	1,335,000	

W2 Non-controlling interest

	₦
NCI's share of net assets at the date of acquisition (40% of 1,335 (W1))	534,000
NCI's share of the post-acquisition retained earnings of S (40% of 265(W1))	106,000
NCI's share of net assets at the date of consolidation	640,000

W3 Goodwill

	₦
Cost of investment	2,000,000
Non-controlling interest at acquisition (W2)	534,000
	2,534,000
Net assets at acquisition (see above)	(1,335,000)
	1,199,000

W4 Consolidated retained profits:

	₦
All of P's retained earnings	2,590,000
Unrealised profit (W5)	(2,500)
P's share of the post-acquisition retained earnings of S (60% of 265(W1))	159,000
	2,746,500

W5 Unrealised profit

	₦
Inventory held at sale value	12,500
Cost (100/125)	(10,000)
Mark-up (25% of cost or 25/125 of sale price)	2,500

Double entry in consolidated financial statements	Dr	Cr
Consolidated retained earnings	2,500	
Closing inventory – statement of financial position		2,500
NCI not affected as sale is from P to S		

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19.6 End of the chapter question and suggested solution

19.6.1 Question

Question

UNITARISATON PLC

Unitarisation Plc is a successful Nigerian Company which recently amended its objects clause in the Memorandum of Association to include "programmes and activities that will promote National unity and encourage anti-terrorism compliance" as part of its social responsibilities. The company, therefore, acquired 60% of the equity share capital of Famous Plc a widely known and successful advertising company to propagate this mission.

The summarised draft financial statements of the two companies are as follows:

Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 October, 2014.

	Unitarisation Plc. ₦'m	Famous Plc. ₦'m
Revenue	51,000	25,200
Cost of sales	(37,800)	(19,200)
Gross profit	13,200	6,000
Distribution costs	(1,200)	(1,200)
Administrative expenses	(3,600)	(1,920)
Finance costs	(180)	(240)
Profit before tax	8,220	2,640
Income tax Expense	(2,820)	(840)
Profit for the year	5,400	1,800

Statement of Financial Position as at 31 October, 2014

	Unitarisation Plc. ₦'m	Famous Plc. ₦'m
Assets:		
Non-current assets:		
Property, plant & equipment	24,360	7,560
Current assets	9,600	3,960
Total assets	33,960	11,520
Equity & Liabilities:		
Equity shares of ₦1 each	6,000	2,400
Retained earnings	21,240	3,900
	27,240	6,300
Non-current liabilities:		
12% loan notes	1,800	2,400
Current liabilities	4,920	2,820
Total equity & liabilities	33,960	11,520

Relevant additional information are presented below:

(a) The shares of Famous Plc. was acquired on 1 May, 2014 and the issue of shares was not recorded by Unitarisation Plc.

(b) There is cash in transit of ₦120,000,000 due from Unitarisation Plc. to Famous

(c) Plc. arising from intra-group trading.

(d) The non-controlling interests are valued at full fair value by the parent company. The fair value of the non-controlling interests in Famous Plc. at the date of acquisition was ₦3,540,000,000. There is no goodwill impairment at the end of the accounting year.

(e) The fair value of Famous Plc. assets were equal to the carrying amounts at the acquisition date except for one equipment with a fair-value of ₦1,200,000,000 over its carrying amount which has a five-year remaining life. Straight line depreciation is adopted. Famous Plc. has not effected the adjustment in the records.

(f) The 60% of share capital of Famous Plc. acquired was settled through share exchange of two shares in Unitarisation Plc. for three shares in Famous Plc. The market value of Unitarisation Plc. at the date of acquisition was ₦6 per share.

(g) In the post-acquisition period, Unitarisation Plc. bought goods from Famous Plc. amounting to ₦4,800,000,000. Famous Plc. had made a mark-up on cost of 40% on the transaction. As at the year end, Unitarisation Plc. had sold part of these goods worth ₦3,120,000,000.

(h) Famous Plc's trade receivables at 31 October 2014 include ₦360,000,000 due from Unitarisation Plc. However, the amount did not agree with the corresponding balance in Unitarisation Plc's trade payable ledger.

(i) Assume that profits or losses accrue evenly over the period except otherwise stated.

Required:

a. Prepare:

i. Unitarisation Plc. Consolidated Profit or Loss and Other Comprehensive Income for the year ended 31 October 2014.

ii. Unitarisation Plc. Consolidated Statement of Financial Position as at 31

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October, 2014.

iii. Consolidated Statement of Changes in Equity for the year ended 31 October 2014.

b. In accordance with IFRS 3 on Business Combinations, what is Gain on Bargain Purchase?

Solution

UNITARISATION PLC.
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 OCTOBER, 2014

	₦'m
Revenue (51,000 + (25,200 x $\frac{6}{12}$) – 4,800 (Wk 3)	58,800
Cost of sales (Wk 2)	4,800
Gross profit	(43,200)
Distribution costs (1,200 + (1,200 x $\frac{6}{12}$)	15,600
Admin. Costs (3,600 + (1,920 x $\frac{6}{12}$)	(1,800)
Finance costs (180 +(240 x $\frac{6}{12}$)	(4,560)
Profit before tax	(300)
Income tax (2,820 + (840 x $\frac{6}{12}$)	8,940
Profit for the year	(3,240)
Other comprehensive income	5,700
Total comprehensive income	Nil
	5,700
Profit attributable to:	
Owners of the parent	5,580
Non-controlling interest (wk 1)	120
	5,700

Workings:

		₦'m
Wk 1	Non-controlling interests:	
	Statement of profit or loss	
	Post acquisition profit (Famous) (1,800 x $\frac{6}{12}$)	900
	Unrealised profit	(480)
	Fair value adjustment movement	(120)
		300
	NCI post acquisition share (40% x 300)	120

Wk 2 Cost of sales

	₦'m
Unitarisation Plc	37,800
Famous Plc (19,200 x $\frac{6}{12}$)	9,600
Movement of fair value adjustment (Wk 1)	120
Intragroup purchases (Wk 3)	(4,800)
Unrealised profit (Wk 3)	480
	43,200

Wk 3 Intragroup Trading:

	DR ₦'m	CR ₦'m
Revenue	4,800	
Purchases		4,800
Being removal of intragroup sales and purchases		
Retained earnings/cost of sales (4,800 – 3,120) x 40/140	480	
Inventories		480
Being elimination of unrealised profit		

(b)

UNITARISATION PLC.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 OCTOBER, 2014

	₦'m
ASSETS	
Non-current assets	
Property, plant & equipment (24,360 + 7,560 + 1,080) (Wk 5)	33,000
Goodwill (Wk 3)	2,700
	35,700
Current assets (Wk 8)	12,840
	48,540
EQUITY AND LIABILITIES	
Equity attributable to owners of parent company:	
Share capital (6,000 + 960) (wk 6)	6,960
Share premium (Wk 6)	4,800
Retained earnings (Wk 2)	21,420
Shareholders fund	33,180
Non-controlling interest (Wk 4)	3,660
	36,840
Non-current liabilities	

12% loan notes (1,800 + 2,400)	4,200
Current liabilities (4,920 + 2,820 – 240) (Wk 7)	7,500
	48,540

Workings

Wk 1 Group structure

Unitarisation Plc.

↓ 60% (1/5/2015)

Famous Plc

The subsidiary was acquired during the year (middle of the accounting Year)

Wk 2 Retained earnings:

	Unitarisation Plc. ₦'m	Famous Plc. ₦'m
As in the question	21,240	3,900
Fair value adjustment movement (Wk 5)		(120)
Unrealised profit (Wk 3)		(480)
Pre-acquisition profit		(3,000)
Retained earnings of subsidiary		300
Group share of subsidiary (60% x 300)	180	
Consolidated retained earnings	21,420	

Wk 3 Goodwill:

	₦'m	₦'m
Consideration transferred		5,760
Fair value of non-controlling interest		3,540
Less: Net asset fair value at acquisition:		
Share capital	2,400	
Retained earnings	3,000	
Fair value adjustment	1,200	(6,600)
Goodwill		2,700

Wk 4 Statement of Financial Position:

	₦'m
NCI at acquisition	3,540
Share of post acquisition retained earnings (40% x 300)	120
	3,660

Wk 5 Fair Value Adjustments:

	Acquisition 1/5/14 ₦'m	Movement (6/12) ₦'m	Year end 31/10/14 ₦'m
Movement in equipment $\left(\frac{1,200}{5} x \frac{6}{12}\right)$	1,200	(120)	1,080

Wk 6 Share exchange:

	DR ₦'m	CR ₦'m
No of share issued (2,400 x 60% x 2/3) = 960		
Consideration transferred (960 x ₦6)	5,760	
Unitarisation share capital (960 x ₦1)		960
Unitarisation share premium (960 x ₦5)		4,800

Wk 7 Cash in transit:

	DR ₦'m	CR ₦'m
Receivables		360
Payables	240	
Group cash	120	

Wk 8 Current asset:

	₦'m
Unitarisation Plc.	9,600
Famous Plc.	3,960
Unrealised profit	(480)
Intercompany receivables (State in the question)	(360)
Cash in transit (WK 8)	120
	2,840

UNITARISATION PLC.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 OCTOBER, 2014

	Share Capital ₦m	Share Premium ₦m	Retained Earnings ₦m	Equity Unitarisation ₦m	NCI ₦m	Total Equity ₦m
As at 1 November, 2013	6,000		15,840	21,840		21,840
Profit for the year			5,580	5,580	120	5,700
Other comprehensive income:						
Transactions with owner's equity:						
Addition paid-in capital	960	4,800		5,760		5,760
Addition on acquisition of Famous Plc.					3,540	3,540
As at 31 October, 2014	6,960	4,800	21,420	33,180	3,660	36,840

d) Gain on Bargain purchase arises when the aggregate of the consideration transferred (which is usually measured at fair value), the non-controlling interest and the fair value of the previously held equity interest is less than the acquisition date amount of the identifiable assets acquired and the liabilities assumed.

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Skills Level
Financial

CHAPTER 20

CONSOLIDATED ACCOUNTS: STATEMENT OF COMPREHENSIVE INCOME

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20 Consolidated Accounts: Statement of Comprehensive Income

20.0 Learning objective

This chapter covers the preparation of statement of comprehensive income of consolidated accounts of a group.

20.1 Learning outcomes

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

a) prepare a basic consolidated statement of profit or loss;

b) eliminate the results of inter-company transactions on consolidation;

c) eliminate unrealised profit on consolidation; and

d) incorporate straight forward fair value adjustments during consolidation.

20.2 Consolidated Statement of Profit or Loss and Other Comprehensive Income

20.2.1 Consolidated income statement: the basic rules

The main problems with preparing a consolidated statement of profit or loss and other comprehensive income relate to reporting profit or loss for the period, and this section therefore focuses on profit or loss items.

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.

All items of income and expense in the consolidated statement of profit or loss are a straight cross cast of equivalent items in the individual financial statements of the members of the group.

20.2.2 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:

a) owners of the parent company; and

b) 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 profit or loss.

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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 profit or loss and other comprehensive income.

Illustration:

Total comprehensive income attributable to:	₦
Owner soft he 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 profit or loss

Example:

Entity P bought 80% of S several years ago.

The income statements for the year to 31 December 20X1 are as follows.

	P	S
	₦	₦
Revenue	500,000	250,000
Cost of sales	(200,000)	(80,000)
Gross profit	300,000	170,000
Other income	25,000	6,000
Distribution costs	(70,000)	(60,000)
Administrative expenses	(90,000)	(50,000)
Other expenses	(30,000)	(18,000)
Finance costs	(15,000)	(8,000)
Profit before tax	120,000	40,000
Income tax expense	(45,000)	(16,000)
Profit for the period	75,000	24,000

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A consolidated statement of profit or loss can be prepared as follows:

Working

	P		Consolidated
	₦	₦	₦
Revenue	500,000	250,000	750,000
Cost of sales	(200,000)	(80,000)	(280,000)
Gross profit	300,000	170,000	470,000
Other income	25,000	6,000	31,000
Distribution costs	(70,000)	(60,000)	(130,000)
Administrative expenses	(90,000)	(50,000)	(140,000)
Other expenses	(30,000)	(18,000)	(48,000)
Finance costs	(15,000)	(8,000)	(23,000)
Profit before tax	120,000	40,000	160,000
Income tax expense	(45,000)	(16,000)	(61,000)
Profit for the period	75,000	24,000	99,000
Total comprehensive income attributable to:			
Owners of the parent (balancing figure)			94,200
Non-controlling interests (20% of 24,000)			4,800
			99,000

20.2.3 Pre-and Post-Acquisition Profits

Only post-acquisition profits are consolidated. When a parent acquires a subsidiary **during** a financial year, the profits of the subsidiary have to be divided into pre-acquisition and post-acquisition profits.

	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

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	P	S (3/12)	Consolidated
	₦	₦	₦
Revenue	400,000	5,000	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

20.3 Complications

20.3.1 Inter-company items

Consolidated income statements are prepared by combining the information given in the income statements 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.

20.3.2 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

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Example:

P acquired 80% of S 3 years ago.

During the year P sold goods to S for ₦50,000.

By the year-end S had sold all of the goods bought from P to customers.

Extracts of the income statements for the year to 31 December 20X1 are as follows.

	P	S
	₦	₦
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000
Gross profit	500,000	200,000

The adjustment in respect of inter-company trading can be shown as follows:

	P	S	Dr	Cr	Consol.
	₦ (000)	₦ (000)	₦	₦	₦ (000)
Revenue	800	420	(000) (50)	(000)	1,170
Cost of sales	(300)	(220)		50	(470)
Gross profit	500	200	(50)	50	700

The adjustment has no effect on gross profit.

20.3.3 Unrealised profits on trading

If any items sold by one group company to another are included in inventory (i.e., have not been sold 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 profit or loss	X	
Closing inventory – Statement of financial position		X

The adjustment in the statement of profit or loss 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.

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Example:

P acquired 80% of S 3 years ago.

During the year P sold goods to S for ₦50,000 at a mark-up of 25% on cost. This means that the cost of the goods to P was ₦40,000 ($^{100}/_{125}$ x ₦50,000) and P made a profit of ₦10,000000 ($^{25}/_{125}$ x ₦50,000) on the sale to S.

At the year-end S still had 30% of the goods in inventory.

This means that S still held goods which it had purchased from P for ₦15,000 at a profit to P of ₦3,000. The ₦3,000 is unrealized by the group as at the year-end.

Extracts of the income statements for the year to 31 December 20X1 are as follows.

	P(₦)	S(₦)
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000
Gross profit	500,000	200,000

The adjustments in respect of inter-company trading[1] and unrealised profit[2] can be shown as follows:

Workings

	P	S	Dr	Cr	Consol.
	₦ (000)	₦ (000)	₦	₦	₦ (000)
Revenue	800	420	(000)	(000)	1,170
			(50)[1]		
Cost of sales	(300)	(220)	(3)[2]	50[1]	(473)
Gross profit	500	200	(53)	50	697

The adjustment in respect of inter-company trading[1] has no effect on gross profit.

The adjustment in respect of and unrealised profit[2] reduces gross profit.

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If the sale is from S to P the unrealised profit adjustment must be shared with the NCI.

Example:

P acquired 80% of S 3 years ago.

During the year S sold goods to P for ₦50,000 at a mark-up of 25% on cost. This means that the cost of the goods to S was ₦40,000 ($^{100}/_{125}$ x ₦50,000) and S made a profit of ₦10,000000 ($^{25}/_{125}$ x ₦50,000) on the sale to S.

At the year-end P still had a third of the goods in inventory.

This means that Ps till held goods which it had purchased from S for ₦15,000 at a profit to S of ₦3,000. The ₦3,000 is unrealized by the group as at the year-end. The NCI's share of the unrealized profit adjustment is ₦600 (20% x ₦3,000)

Extracts of the income statements for the year to 31 December 20X1 are as follows.

	P(₦)	S(₦)
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000
Gross profit	500,000	200,000
Expenses	(173,000)	(123,000)
Profit before tax	327,000	77,000

The adjustments in respect of inter-company trading and unrealised profit can be shown as follows:

	P	S	Workings Dr	Cr	Consol.
	₦ (000)	₦	₦	₦	₦ (000)
Revenue	800	(000) 420	(000) (50)1	(000)	1,170
Cost of sales	(300)	(220)	(3)2	501	(473)
Gross profit	500	200	(53)	50	697
Expenses	(173)	(123)			(296)
Profit	427	77	(53)	50	401

The adjustment in respect of and unrealised profit reduces gross profit and is shared with the NCI.

Total comprehensive income attributable to:	₦ (000)
Owners of the parent (balancing figure)	386.2
Non-controlling interests (20% x 77) – 0.6)	14.8
	401.0

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20.3.4 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

	P	S
	₦	₦
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000)
Gross profit	500,000	200,000
Administrative expenses	(100,000)	(90,000)
Distribution costs	(85,000)	(75,000)
Other income	12,000	2,000
Profit before tax	327,000	37,000

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Example continued

The adjustments in respect of inter-company management charge can be shown as follows:

	P	S	Dr	Cr	Consol.
	₦ (000)	₦ (000)	₦ (000)	₦ 000)	₦ (000)
	800	420			1,220
	Workings				
Revenue					
Cost of sales	(300)	(220)			(520)
Gross profit	500	200			700
Administrative expenses	(100)	(90)		5	(185)
Distribution costs	(85)	(75)			(160)
Other income	12	2	(5)		9
Profit before tax	327	37			364

The adjustment in respect of inter-company management charge has no effect on gross profit.

20.3.4 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 profit or loss because the profit out of which they are paid has already been consolidated.

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20.3.5 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.

Example:

P acquired 80% of S 3 years ago.

At the date of acquisition S had a depreciable asset with a fair value of ₦120,000 in excess of its book value. This asset had a useful life of 10 years at the date of acquisition.

This means that the group has to recognize extra depreciation of ₦36,000 (₦^{120,000} / $_{10 years}$ x 3 years) by the end of this period. One year's worth of this (₦12,000) is recognised in S's statement of profit or loss prior to consolidation this year.

Extracts of the income statements for the year to 31 December 20X1 are as follows:

	P	S
	₦	₦
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000)
Gross profit	500,000	200,000
Expenses	(173,000)	(163,000)
Profit before tax	327,000	37,000

The adjustments in respect of extra depreciation can be shown as follows:

	P	S	Dr	Cr	Consol.
	₦ (000)	₦ (000)	₦	₦	₦
Revenue	800	420	(000)	(000)	(000)
					1,220
Cost of sales	(300)	(220)			(520)
Gross profit	500	200			700
Expenses	(173)	(163)			
Adjustment		(12)			
Profit before tax	327	25			

The adjustment in respect of the extra depreciation reduces the profit of S that is consolidated.

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20.3.6 Impairment of goodwill and consolidated profit

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:

a) It is written down in value in the consolidated statement of financial position, and

b) The amount of the write-down is charged as an expense in the consolidated income statement (normally in administrative expenses)

c) **Example:**

P acquired 80% of S 3 years ago.

Goodwill on acquisition was ₦200,000.

The annual impairment test on goodwill has shown it to have a recoverable Amount of only ₦175,000. Thus, a write down of ₦25,000 is required.

Extracts of the income statements for the year to 31 December 20X1 are as follows.

	P	S
	₦	₦
Revenue	800,000	420,000
Cost of sales	(300,000)	(220,000)
Gross profit	500,000	200,000
Expenses	(173,000)	(163,000)
Profit before tax	327,000	37,000

The adjustment in respect of inter-company trading[1] and unrealised profit[2] can be shown as follows:

	P	S	Dr	Cr	Consol.
	₦ (000)	₦ (000)	₦	₦	₦
Revenue	800	420	(000)	(000)	(000)
					1,220
Cost of sales	(300)	(220)			(520)
Gross profit	500	200			700
Expenses	(173)	(163)	(25)		(361)
Profit before tax	327	37	(25)		339

The adjustment in respect of the goodwill reduces the consolidated profit. (There is no impact on NCI).

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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.

The distribution costs of S include 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 income statements 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.

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20.4 Chapter review

Chapter review

Before moving on to the next chapter, check that you are able to:

a) prepare a basic consolidated statement of profit or loss;

b) eliminate the results of inter-company transactions on consolidation;

c) eliminate unrealised profit on consolidation; and

d) incorporate straightforward fair value adjustments during consolidation.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Consolidated statement of profit or loss for the year ended 31 December.

Workings

	P	S	Dr	Cr	Consol.
	₦ (000)	₦ (000)	₦	₦	₦
Revenue	1,000	800	(000)	(000)	(000)
			(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 35,000)	77
	700

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Notes:

1: Extra depreciation on fair value adjustment($^{100}/_{10}$years)

2: Goodwill impairment

3: Unrealised profit

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20.5 End of chapter questions and suggested solutions

20.5.1 Questions

Question 1

The statements of profit or loss and other comprehensive income of Okechukwu and its subsidiary, Ogenta Limited for the year ended December 31, 2019 are presented below:

	Okechukwu Plc	Ogenta Ltd
	₦'000	₦'000
Revenue	487,500	330,800
Cost of sales	(304,500)	(258,300)
Gross profit	183,000	72,500
Investment income	26,300	10,200
Distribution cost	(24,050)	(13,370)
Administrative expenses	(40,625)	(21,120)
Finance costs	(10,500)	(9,860)
Profit before tax	134,125	38,350
Income tax expense	(33,800)	(13,000)
Profit for the year	100,325	25,350
Other comprehensive income	23,880	10,440
Total comprehensive income	124,205	35,790

Additional Information:

(i) Okechukwu Plc acquired 300 million of the ordinary shares issued by Ogenta Limited for ₦428 million.

(ii) During the year ended December 31, 2019, Okechukwu Plc invoiced goods worth ₦80million to Ogenta Limited. It has been the policy of Okechukwu Plc to invoice goods at cost plus 33⅓%. Three-quarters of these goods are yet to be sold by Ogenta Limited at the year end.

(iii) Extracts from the books of Ogenta Limited as at the date of acquisition revealed the following capital structure:

	₦'000
Issued ordinary shares of 50 kobo each	200,000
General reserves	80,000
Retained earnings	52,500

(iv) The fair value of the non-controlling interests at the acquisition date amounted to ₦92.5million.

(v) An impairment test on the goodwill of Ogenta Limited carried out on December 31, 2019 showed that the goodwill should be written down by ₦3.2million.

(vi) On the acquisition date, the fair value of net assets of Ogenta Limited were same as their carrying amount except for the land and building and office equipment which had fair values of ₦5million and ₦1.5million respectively in excess of their carrying amounts. The group non-current assets are depreciated at the rate of 10% per annum on straight-line and charged to administration expenses.

(vii) Ogenta Limited paid a total of ₦20million as dividend to all its shareholders for the year ended December 31, 2019. Okechukwu Plc has accounted for the dividend received.

(viii) The finance cost of Ogenta Limited included ₦2million interest paid to Okechukwu Plc as interest on loan granted. Okechukwu Plc has recognised the amount as interest received.

Required:

Prepare the consolidated statement of profit or loss and other comprehensive income of Okechukwu group for the year ended December 31, 2019.

Question 2

a. Adanna Plc. has a subsidiary, Ebuka Limited. The statement of profit or loss and other comprehensive income of the companies are as follows:

Statement of Profit or Loss and Other Comprehensive Income for the year ended December 31, 2017

	Adanna Plc	Ebuka Limited
	₦'000	₦'000
Revenue	986,546	614,206
Cost of sales	(593,204)	(365,903)
Gross profit	393,342	248,303
Other income	57,850	12,420
Distribution costs	(69,496)	(40,562)
Administrative expenses	(158,624)	(95,036)
Other expenses	(32,108)	(15,814)
Finance costs	(20,600)	(10,220)
Profit before tax	170,364	99,091
Income tax expense	(51,110)	(26,727)
Profit for the year	119,254	72,364
Other comprehensive income:		
Gain on revaluation of property	68,166	29,202
Total comprehensive income	187,420	101,566

Additional Information

(i) Adanna Plc. acquired 75% of the issued equity shares of Ebuka limited three years ago. Goodwill on acquisition was ₦280 million. The recoverable amount of goodwill at the year-end was estimated to be

₦268 million and this was the first time that the recoverable amount of goodwill had fallen below the amount at initial recognition.

(ii) During the year, Ebuka Limited invoiced goods worth ₦300 million to Adanna Plc. A quarter of these goods are included in the inventory of Adanna Plc. at year end. It is the policy of Ebuka Limited to invoice goods at cost plus 25%.

(iii) The distribution costs of Ebuka Limited include depreciation of an asset which had been subject to a fair value increase of ₦155 million on acquisition. The asset is being written off on a straight line basis over ten years.

(iv) The other income in Adanna Plc.'s statement of profit or loss and other comprehensive income includes an inter-company management charge of ₦10 million to Ebuka Limited and Ebuka Limited has recognised this in administrative expenses.

Required:

Prepare the Consolidated Statement of Profit or Loss and other Comprehensive Income of Adanna Plc's group for the year ended December 31, 2017. (20 Marks)

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20.5.2 Suggested solutions

Solution 1

Okechukwu Plc

Consolidated statement of profit or loss and other comprehensive income for the year ended December 31, 2010

	₦000
Revenue (487,500+330,800-80,000)	738,300
Cost of sales (304,500+258,300-80,000+15,000	(497,800)
Gross profit	240,500
Investment income (26,300+10,200-15,000-2000)	19,500
Distribution cost (24,050+13,370)	(37,420)
Administrative expenses (40,625+21,120+650+3,200	(65,595)
Finance cost (10,500+9,860-2000)	(18,360)
Profit before taxation	138,625
Income tax expense (33,800+13,000)	(46,800)
Profit for the year	91,825
Other Comprehensive Income (23,800+10,440)	34,320
Total Comprehensive Income	126,145
Profit attributable to:	
Owners of parent (Bal. Figure)	86,450
Non-controlling interests	5,375
	91,825
Total comprehensive income attributable to:	
Owners of parent (Bal. Figure)	118,160
Non-controlling interests	7,985
	126,145

Workings

Wk 1: Group structure

Okechukwu -------- 75% --------- Ogenta

NCI ----------25%

Wk 2: Unrealised profit

URP = 80,000 × 1/4 × 3/4 =

Wk 3: Intra-group dividend

20,000 × 75% = ₦15,000

Wk 4: Fair value adjustment	₦'000
Land and building (5,000,000 ×10%)	500
Land & Building (1.5,000,000 x 10%)	150
	650

Wk 5: Share of subsidiary's profit	PFTY	TCI
	₦'000	₦'000
For the year	25,350	35,790
Impairment losses	(3,200)	(3,200)
Fair Value Adjustment	(650)	(650)
	21,500	31,940
NCI @ 25%	5,375	7,985

Solution 2

(a) **Adanna Plc**

Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended December 31, 2017

	₦'000
Revenue (Wk 1)	1,300,752
Cost of sales (Wk 2)	(674,107)
Gross profit	626,645
Other income (wk 3)	60,270
Distribution cost (wk 4)	(125,558)
Administrative expenses (wk 5)	(255,660)
Other expenses	(47,922)
Finance costs	(30,820)
Profit before tax	226,955
Income tax expenses	(77,837)
Profit for the year	149,118
Other comprehensive income:	
Gain on revaluation of property	97,368
Total comprehensive income	246,486
Profit for the year attributable to:	
Equity owners of parent (149,118 – 12,966)	136,152
Non-controlling interest (NCI) Wk 7	12,966
	149,118
Total comprehensive income attributable to:	
Equity owners of parent (246,486 - 20,267)	226,220
Non-controlling interest (NCI) Wk 4	20,267
	246,486

Working Notes

Wk 1: Revenue	**₦'000**
Adanna Plc	986,546
Ebuka Limited	614,206
Intra-group Sales	(300,000)
Consolidated Revenue	1,300,752

Wk 2: Cost of Sales	**₦'000**
Adanna Plc	593,204
Ebuka Limited	365,903
Intra-group Sales	(300,000)
Unrealised profit on inventory (working 6)	15,000
Consolidated Cost of Sales	674,107

Wk 3: Other Income	**₦'000**
Adanna	57,850
Ebuka	12,420
Inter group mgt charges	(10,000)
	60,270

Wk 4: Distribution Costs	**₦'000**
Adanna	69,496
Ebuka	40,562
Under – Depreciation	15,500
	125,558

Wk 5: Administrative Expenses	**₦'000**
Adanna	158,624
Ebuka	95,636
Inter group mgt charges	(10,000)
	255,660

Wk 6: Unrealised Profit on Inventory	**₦'000**
25/125 of (¾ x ₦300,000)	15,000

Wk 7: Profit Attributable to NCI	**₦'000**
Profit for the year	72,364
Intra-group Management charges	10,000
Unrealised profit on inventory (Wk 6)	(15,000)
Under-depreciation (155,000/10)	(15,500)
	51,864

NCI Share at (25% x 51864)	12,966
NCI Share of OCI (25% x 29,202)	7,301
Total Comprehensive Income to NCI	20,267

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Skills level
Financial Reporting

CHAPTER 21

CONSOLIDATED ACCOUNTS: STATEMENT OF COMPREHENSIVE INCOME - ASSOCIATES AND JOINT VENTURES

Contents

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21.1 Learning outcome
21.2 IFRS 11: Joint arrangements
21.3 IAS 28: Investments in associates and joint ventures
21.4 Chapter review
21.5 End of chapter questions and suggested solutions

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21 Consolidated Accounts: Statement of Comprehensive Income – Associates and Joint Ventures

21.0 Learning objective

This chapter covers preparation of statement of comprehensive income of consolidated accounts involving associates and joint ventures.

21.1 Learning outcomes

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

a) define an associate;

b) explain equity accounting;

c) measure investment in an associate for inclusion in the statement of financial position using equity accounting;

d) measure share of profit of an associate for inclusion in the statement of comprehensive income; and

e) account for unrealised profit on transactions between an associate and its parent or a member of the parent's group.

21.2 IFRS 11: Joint Arrangements

21.2.1 Introduction

A controlling interest in an investee, result 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:

a) The shares are shown in the statement of financial position as long-term assets (an investment) and valued in accordance with IAS 39 (IFRS 9); and

b) 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.

IFRS 11 is not an examinable document at this level. It is discussed briefly to provide an introduction to IAS 28.

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Joint arrangements

Definition

A j**oint 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.

21.2.2 Types of joint arrangements

There are two types of joint arrangement. A joint arrangement is either a joint operation or a joint venture.

a) 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.

b) 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.

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.

21.3 IAS 28: Investments in Associates and Joint Ventures

21.3.1 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.

(a) 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.

(b) 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

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usually evidenced in one or more of the following ways:

a. representation on the board of directors;

b. participation in policy-making processes, including participation in decisions about distributions(dividends);

c. material transactions between the two entities;

d. an interchange of management personnel between the two entities; or

e. the provision of essential technical information by one entity to the other.

21.3.2 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.

21.3.3 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: Investment in associate

	₦
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	(X)
recognised Investment in associate	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).

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21.3.4 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:

a) 'Share of profits of associate (or JV)' in the profit and loss section of the statement

b) '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.

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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 31December 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?

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:

a) Inter-company balances (amounts owed between the parent (or group) and the associate (or JV) in either direction); and

b) 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.

21.3.5 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.

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21.3.6 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)

a) 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.

b) 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	X	
Investment in associate		X

Associate (or JV) sells to parent:

a. The unrealised profit is held in inventory of the parent and this should be reduced in value by the parent's share of the unrealized profit.

b. 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 should 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.

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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.

A sat 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 (N200,000 x (100%/200%))	100,000
Unrealised profit (₦30,000 x (100%/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 unrealized 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

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Practice question **2**

Entity P acquired 30% of the equity shares of Entity A several years ago at a cost of ₦275,000.

A sat 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 financial 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.

21.4 Chapter review

Chapter review

Before moving on to the next chapter check that you are able to:

a) define an associate;

b) explain equity accounting;

c) measure investment in an associate for inclusion in the statement of financial position using equity accounting;

d) measure share of profit of an associate for inclusion in the statement of comprehensive income; and

e) account unrealised profit on transactions between an associate and its parent or a member of the parent's group.

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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 (N180,000 x (20%/120%))	30,000
Unrealised profit (₦60,000 x (20%/120%))	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

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21.5 End of chapter questions and suggested soultions

21.5.1 Questions

Question for Associates IAS 28

1a) IAS 28 - Investments in Associates and Joint Ventures permits, the application of equity method when accounting for investments in associates and joint ventures.

Required:

Explain the Equity Method and state the circumstances under which an entity can discontinue the use of equity method under IAS 28.

1b) Agbantara Plc. acquired equity shares from Odinma Plc. and Dangari Limited. The following are the Statements of Profit or Loss and Other Comprehensive Income for the year ended 31 December 2014 for the three companies

	Agbantara Plc.	Odinma Plc.	Dangari Ltd
	₦'m	₦'m	₦'m
Revenue	4,500	1,350	630
Cost of sales	(2,430)	(720)	(270)
Gross profit	2,070	630	360
Admin expenses	(1,350)	(180)	(135)
Finance income	135	90	-
Finance costs	(180)	-	(90)
Profit before tax	675	540	135
Income tax expenses	(225)	(135)	(45)
Profit for the year	450	405	90
Other comprehensive income:			
Gains on property revaluation, net of tax	180	90	45
Total comprehensive income for the year	630	495	135

The following information is also relevant:

i. Agbantara Plc. acquired 72 million ordinary shares in Odinma Plc. out of its 120,000,000 ordinary shares of N1 each par value for ₦160,000,000. The shares were acquired four years ago when it had ₦15,000,000 credit balance on its retained earnings. During the year, Odinma Plc. sold goods costing ₦38,000,000 to Agbantara Plc. for ₦45,000,000. These goods were yet to be sold as at 31 December, 2014.

ii. Agbantara Plc. acquired 35,000,000 ordinary shares in Dangari Limited out of 100,000,000 ordinary shares. The shares were acquired three years ago when the company had a credit balance on its retained earnings of ₦10,000,000.

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iii. Agbantara Plc's group policy is to measure non-controlling interests (NCI) at fair value. NCI at acquisition date in Odinma Plc. at fair value was ₦48,000,000. Impairment test carried out on the goodwill relating to Odinma Plc. and investment in Dangari Limited at year end resulted in ₦10,000,000 and ₦15,000,000 losses, respectively.

Required:
Prepare Agbantara Plc. Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December 2014.

QUESTION 2a

i. In the context of financial reporting and group accounting, understanding the nature of relationships between entities is crucial for accurate consolidation and disclosure. Two key concepts that often arise in this regard are "associate" and "significant influence."

Required:
Explain what is meant by the terms "associate" and "significant influence"

ii. When an entity holds an investment in an associate, it does not exercise full control but has significant influence over the financial and operating policies of the investee. In such cases, the investor does not consolidate the associate's financial statements but instead applies a specific accounting technique known as the **equity method**.

Required:

Explain the equity method of accounting which is used to account for investment in an associate.

iii. In the realm of financial reporting under joint arrangements, entities may collaborate to undertake economic activities without necessarily forming a separate legal entity. The classification of such arrangements is crucial for determining the appropriate accounting treatment. Two common forms of joint arrangements are **joint operations** and **joint ventures**, each with distinct characteristics and implications for financial reporting. Understanding the differences between them is essential for accurate recognition, measurement, and disclosure.

Required:
Distinguish between joint operation and joint ventures.

b) On October 31, 2013, Y Limited paid ₦70,000 to acquire 40% of the share capital of Z Limited (which became its associate). Draft financial statements of the two companies for the year to October 31, 2017:

	Y Limited	**Z Limited**
	₦`000	₦`000
Operating profit	325	70
Dividend received from Z Ltd	10	-

Profit before tax	335	70
Income tax expense	(85)	(15)
Profit for the Year	250	55

STATEMENT OF FINANCIAL POSITION AS AT OCTOBER 31, 2017

	Y Limited	Z Limited
	N`000	N`000
Assets		
Non-current asset		
Property, plant & equipment	800	400
Investment in Z Ltd at cost	70	-
	870	400
Current asset	390	145
	1260	545
Equity		
Ordinary share capital	500	100
Retained earnings	605	360
	1105	460
Liabilities		
Current liabilities	155	85
	1260	545

Statement of Changes in equity (retained earnings only) for the year to October 31, 2017

	Y Limited ₦`000	Z Limited ₦`000
Balance at October 31, 2016	355	330
Profit for the year	250	55
Dividend paid	-	(25)
Balance at October 31, 2017	605	360

The following information is also available:

i. In the draft financial statements of Y Limited, the company's investment in Z Limited has been recognised at cost and the dividend received from Z Limited has been recognised as income. The financial statements, showed the situation as it would be without application of the equity method, either in the year October 31, 2017 or in

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previous year.

ii. The retained earnings of Z Limited on October 31, 2013 were N50,000 and all of its assets and liabilities were carried at fair value. None of the companies has issued any share since that date.

iii. During the year to October 31, 2017 Y Limited bought goods from Z Limited for N15,000, which had cost Z Limited N10,000. One-quarter of these goods were unsold by Y Limited at October 31, 2017.

Required:
Prepare the separate financial statements of Y Limited for the year ended October 31, 2017, incorporating the result of the associate Z Limited, using the equity method of accounting. (14 Marks)

SOLUTION 1

a. (i) The Equity Method is a method of accounting whereby the investment is initially recognized 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.

(ii) Discontinuing the Use of Equity Method
An entity shall discontinue the use of Equity Method from the date when its investment ceases to be an associate or joint venture as follows:
If the investment becomes a subsidiary, the entity shall account for its investment in accordance with IFRS 3 on Business combination and IFRS 10.
If the retained interest in the former associate or joint venture is a financial asset, the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as its financial asset in accordance with IFRS 9. The entity shall recognise in profit or loss any difference between:

The fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture;

The carrying amount of the investment at the date the equity method was discontinued.
When an entity discontinues the use of the equity method, the entity shall account for all amounts previously recognised in other comprehensive income in relation to that investment on the same basis as would have been recognised if the investee had directly disposed of the related assets or liabilities.

Revenue ₦(4,500 + 1,350 - 45)	5,805.00
Cost of sales ₦(2,430 + 720) - 38 (Wk 4)	(3,112.00)
Gross profit	2,693.00
Administrative expenses ₦(1,350 + 180 + 10)	1,540.00
Operating profit	1,153.00
Finance income ₦(135 + 90)	225.00

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Share of Associate Profit [(35% x ₦90) – ₦15]		16.50
Finance costs (₦180)		(180.00)
Profit before taxes		1,214.50
Income taxes ₦(225 + 135)		360.00
Profit for the year		854.50
Other comprehensive Income:		
Items that may not be reclassified to Profit or Loss;		
Gains on property valuation ₦(180 + 90)	270.00	
Gains on property valuation of Associat (35% x ₦45)	15.75	285.75
Total Comprehensive Income		1,140.25
Profit for the year attributable to:		
1. Owners'of Agbantara Plc.		699.30
2. Non Controlling Interest		155.20
		854.50
3. Owners'of Agbantara Plc.	Wk 5	949.05
4. Non Controlling Interest	Wk 5	191.20
Total Comprehensive Income attributable to:		1,140.25

Workings:

Wk 1 - % Holding in Odinma Plc. by Agbantara Plc.

= 72 million on shares / 120 million on shares

=60% (Subsidiary)

Wk 2 - %Holding in Dangari Ltd by Agbantara Plc.

=

35 million on shares / 100 million on shares

=35% (Associate)

Wk 3 - Unrealised Profit on Sales of Goods

= 100% x (₦45 million – ₦38 million)

= ₦7 million

Wk 4 - Inter Company Cost of Sales

=Inter-company Revenue – Unrealised Profit

= (₦45 million – ₦7 million)

= ₦38 million

Wk 5 -Profit/Total Comprehensive Income Attributable to:

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	Agbantara Plc.	NCI
	₦'million	₦'million
Agbantara Plc for the year	450.00	–
Share of Post-acquisition Profit for the Year ₦405 million in the ratio 60:40	243.00	162.00
Unrealized Profit on Inventory ₦7 million in the ratio 60:40	(4.20)	(2.80)
Share of Dangari Profit (35% x ₦90)	31.50	–
Impairment Loss on Goodwill ₦10 million in the ratio 60:40	(6.00)	(4.00)
Impairment loss on Investment of Dangari	(15.00)	–
	699.30	155.20
Other Comprehensive Income:		
a) Gain on Revaluation – Agbantara Plc.	180.00	–
b) Gain on Revaluation – Odunma Plc. ₦90 million in the ratio 60:40	54.00	36.00
c) Gain on Revaluation – Dangari Ltd (35% x ₦45 million)	15.75	–
	949.05	191.20

Alternative Solution to Working 5

Calculation of NCI	₦'m
Total comprehensive income	1,140.25
Attributable to:	
Owners of the parent (balancing figure)	949.05
Non-controlling interests	191.20
	1,140.25

Working 5

Calculation of NCI - ODINMA

	₦'m
n profit for the period N405m x 40%	162
On gains on revaluation of property N405 x N90	36
Unrealised profit on intercompany sales N7 x 40%	(2.8)
Impairment of goodwill N10 x 40%	(4.0)

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SOLUTION 2

a.

i. An associate is an entity over which the investor has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of the investee, without having control or joint control over those policies.
Significant Influence is normally assumed to exist if the investors own between 20% and 50% of the investee's ordinary shares excluding joint control.

ii. Under the equity method of accounting the investment made in the associate is recorded initially at cost. In each subsequent year, the investor's share of the associate's profit is added to the carrying amount of the investment and is also recognized as income in the investor's financial statements. Dividends received from the associate are subtracted from carrying amount of the investment. Only the investor's share of the associate's profit is shown in the investor's statement of comprehensive Income and only the investor's share of the associate net assets is shown in the investor's statement of financial position. These are items that are shown as a single line items and there is no need to account for non-controlling interest.

This differs from the acquisition method used for subsidiaries, whereby all of a subsidiary's assets, liabilities, income and expenses are incorporated online by line basis into the consolidated financial statements and then the non-controlling interest (if any) is accounted for. Therefore, in the statement of financial position of the reporting entity (the investor) an investment in associate is measured at carrying amount, thus:

iii. 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. While 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. These parties are called joint venturers.

Carrying amount	N
Cost of investment	X
Parent's share of post acquisition profits/(losses) of the associate (or JV)	X
Impairment of the investment recognised	(X)
	X

(b) Y Limited Statement of Comprehensive, Income

	₦'000	₦'000
Operating profit		325
Share of associate profit 40% x N55	22	
Unrealised profit (15-10) x 40% x ¼	(0.5)	21.5
Profit before taxation		346.5
Income tax exp. (N85 + 40% of N15)		(91)

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	255.5
Statement of Changes in Equity	**₦'000**
Balance b/f	355
Associate balance b/f: (N330- N50)x40%	112
Profit for the year	255.5
	722.50

Statement of Financial Position as at October 30 2017, Assets	**₦'000**	
Non-current assets (PPE)	800	
Investment in associate	(W1)	204
		1,004
Current assets	(W2)	379.5
		1,383.5
Equity and liabilities		
Ordinary share capital		500
Retained earnings	(W3)	
722.5		
1222.5		
Current liabilities (155+ Associate Tax 40% of N15)		
Workings		161
		1,383.5

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CHAPTER 22

SUNDRY STANDARDS

Contents

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22 Sundry Standards

22.0 Learning objective

This chapter covers the application of the provisions of IAS 10, IAS 21 and IAS 24 in preparing financial statements.

22.1 Learning outcomes

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

a. distinguish between adjusting and non-adjusting items;
b. explain and apply the ias 10 guidance on the recognition of dividends;
c. explain the objective of ias 24 in setting out rules on disclosure of related party relationships and transactions;
d. define and identify related parties;
e. prepare related party disclosures based on a scenario; and
f. explain and show the effect of foreign exchange on transactions.

22.2 IAS 10: Events After the Reporting Period

22.2.1 Purpose of IAS 10

IAS 10 **Events after the reporting period** has two main objectives:

a) to specify when a company should adjust its financial statements for events that occur after the end of the reporting period, but before the financial statements are authorised for issue, and

b) to specify the disclosures that should be given about events that have occurred after the end of the reporting period but before the financial statements were authorised for issue.

IAS 10 also includes a requirement that the financial statements should be disclosed when the statements were authorised for issue, and who gave the authorisation.

IAS 10 sets out the following key definitions.

Definitions

Events after the reporting period: Those events, favourable and unfavourable that occur between the end of the reporting period and the date the financial statements are authorised for issue.

Adjusting events: Events that provide evidence of conditions that already existed as at the end of the reporting period.

Non-adjusting events: Events that have occurred due to conditions arising after the end of the reporting period.

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22.2.2 Accounting for adjusting events after the reporting period

IAS 10 states that if a company obtains information about an adjusting event after the reporting period, it should update the financial statements to allow for this new information.

IAS 10 gives the following examples of **adjusting events**.

a) The settlement of a court case after the end of the reporting period, confirming that the company had a present obligation as at the end of the reporting period as a consequence of the case.

b) The receipt of information after the reporting period indicating that an asset was impaired as at the end of the reporting period.

c) The discovery of fraud or errors showing that the financial statements are incorrect.

22.2.3 Disclosures for non-adjusting events after the reporting period

Non-adjusting events after the reporting period are treated differently. A non- adjusting event relates to conditions that did not exist at the end of the reporting period, therefore the financial statements must not be updated to include the effects of the event. IAS 10 states quite firmly: 'A company shall **not** adjust the amounts recognised in the financial statements to reflect non-adjusting events after the reporting period'.

However, IAS 10 goes on to say that if a non-adjusting event is material, a failure by the company to provide a disclosure about it could influence the economic decisions taken by users of the financial statements. For material non-adjusting events IAS 10 therefore requires disclosure of:

a. the nature of the event; and

b. an estimate of its financial effect or a statement that such an estimate cannot be made.

IAS 10 gives the following examples of non-adjusting events:

a. a fall in value of an asset after the end of the reporting period, such as a large fall in the market value of some investments owned by the company, between the end of the reporting period and the date the financial statements are authorised for issue.

b. the acquisition or disposal of a major subsidiary;

c. the formal announcement of a plan to discontinue a major operation;

d. announcing or commencing the implementation of a major restructuring; and

e. the destruction of a major plant by a fire after the end of the reporting period.

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22.2.4 Dividends

IAS 10 also contains specific provisions about proposed dividends and the going-concern presumption on which financial statements are normally based.

If equity dividends are declared after the reporting period, they should not be recognised, because they did not exist as an obligation at the end of the reporting period.

Dividends proposed after the reporting period (but before the financial statements are approved) should be disclosed in a note to the financial statements, in accordance with IAS 1.

22.2.5 The going concern assumption

There is one important exception to the normal rule that the financial statements reflect conditions as at the end of the reporting period.

A deterioration in operating results and financial position after the end of the reporting period may indicate that the going concern presumption is no longer appropriate.

There are a large number of circumstances that could lead to going concern problems. For example:

a. The financial difficulty of a major customer leading to their inability to pay their debt to the agreed schedule if at all.

b. An event leading to the net realisable value of lines of inventory falling to less than cost.

c. An event leading to a crucial non-current asset falling out of use. This might cause difficulties in supplying customers and fulfilling contracts.

d. A change in market conditions leading to a loss in value of major investments.

e. Shortages of important supplies

f. The emergence of a highly effective competitor.

If it becomes clear that the client cannot be considered to be a going concern, the financial statements will need to disclose this and the basis for preparing them will change to the 'break-up' basis.

This means that values will have to be adjusted to the amounts expected to be realised through sale.

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22.3 IAS24: Related Party Disclosures

22.3.1 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

a. Transactions have taken place that were not at 'arm's length'; or
b. 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'.

22.3.2 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:

a. the existence of related parties; and
b. 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:

a) related party relationships; and
b) related party transactions.

Definitions

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

22.3.3 Related party

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

a) the party controls the entity or is controlled by it;
b) it has significant influence over the entity;
c) it has joint control over the entity;
d) the parties are under common control;
e) the party is an associate;
f) the party is a joint venture in which the entity is a venturer;
g) the party is a member of the key management personnel of the entity or its parent; or
h) 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

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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:

a. two venturers that simply share joint control over a joint venture;
b. providers of finance (such as a lending bank or a bondholder);
c. trade unions;
d. public utilities;
e. government departments and agencies; and
f. 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:

a. the individual's partner, children and dependants; and
b. children or dependants of the individual's partner.

Related party transactions
A related party transaction is:

a. A transfer of resources, services, or obligations between related parties; and
b. 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

a) Purchases or sales of property and other assets
b) Rendering or receiving of services
c) Leases
d) Transfer of research and development costs
e) Finance arrangements (such as loans or contribution to equity)
f) Provision of guarantees
g) 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.

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Answer

c.4 W Plc
W PLC is related to both X Ltd and Y Ltd (both subsidiaries) because of its controlling interest.Y Ltd and Y Ltd are related because they are under the common control of W PLC.

c.5 Z Ltd is related to X Ltd because of its subsidiary status.
Z 1td is also related to W PLC as he is indirectly controlled by w PLC through W PLC's holding of X Ltd.

c.6 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.7 Q Ltd

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

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:

(a) the name of the entity's parent
(b) 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, the following should be disclosed:

(a) The nature of the related party relationship
(b) The amount of the transactions
(c) In respect of outstanding balances:
  i. the amount;
  ii. their terms and conditions any guarantees given or received; and
  iii. any provision for doubtful/irrecoverable debts.
(d) 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:

(a) the parent;
(b) entities with joint control or significant influence over the entity;
(c) subsidiaries;

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(d) associates;
(e) joint ventures in which the entity is a venturer;
(f) key management personnel of the entity or its parent; and
(g) other related parties.

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

(a) short-term employee benefits;
(b) post-employment benefits;
(c) other long-term benefits;
(d) termination benefits; and
(e) share-based payments.

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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			

23.4 IAS 21 The Effect of Changes in Foreign Exchange Rates

23.4.1 Objective of IAS 21

The objective of IAS 21 is to produce rules that an entity should follow in the translation of foreign currency activities.

Definitions

Exchange rates

a) Historic rate: rate in place at the date the transaction takes place, sometimes referred to as the spot rate.

b) Closing rate: rate at the reporting date.

c) Average rate: average rate throughout the accounting period.

Assets and liabilities

a) Monetary items: items that can be easily converted into cash, e.g. receivables, payables, loans.

b) Non-monetary items: items that give no right to receive or deliver cash, e.g. inventory, plant and machinery.

Currency

a) Functional currency: **'the currency of the primary economic environment in which an entity operates'** (IAS 21, para 8). This will usually be the currency in which the majority of an entity's transactions take place.

b) Presentation currency**: 'the currency in which the financial statements are presented'** (IAS 21, para 8).

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Functional currency

IAS 21 says that an entity should consider the following primary factors when determining its functional currency:

a) the currency that mainly influences sales prices for goods and services

b) the currency of the country whose competitive forces and regulations mainly determine the sales price of goods and services

c) the currency that mainly influences labour, materials and other costs of providing goods and services.

If the primary factors are inconclusive then the following secondary factors should also be considered:

a) the currency in which funds from financing activities are generated

b) the currency in which receipts from operating activities are retained.

Individual company – Translating transactions

Mechanics of translation

Initial transactions

a) Translate using the historic rate prevailing at the transaction date.

b) The average rate can also be used if it does not fluctuate significantly during the accounting period.

Settled transactions

If a transaction is settled (payment or receipt occurs) during the accounting period:

a) Translate at the date of payment / receipt using the historic rate prevailing at that date.

b) As this may be different to the initial transaction an exchange difference may arise, this is posted to the **statement of profit or loss (see Treatment of exchange differences below).**

Unsettled transactions

a) If a transaction is still unsettled at the reporting date, there will be an outstanding asset or liability on the statement of financial position.

b) If the asset/liability is a monetary item it should be retranslated at the closing rate.

c) If the asset/liability is a non-monetary item it should remain at the historic rate.

d) Exchange differences will arise on the retranslation of the monetary items, and these are also posted to the statement of profit or loss.

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Treatment of exchange differences

a. If the exchange difference relates to trading transactions it is disclosed within other operating income/operating expenses

b. If the exchange difference relates to non-trading transactions it is disclosed within interest receivable and similar income/finance costs.

Non-monetary Items

a) Cost model

Non-monetary items that are held at cost are initially translated at the historic rate and carried forward at this value. They are not retranslated.

b) Revaluation/fair value model

Non-monetary items that are carried under the revaluation or fair value model are initially translated at the historic rate. When revalued, the fair value will incorporate the exchange rate on the date of the revaluation.

Gains or losses on exchange are not separately recognised.

IAS 21 summary

Initial treatments

Transactions are translated at historic rate.

Settled transactions

Settlement is translated at spot rate.

Unsettled transactions

Monetary items are retranslated at closing rate.

Non-monetary items remain translated at historic rate when cost was first measured.

Exchange gains/losses

Recorded in statement of profit or loss unless movement in fair value recorded in equity, in which case the exchange gain/loss is also taken to equity.

Practice question 1

Scenario A

On 1 April 20X8, **Collins Co**, whose functional and presentation currency is the **Naira (₦)**, purchased inventory from an overseas supplier whose functional currency is the **Kromit (Kr)**. The invoice value was **Kr54,000**, and payment was settled on **31 May 20X8**.

Exchange rates applicable were:

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(a) 1 April 20X8: Kr1.80 = ₦1

(b) 31 May 20X8: Kr1.75 = ₦1

Required:

i. In accordance with IAS 21, explain the treatment of the foreign currency transaction on initial recognition and settlement.

ii. Prepare the journal entries to reflect the purchase and subsequent settlement, clearly showing the exchange gain or loss.

Scenario B

On 1 January 20X6, **Wilkie Co**, with the Naira (₦) as its functional currency, purchased goods from a supplier in a country where the functional currency is the **Dinar (D)**. The invoice value was **D35,000** and remained unpaid at the reporting date of **31 March 20X6**. Exchange rates were:

(a) 1 January 20X6: D1.75 = ₦1

(b) 31 March 20X6: D1.90 = ₦1

Required:

i. In line with IAS 21, explain how monetary items should be treated at the reporting date.

ii. Show the journal entries on initial recognition and year-end revaluation.

Scenario C

ABC Co, with a 31 December year-end and functional currency in Naira (₦), purchased inventory on **25 October 20X1** from a Swedish supplier for **SWK286,000**. Relevant exchange rates are:

a) 25 October 20X1: ₦1 = SWK11.16

b) 16 November 20X1 (payment date): ₦1 = SWK10.87

c) 31 December 20X1 (year-end): ₦1 = SWK11.02

Required:

i. Explain the accounting treatment for the purchase and payment if payment is made on 16 November 20X1.

ii. Explain the accounting treatment if the amount remains unpaid at the reporting date.

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Scenario D

A Lagos-Based entity entered the following transactions in March 20X3:

On 28 March 20X3, the company sold goods overseas for **Kr200,000**.

a. Exchange rate on 28 March 20X3: Kr0.65 = ₦1
b. Exchange rate on receipt in April: Kr0.70 = ₦1
c. Exchange rate at 30 June 20X3 (year-end): Kr0.75 = ₦1

On the same date, the company purchased goods for **Kr200,000**. The inventory remained unsold at the year-end.

On 15 April 20X3, the entity purchased land for **Kr100,000** on credit.

a. Exchange rate on 15 April: 1Kr = ₦0.85
b. Exchange rate at year-end: 1Kr = ₦0.92

Required:

i. Prepare journal entries for the sales and receipts transactions and determine the total exchange gain or loss if the amount was outstanding at the year-end.

ii. Compute the carrying amount of inventory at year-end and any exchange gain or loss.

iii. Explain and justify the treatment of the land and the trade payable as of year-end in accordance with IAS 21.

Suggested solutions

Scenario A

a) **Initial Recognition**:

Translate at the spot rate on the transaction date:

Kr54,000 ÷ 1.80 = **₦30,000**

Journal Entry (1 April 20X8):

Dr Purchases (Inventory) ₦30,000
Cr Trade Payables ₦30,000

b) **On Settlement (31 May 20X8):**

Kr54,000 ÷ 1.75 = **₦30,857**

Exchange difference = ₦30,857 – ₦30,000 = **₦857 loss**

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Journal Entry:

Dr Trade Payables	₦30,000	
Dr Exchange Loss (SPL)	₦857	
Cr Bank/Cash		₦30,857

Scenario B

(a) Initial Recognition (1 Jan 20X6):

D35,000 ÷ 1.75 = **₦20,000**

(b) Dr Purchases ₦20,000

(c) Cr Trade Payables ₦20,000

(d) Year-End Revaluation (31 Mar 20X6):

D35,000 ÷ 1.90 = **₦18,421**

Exchange gain = ₦20,000 – ₦18,421 = **₦1,579**

(e) Dr Trade Payables ₦1,579

(f) Cr Exchange Gain (SPL) ₦1,579

Scenario C

(a) Payment on 16 November 20X1:

(a) 25 Oct rate: SWK286,000 ÷ 11.16 = **₦25,627**

(b) 16 Nov rate: SWK286,000 ÷ 10.87 = **₦26,311**

(c) Exchange difference: **₦684 loss**

Dr Purchases	₦25,627	
Cr Trade Payables		₦25,627
Dr Trade Payables	₦25,627	
Dr Exchange Loss (SPL)	₦684	
Cr Cash/Bank		₦26,311

(b) If unpaid at 31 Dec 20X1:

a) Closing rate: 286,000 ÷ 11.02 = **₦25,953**

b) Payable was ₦25,627 → exchange **loss of ₦326**

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Dr Exchange Loss (SPL) ₦326

Cr Trade Payables ₦326

Scenario D

(i) Sale of Goods (28 Mar):

Kr200,000 ÷ 0.65 = **₦307,692**

Dr Trade Receivables ₦307,692

Cr Revenue ₦307,692

Payment in April (Kr0.70):

Kr200,000 ÷ 0.70 = **₦285,714**

Exchange loss = **₦21,978**

Dr Bank ₦285,714

Dr Exchange Loss (SPL) ₦21,978

Cr Receivables ₦307,692

If unpaid at 30 June (Kr0.75):

Kr200,000 ÷ 0.75 = **₦266,667**

Loss = ₦307,692 – ₦266,667 = **₦41,025**

Dr Exchange Loss (SPL) ₦41,025

Cr Receivables ₦41,025

(ii) Inventory Valuation:

a) Inventory = Kr200,000 ÷ 0.65 = **₦307,692**

b) Inventory is **non-monetary** → not retranslated at year-end.

Payables at 30 June:

a) Payables restated: Kr200,000 ÷ 0.75 = **₦266,667**

b) Gain = ₦307,692 – ₦266,667 = **₦41,025**

Dr Trade Payables ₦41,025

Cr Exchange Gain (SPL) ₦41,025

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(iii) Land Purchase on Credit:

- Acquisition cost: Kr100,000 × 0.85 = **₦85,000**

→ Land (non-monetary asset) remains at ₦85,000

- Payables at 30 June: Kr100,000 × 0.92 = **₦92,000**

→ Exchange loss = ₦92,000 – ₦85,000 = **₦7,000**

Dr Property, Plant & Equipment ₦85,000
Cr Trade Payables ₦85,000

Dr Exchange Loss (SPL) ₦7,000
Cr Trade Payables ₦7,000

Final Note for Candidates:
Carefully distinguish between **monetary** and **non-monetary** items.
Only **monetary items** (like payables, receivables, loans) are retranslated at year-end.
Non-monetary items (like inventory and PPE) are translated at **historical rates**, unless carried at fair value under other standards.

22.4 Chapter review

Chapter review

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

(a) distinguish between adjusting and non-adjusting items;

(b) explain and apply the IAS 10 guidance on the recognition of dividends;

(c) understand related party transactions and its disclosures; and

(d) ascertain the impact of foreign exchange rates on foreign transactions, profitability and its disclosures.

22.5 End of chapter questions and suggested solutions

22.5.1 Questions

QUESTION 1

a) There is usually a lead time between the end of an entity's accounting year and when the financial statements are approved and signed off by the directors. In between this period, there are two types of events according to IAS 10-Events After the Reporting Period, which may require consideration when preparing financial statements.

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Required:
Identify and explain these events and state how they are treated in the financial statements.

b) Company A is indebted to company B to the tune of ₦50,000,000. The financial year-end of company B is 30 June, 2014. On 30 July 2014, company B received a letter from a liquidator advising it that company A has gone into insolvency.

The letter revealed that company A ceased operations a month ago and that company B is only likely to receive a liquidation dividend of 20k for every naira owed by company A. It is the normal practice of company B's board to approve the audited financial statements three months after the financial year end.

Required:

i. Explain how the above transactions should be treated in the financial statements of company B in accordance with IAS 10-Events After the Reporting Period.

ii. Prepare journal entries that are required to adjust company B's financial statements to account for the above event.

iii. State what would have been the treatment in the financial statements assuming it was fire that destroyed company B's factory building on 30 July, 2014.

c) The directors of XYZ Plc declared that a dividend of ₦1 per ordinary share be paid to shareholders on the company's register as at 15 April, 2014. The financial statements were approved by the company's board on 30 May, 2014.

The shareholders, at the company's annual general meeting held on 15 June, 2014, approved the payment of the dividend to eligible shareholders on 1 July, 2014.

Required:
Explain how the dividend proposed by the Directors should be treated in the financial statements of XYZ Plc in accordance with IAS 10.

Question 2

IAS 10 on events after reporting period has two main objectives:

(a) To specify when a company should adjust its financial statements for events that occur after the end of the reporting period; and

(b) To specify the disclosure that should be given about events that have occurred after the end of the operating period but before the financial statements were authorised for issue.

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Required:
Discuss the following key concepts under IAS 10:

i. Event after reporting period

ii. Adjusting events

iii. Non-adjusting events

b. The following events took place in Chakachaka Company Nig. Limited:

(a) Shortly after the financial year ended on June 30, 2018 but before the financial statements were authorised for issue, Chakachaka Nigeria Limited's inventory was destroyed by a fire outbreak which resulted in a loss of ₦200 million.

(b) The company"s financial year that ended June 30, 2018 shows an amount of ₦60million that is due from one of its debtors, Mr. Onigbese.

(c) Chakachaka Nigeria Limited provided for impairment at June 30, 2018 of ₦15million against the gross value of ₦60million due from Mr. Onigbese. On July 31, 2018 before the financial statements were authorised for issue, Mr. Onigbese was declared bankrupt and unable to pay the debt.

(d) Chakachaka Nigeria Limited was sued on June 30, 2018 but the judgment was only handed down on July 21, 2018. The Company was found liable for damages and cost amounting to ₦31million were awarded against it. On July 22, 2018, Chakachaka Nigeria Limited filed a claim with its insurers and on July 29, 2018, it was notified that the insurer would only cover ₦26 million of the loss.

Required:
Prepare a brief memorandum advising the directors of Chakachaka Nigeria Limited on the accounting treatment and/or disclosure required as a result of the events in (i) to (iii) after the reporting date.

22.5.2 Suggested solution

Solution 1
a) Events after the reporting period are those events favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for use.

Types of events

(a) Adjusting events

These are events that provide evidence of conditions that existed at the end of the reporting period.

(b) Non-Adjusting events

These are events that indicate conditions that arose after the reporting period.

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(c) Treatment of Events

(d) Adjusting events - require adjustment in the financial statement.

Examples are:
· Evidence of permanent diminution of property before the year-end;
· Insolvency of a customer with balance owing at the year end;
· Amount received or paid in respect of legal or insurance.
ii. Non-Adjusting events - do not require adjustment in the financial statement.
Examples are:
· Acquisition or disposal of a subsidiary after the year-end;
· Announcement of a plan to discontinue an operation;
· Major purchase and disposal of assets.

b. (i) IAS 10 provision confirms that the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period or that the amount of a previously recognized impairment loss for that asset needs to be adjusted. In this scenario, the bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit – impaired at the end of the reporting period.
Hence, company should adjust its financial statements for the year ended 30 June, 2014 for the probable loss (bad debts) of N40 million (i.e. 80% of N50 million) suffered as a result of Company A insolvency as confirmed by the appointed liquidation on 30 July, 2014.

(ii) **General Journal**

	DR ₦'000	CR ₦'000
Bad debt (written off)	40,000	
Trade receivable (Company A)		40,000
Being bad debt written off of ₦40 million (i.e. 80% of ₦50 million) suffered as a result of Company A insolvency as confirmed by the liquidator on 30 July, 2014		

(iii) A fire incident occurring on 30 July, 2014 is a "Non-Adjusting Event" as the event occurred subsequent to (or after) the reporting date (30 June, 2014).
The requirement of IAS 10 requires only a disclosure of the incident with respect to its occurrence (i.e. the nature), the circumstances and the financial effects, unless if it is so material that it may affect the going concern status of Company B.

c) If an entity declares dividend to equity shareholders (as defined in IAS 32 – Financial Instruments Presentation) after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period. If dividends are declared after the reporting period but before the financial statements are authorised for issue, the dividends are not recognised as a liability at the end of the reporting period because no

obligation exists at that time. Such dividends are disclosed in the notes in accordance with IAS 1 - Presentation of Financial Statements.

Solution 2

(a)

i. Events after reporting period: These are events favourable or unfavourable which occur between the end of the reporting date and the date the financial statements are authorised for issue.

ii. Adjusting event:

An adjusting event is an event which provides further evidence of a condition existing at the reporting date. An entity shall adjust the amounts recognised in its financial statements for the period just ended to reflect adjusting event after the reporting period.

iii. Non –adjusting event

An entity shall not adjust the amount recognised in its financial statement to reflect non-adjusting event after the reporting date. In this case, there was no condition existing at the reporting date, so no adjustment should be made.

Disclosure should be made in note form in the financial statement for significant non-adjusting event after reporting date.

If a non-adjusting event means the going concern concept no long applies to the entity, then the event should be treated as an adjusting event i.e. the financial statement should not be prepared on going concern basis.

(b). Memo

To: Directors of Chakachaka Nig. Ltd.
From: Consultants
Subjects: Event after reporting period

The following accounting treatments and disclosures are recommended for the events highlighted:

(a) Inventory destroyed by fire outbreak

This event is a „non-adjusting event" as it is indicative of a condition (fire) that arose after the end of the reporting period.

As this is a non-adjusting event, no adjustment will be made to the amount recognised in the financial statement of your company for the year ended June 30, 2018.

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However, if the loss of N200million is consequential enough that its non-disclosure would influence the economic decision of the users of the financial statements, disclosure of the nature of the event, the estimate of its financial effects or a statement if such an estimate cannot be made would be required.

(b) Bankrupt Debtor – Mr. Onigbese
This is an adjusting event and Chakachaka Nig. Ltd. should impair the amount receivable (N60 million) from Mr. Onigbese as at June 30, 2018.
His bankruptcy after the end of the reporting period provides evidence of the fact that the amount receivable from the debtor was impaired at the end of the reporting period.

(c) Judgement debt

i. This is an „Adjusting event" – This is because the liability existed at the reporting date, but confirmation of the amount was only received on July 21, 2018.

ii. The financial statement should be adjusted to reflect the information received subsequently. Accordingly, provisions should be made for the entire amount of the judgement debt.

iii. The filing of the insurance claim only took place following the reporting date; hence no account should be taken of this at June 30, 2018. As confirmation of the success of the claim statements of Chakachaka Nig. Ltd.

Conclusion
You should not hesitate to contact me if you need further explanation.

Thank you.
Consultant

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Skills Level
Financial Reporting

CHAPTER 23

IAS 7: STATEMENT OF CASH FLOWS

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23 Statement of Cash flows

23.0 Learning objective

This chapter covers the preparation of statement of cash flows in accordance with IAS 7.

23.1 Learning outcomes

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

(a) prepare extracts from a statement of cash flow; and

(b) prepare a statement of cash flow for single entity and simple group.

23.2 Statement of Cash flows: Introduction

23.2.1 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:

a) the cash flows of the entity during the reporting period, and

b) the changes in cash and cash equivalents during the period.

*IAS 7: Statement of cash flow*s sets out the benefits of cash flow information to users of financial statements.

a) A statement of cash flows provides information that helps users to evaluate changes in the net assets of an entity and in its financial structure (including its liquidity and solvency).

b) It provides information that helps users to assess the ability of the entity to affect the amount and timing of its cash flows in order to adapt to changing circumstances and unexpected opportunities.

c) It is useful in assessing the ability of the entity to generate cash and cash equivalents.

d) It helps users of accounts to compare the performance of different entities because unlike profits, comparisons of cash flows are not affected by the different accounting policies used by different entities.

e) Historical cash flows are often a fairly reliable indicator of the amount, timing and certainty of **future** cash flows.

23.2.2 Statement of cash flows

A statement of cash flows provides information about where a business obtained its cash during the financial period, and how it made use of its cash.

A statement of cash flows groups inflows and outflows of cash under three broad headings:

a) cash from operating activities

b) cash used in (or obtained from) investing activities

c) cash paid or received in financing activities.

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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:

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.

23.2.3 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 in significant risk of changes in value.

Cashflows are inflows and outflows of cash and cash equivalents.

For the purpose of a statement of cash flows, cash and cash equivalents are treated as being the same thing. This means that cash flows between cash and cash equivalent balances are not shown in the statement of cash flows. These components are part of the cash management of an entity rather than part of its operating, investing and financing activities.

Cash and cash equivalents are held in order to meet short-term cash commitments, rather than for investment purposes or other purposes.

Examples of cash equivalents are:

a) a bank deposit where some notice of withdrawal is required

b) short-term investments with a maturity of three months or less from the date of acquisition (e.g., government bills).

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Bank borrowings are generally considered to be financing activities. In that case they would be held outside cash and cash equivalents and movements on the bank borrowings would be shown under financing activities as a cash inflow if borrowing increase or as a cash outflow if borrowings fell.

Sometimes, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents.

Sundry disclosures

An entity must disclose the components of cash and cash equivalents and present a reconciliation of the amounts in its statement of cashflows with the equivalent items reported in the statement of financial position.

Any significant cash and cash equivalent balances held by the entity that are not available for use by the group must be disclosed together with a commentary by management. This might be the case when a group of companies has a subsidiary whose dividend payments are subject to a debt covenant or exchange control regulations which would prevent payment of a dividend to the parent company.

Comment on technique

Theoretically this could be done by analysing every entry in and out of the cash account(s) over the course of a period. However, the cash account is often the busiest account in the general ledger with potentially many thousands of entries. Documents that summarise the transactions are needed.

These documents already exist! They are the other financial statements (statement of financial position and statement of comprehensive income).

Illustration:

A business might buy 100 new non-current assets over the year. There would be 100 different entries for these in the cash account.

However, it should be easy to estimate the additions figure from comparing the opening and closing balances for non-current assets and isolating any other causes of movement.

For example, if we know that property plant and equipment has increased by ₦100,000 and that the only other cause of movement was depreciation of ₦15,000 then additions must have been ₦115,000.

A lot of the numbers in cashflow statements are derived from comparing opening and closing positions of line items in the statement of financial position. Other causes of movement can then be identified leaving the cash double entry as a balancing figure.

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23.2.4 The sections of a statement of cash flows

The content and format of statements of cashflows are specified by IAS 7 **Statement of cash flows**. IAS 7 does not specify what the **exact** format of a statement of cash flows should be, but it provides suggested layouts in an appendix.

Entities are required by IAS 7 to report cash flows for the period under three headings:

a) cash flows from operating activities;

b) cash flows from investing activities; and

c) cash flows from financing activities.

All cash flows (except for changes from cash-to-cash equivalents or from cash equivalents to cash) can be included in one of these three categories.

Together, the cash flows arising from these three categories of activity explain the increase or decrease in cash and cash equivalents during the financial period.

The cash flow for each category might be positive or negative. The total of the cash flows for all three categories together explains the overall increase or decrease in cash and cash equivalents during the period.

A single transaction might include more than one type of cashflow. For example, a cash repayment of a loan might include both interest and capital. In this case the interest element might be classified as an operating activity and the capital element as a financing activity.

23.2.5 Cash flows from operating activities

Operating activities are the normal trading activities of the entity. Cash flows from operating activities are the cash inflows or cash outflows arising in normal trading activities.

Operating activities normally provide an operating profit before tax. However, profit is not the same as cash flow, and the cash flows from operating activities are different from profit.

A statement of cash flows normally makes a distinction between:

a) **cash generated from operations**, which is the cash from sales less the cash payments for operating costs, and

b) **net cash from operating activities**, which is the cash generated from operations, less interest payments and tax paid on profits.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss.

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Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments from contracts held for dealing or trading purposes.

Some transactions result in the recognition of a gain or loss profit or loss (e.g., sale of an item of plant). However, the cash flows relating to such transactions are cashflows from investing activities.

Cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cashflows from operating activities.

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cashflows to function without recourse to external sources of financing. In addition, it forms a basis for forecasting future operating cashflows.

23.2.6 Cash flows from investing activities

The second section of a statement of cashflows shows cash flows from investing activities. Investing activities are defined by IAS 7 as 'the acquisition and disposal of long-term assets and other investments not included in cash equivalents'.

Cash flows from investing activities might also include cash received from investments, such as interest or dividends received.

The separate disclosure of cashflows arising from investing activities is important because the cashflows represent the extent to which expenditures have been made for resources intended to generate future income and cashflows.

Examples of cash flows arising from investing activities are:

a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets (including those relating to capitalised development costs and self-constructed tangible assets);

b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

c) cash payments to acquire equity or debt instruments;

d) cash receipts from sales of equity or debt instruments of other entities;

e) cash advances and loans made to other parties (other than advances and loans made by a financial institution which would be an operating activity); and

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f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution).

23.2.7 Cash flow from financing activities

The third section of the statement of cash flows shows the cash flows from financing activities. These activities are defined by IAS 7 as 'activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.'

Examples of cash flows arising from financing activities are:

a) cash proceeds from issuing shares or other equity instruments;

b) cash payments to owners to acquire or redeem the entity's shares;

c) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings; and

d) cash repayments of amounts borrowed.

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cashflows by providers of capital to the entity.

23.2.8 Gross or net

Generally, major classes of cash flows arising from investing and financing activities are reported gross. That is to say that cash receipts and cash payments are shown separately even if from and to the same party.

However, cash flows arising from the following activities may be reported on a net basis:

a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity (for example if rent is collected on behalf of and paid on to owners of properties); and

b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short (e.g., payments made by credit card companies on behalf of their customers and receipts from those customers.

It is unlikely that you will see this in a question.

23.3 Statement of Cash flows: Format

23.2.1 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.

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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:

a) the direct method, and

b) 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.

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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.

23.3.2 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 adjustments remove the impact of accruals and non-cash items and also relocate some figures to other positions in the statement of cashflows.

The following illustration shows how the net cashflow from operating activities figure seen in the previous example was arrived at using the indirect method.

Illustration:

Statement of cashflows: indirect method	₦	₦
Cashflows 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 cashflow from operating activities		**75,300**

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23.3.3 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:

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 cashflow 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 cashflows that produced the 'Cash generated from operations'.

23.4 Cash flows from Operating Activities: The Indirect Method

23.4.1 Profit before taxation

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:

a) Non-cash items, for example:
   i. Depreciation and amortisation (depreciation of intangible non-current assets);
   ii. Profit or loss on disposal of non-current assets; and

b) Accruals based figures, for example:
   i. Interest expense or income;
   ii. Movement on working capital items (receivables, payables and inventory).

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23.4.2 Non-cash items

Depreciation and amortisation

Depreciation charges and amortisation charges are not cash flows. They are expenses in the income statement, but do not represent payments of cash.

In order to obtain a figure for cash flow from the figure for profit, charges for depreciation and amortisation must therefore be added back to the profit figure.

Gains or losses on disposal of non-current assets

Gains or losses on the disposal of non-current assets are not cash flows. The gain or loss is calculated as the difference between:

(a) the net cash received from the disposal, and

(b) the carrying value (net book value) of the asset at the date of disposal.

The effect of the gain or loss on disposal (a non-cash item) from the operating profit is removed by:

(a) deducting gain on disposal; and

(b) adding back losses on disposal.

The relevant cash flow is the net cash received from the sale. This is included in cash flows from investing activities as the net cash flows received from the disposal of non-current assets.

Example:

A company disposed of an item of equipment for ₦40,000. The equipment had originally cost ₦60,000 and the accumulated depreciation charged up to the date of disposal was ₦32,000.

	₦
Cost	60,000
Accumulated depreciation	32,000
Carrying value at date of disposal	28,000
Cash proceeds from sale	40,000
Gain on disposal	12,000

In the statement of cash flows, the gain on disposal of ₦12,000 is deducted as an adjustment to the operating profit.

The cash proceeds of ₦40,000 is included as a cash inflow under the heading: 'Cash flows from investing activities'.

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Practice question **1**

A company made a loss on the disposal of a company motor vehicle of ₦8,000.
The vehicle originally cost ₦50,000 and at the date of disposal, accumulated depreciation on the vehicle was ₦20,000.
What are the items that should be included for the disposal of the vehicle in the statement of cash flows for the year:

(a) In the adjustments to get from operating profit to cash flow from operations?

(b) Under the heading: 'Cash flows from investing activities'?

23.4.3 Accruals based figures -Interest

The accruals concept is applied in accounting.

Interest charge in the income statement is an accrual-based figure. It is added back to profit and the actual cash interest paid is deducted further down the cash flow statements.

The final items in the operating cash flows part of a statement of cash flows are the amount of interest paid and the amount of tax paid (see later).

This figure must be calculated as follows:

Illustration:

	₦
Interest liability at the beginning of the year	X
Interest charge for the year (income statement	X
figure) Total amount of interest payable in the year	X
Interest liability at the end of the year	(X)
Interest paid in the year (cash)	X

Take a few minutes to make sure that you are happy about this. The same approach is used to calculate other figures.

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.

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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	3,000

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

Note that this approach would work to find the cash paid in respect of any liability in respect of which expense was recognised in the statement of profit or loss.

It would not matter if you did not know anything about the type of liability as long as you are told that there is a movement and you are given the amount recognised in the statement of profit or loss. For example, instead of the above example being about interest it could be about warranty provision, gratuity, retirement benefit, health insurance, bonus pool, and so on.

23.4.4 Accruals based figures -Taxation

The tax paid is the last figure in the operating cash flow calculation.

There is no adjustment to profit in respect of tax. This is because the profit figure that we start with is profit before tax; therefore, tax is not included in it to be adjusted!

However, there is a tax payment and this must be recognised as cash flow. It is calculated in the same way as shown above.

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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 cashflows 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. You have not covered this yet, but it can still be dealt with here as its impact on a statement of cash flows at this level is quite straightforward.

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:

a) 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

b) include it in every tax balance in the working. The second approach is usually used.

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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 ta 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

23.4.5 Accruals based figures – Dividends

A question might require the calculation of cash paid out as dividends in the year.

This is calculated in the usual way remembering that the dividend charge is a debit in the statement of changes in equity.

Illustration:

	₦
Dividend liability at the beginning of the year	X
Dividend charge for the year	X
Total amount of dividend payable in the year	X
Dividend liability at the end of the year	(X)
Dividend paid in the year (cash)	

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Example: Dividend paid

A company had liabilities in its statement of financial position at the beginning and at the end of 20X9, as follows:

	Dividends(₦)
Beginning of 20X9	65,000
End of 20X9	71,000

The company had share capital of ₦1,000,000.

The directors recommended a dividend of 20% (20X8: 18%) on 25th December 20X9.

The company AGM is held in March each year.

The dividend payment (cashflows) for inclusion in the statement of cashflows can be calculated as follows:

	₦
Dividend liability at the start of the year	65,000
Dividend in the year (18% of 1,000,000)	180,000
Total amount payable	245,000
Dividend liability at the end of the year	(71,000)
Cash paid	171,000

23.4.6 Presentation of interest, taxation and dividends cash flows

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:

a) interest received;

b) dividends received;

c) interest paid; and

d) dividends paid.

Interest payments

IAS 7 states that there is no consensus about how to treat interest payments by an entity, other than a financial institution such as a bank. Interest payments may be classified as either:

a) an operating cash flow, because they are deducted when calculating operating profit before taxation, or

b) a financing cash flow, because they are costs of obtaining finance.

In examples of statements of cash flows in the appendix to IAS 7, interest paid is shown as a separate line item within cash flows from operating activities. This approach is therefore used here.

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Interest and dividends received

Interest received and dividends received may be classified as either:

a) an operating cash flow, because they are added when calculating operating profit before taxation, or

b) an investing cash flow, because they represent returns on investment.

In examples of statements of cash flows in the appendix to IAS 7, interest received and dividend received are shown as separate items within cash flows from investing activities. This approach is therefore used here.

Dividends paid

IAS 7 allows dividend payments to be treated as either:

a) a financing cash flow because they are a cost of obtaining financial resources, or

b) a component of the cash flows from operating activities, in order to assist users to determine the ability of the entity to pay dividends out of its operating cash flows.

In examples of statements of cash flows in the appendix to IAS 7, dividends paid are shown as a line item within cash flows from financing activities. This approach is therefore used here.

Taxes on profits

Cash flows arising from taxation on income should normally be classified as a cash flow from operating activities (unless the tax payments or refunds can be specifically associated with an investing or financing activity).

The examples of statements of cash flows in this chapter therefore show both interest paid, and tax paid as cash flow items, to get from the figure for cash generated from operations to the figure for 'net cash from operating activities'.

23.5 Indirect Method: Adjustments for Working Capital

23.5.1 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:

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a) trade receivables and prepayments.

b) inventories; and

c) 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.

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23.5.2 Working capital

Working capital is made up of the following balances:

Illustration:

	₦
Inventory	X
Trade and other receivables	X
Cash	X
Trade payables	(X)
Working capital	X

Trade and other receivables include any prepayments.

Trade payables include accrued expenses, provided the accrued expenses do not relate to other items dealt with separately in the statement of cash flows, in particular:

a) accrued interest charges; and

b) taxation payable.

Interest charges and payments for interest are presented separately in the statement of cash flows, and so accrued interest charges should be excluded from the calculation of changes in trade payables and accruals.

Similarly, taxation payable is dealt with separately; therefore, taxation payable is excluded from the calculation of working capital changes.

Accrued interest and accrued tax payable must therefore be deducted from the total amount for accruals, and the net accruals (after making these deductions) should be included with trade payables.

Changes in working capital and the effect on cash flow

When working capital increases, the cashflows from operations is less than the operating profit, by the amount of the increase.

Similarly, when working capital is reduced, the cash flows from operations is more than the operating profit, by the amount of the reduction.

This important point will be explained with several simple examples.

23.5.3 Changes in trade and other receivables

Sales revenue in a period differs from the amount of cash received from sales by the amount of the increase or decrease in receivables during the period.

When trade and other receivables go up during the year, cashflows from operations are less than operating profit by the amount of the increase.

When trade and other receivables go down during the year, cash flows from operations are more than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for receivables is therefore:

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a) subtract the increase in receivables during the period (the amount by which closing receivables exceed opening receivables); or

b) add the reduction in receivables during the period (the amount by which opening receivables exceed closing receivables).

Prepayments in the opening and closing statement of financial position should be included in the total amount of receivables.

Example: trade and other receivables

A company had receivables at the beginning of the year of ₦6,000 and at the end of the year receivables were ₦9,000.

During the year, sales were ₦50,000 in total. Purchases were ₦30,000, all paid in cash.

The company holds no inventories. The profit before tax for the year was ₦20,000 (₦50,000– ₦30,000).

The cashflow from operations is calculated as follows:

	₦
Profit before tax	20,000
Adjustments for increase in receivables (9,000–6,000)	(3,000)
	17,000

Proof

Cashflow from operations can be calculated as follows:

	₦
Receivables at the beginning of the year	6,000
Sales in the year	50,000
	56,000
Receivables at end of the year	(9,000)
Cash received	47,000
Cash paid (purchases)	(30,000)
Cashflow from operations	17,000

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23.5.4 Possible complication: Allowances for doubtful debts

A question might provide information on the allowance for doubtful debts at the start and end of the year.

There are two ways of dealing with this:

a) Adjust the profit for the movement on the allowance as a non-cash item and adjust the profit figure for the movement in receivables using the gross amounts (i.e. the balances before any deduction of the allowance for doubtful debts); or

b) Make no adjustments for the movement on receivables as a non-cash item adjust the profit figure for the movement in receivables using the net amounts (i.e., the balances after the deduction of the allowance for doubtful debts).

Example: Allowance for doubtful debts

The following information is available:

	20X8	20X9
	(₦ m)	(₦m)
Receivables	5,000	7,100
Allowance for doubtful debts	(500)	(600)
Net-amount	4,500	6,500

	₦'m	or	₦'m
Profit before taxation	10,000		
Adjustments for non-cash items:	100		–
Increase in allowance for doubtful debts	10,100		10,000
Increase in receivables:			
Gross amounts:(7,100–5,000)	(2,100)		
Net amounts:(6,500–4,500)			(2,000)
	8,000		8,000

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23.5.5 Changes in inventory

Purchases in a period differ from the cost of sales by the amount of the increase or decrease in inventories during the period.

If all purchases were paid for in cash, this means that cash payments and the cost of sales (and profit) would differ by the amount of the increase or decrease in inventories.

When the value of inventory goes up between the beginning and end of the year, cashflows from operations are less than operating profit by the amount of the increase.

When the value of inventory goes down between the beginning and end of the year, cashflows from operations are more than operating profit by the amount of the reduction.

In a statement of cashflows presented using the indirect method, the adjustment for inventories is therefore:

a) subtract the increase in inventories during the period (the amount by which closing inventory exceeds opening inventory); or

b) add the reduction in inventories during the period (the amount by which opening inventory exceeds closing inventory).

Example: inventory

A company had inventory at the beginning of the year of ₦5,000 and at the end of the year the inventory was valued at ₦3,000.

During the year, sales were ₦50,000 and there were no receivables at the beginning or end of the year.

Purchases were ₦28,000, all paid in cash.

The operating profit for the year was ₦20,000, calculated as follows:

	₦
Sales	50,000
Opening inventory	5,000
Purchases in the year (all paid in cash)	28,000
	33,000
Closing inventory	(3,000)
Cost of sales	(30,000)
Profit before tax	20,000

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Example (continued)

Profit before tax	20,000
Adjustment for decrease in inventory (5,000 – 3,000)	2,000
	22,000

Proof: The cashflow from operations is calculated as follows:

	₦
Cash from sales in the year	50,000
Purchases paid in cash	(28,000)
Cash flow from operations	22,000

23.5.6 Changes in trade payables

Payments for purchases in a period differ from purchases by the amount of increase or decrease in trade payables during the period.

When trade payables go up between the beginning and end of the year, cash flows from operations are more than operating profit by the amount of the increase.

When trade payables go down between the beginning and end of the year, cash flows from operations are less than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for trade payables is therefore:

a) add the increase in trade payables during the period (the amount by which closing trade payables exceed opening trade payables); or

b) subtract the reduction in trade payables during the period (the amount by which opening trade payables exceed closing trade payables).

Accruals in the opening and closing statements of financial position should be included in the total amount of trade payables.

However, deduct interest payable and tax payable from opening and closing payables, if the total for payables includes these items.

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Example: trade payables

A company had no inventory and no receivables at the beginning and end of the year. All its sales are for cash, and sales in the year were ₦50,000. Its purchases are all on credit. During the year, its purchases were ₦30,000.

Trade payables at the beginning of the year were ₦4,000 and trade payables at the end of the year were ₦6,500.

The operating profit for the year was ₦20,000 (₦50,000 – ₦30,000)

	₦
Profit before tax	20,000
Adjustments for:	
Increase in payables (6,500 – 4,000)	2,500
	22,500

Proof: The cash flow from operations is calculated as follows:

	₦
Trade payables at the beginning of the year	4,000
Purchases in the year	30,000
	34,000
Trade payables at the end of the year	(6,500)
Cash paid to suppliers	27,500
Cash from sales	(50,000)
Cash flow from operations	22,500

The cash flow is ₦2,500 more than the operating profit, because trade payables were increased during the year by ₦2,500.

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Example:

A company made an operating profit before tax of ₦16,000 in the year just ended. Depreciation charges were ₦15,000.

There was again 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 cashflows using the indirect method.

Answer

	₦	₦
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 cashflow from operating activities		24,700

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Practice question **2**

During 20X9, a company made a profit before taxation of ₦60,000. Depreciation charges were ₦25,000 and there was again on the disposal of a machine of ₦14,000.

Interest charges and payments of interest in the year were the same amount ₦10,000.

Taxation payments were ₦17,000.

Values of working capital items at the beginning and end of the year were:

	Receivables	Inventory	Trade payables
Beginning of the year	₦32,000	₦49,000	₦17,000
End of the year	₦27,000	₦53,000	₦11,000

Calculate the net cash from operating activities, as it would be shown in a statement of cash flows (indirect method).

23.5.7 Lack of detail

A question might not provide all the details needed to split working capital into all of its component parts. If this is the case, the adjustment must be made using whatever totals are available in the question.

Example:

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:

	Current assets	Trade payables
Beginning of the year	₦12,000	₦4,000
End of the year	₦11,000	₦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.

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Suggested solution

	₦	₦
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 current assets	1,000	
Increase in trade payables	2,500	
Cash generated from operations	29,500	
Taxation paid (tax on profits)	(4,800)	
Net cashflow from operating activities		24,700

23.6 Cash flows from operating activities: The direct method

23.6.1 Cash from sales

The format for the direct method of presenting a statement of cash flows is as follows:

Illustration:

Statement of cashflows: direct method	₦
Cashflows 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 cashflow from operating activities	75,300

The task is therefore to establish the amounts for cash receipts and cash payments. In an examination, you might be expected to calculate any of these cash flows from figures in the opening and closing statements of financial position, and the statement of comprehensive income.

The cash receipts from sales during a financial period can be calculated as

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follows:

Illustration

	₦
Trade receivables at the beginning of the year	X
Sales in the year	X
Trade receivables at the end of the year	X
Cash from sales during the year	(X)

AT account could also be used to calculate the cash receipt

Receivables

Balance b/f	X		
Sales	X	Cash (balancing figure)	X
		Balance c/f	X
	X		X

23.6.2 Cash paid for materials

To calculate the amount of cash paid to suppliers, you might need to calculate first the amount of material purchases during the period.

Illustration: Calculation of purchases in the year

	₦
Closing inventory at the end of the year	X
Cost of sales	X
	X
Opening inventory at the beginning of the year	(X)
Purchases in the year	X

Having calculated purchases from the cost of sales, the amount of cash payments for purchases may be calculated from purchases and opening and closing trade payables.

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Illustration:

	₦
Trade payables at the beginning of the year	X
Purchases in the year (as above)	X
	X
Trade payables at the end of the year	(X)
Cash paid for materials	X

AT account could also be used to calculate the cash paid

		Balance b/f	X
Cash (balancing figure)	X	Purchases	X
Balance c/f	X		
	X		X

Note that if the business had paid for goods in advance at the start or end of the year they would have an opening or closing receivable but this situation would be quite unusual.

23.6.3 Cash paid for wages and salaries

Cash payments for wages and salaries can be calculated in a similar way.

Illustration:

	₦
Accrued wages and salaries at the beginning of the year	X
Wages and salaries expenses in the year	X
	X
Accrued wages and salaries at the end of the year	(X)
Cash paid for wages and salaries	X

AT account could also be used to calculate the cash paid

		Balance b/f	X
Cash (balancing figure)	X	Wages and salaries	X
Balance c/f	X		
	X		X

If wages and salaries had been paid in advance the business would have a receivable and the workings would change to the following.

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Illustration:

	₦
Wages and salaries paid in advance at the beginning of the year	(X)
Wages and salaries expenses in the year	X
	X
Wages and salaries paid in advance at the end of the year	X
Cash paid for wages and salaries	X

AT account could also be used to calculate the cash paid

Payables			
Balance b/f	X		
Cash (balancing figure)	X	Purchases	X
		Balance c/f	X
	X		X

23.6.4 Cash paid for other expenses

Other expenses in the statement of comprehensive income usually include depreciation charges, which are not cashflows. Depreciation charges should therefore be excluded from other expenses when calculating cash payments.

Cash payments for other expenses can be calculated as follows.

Illustration:

	₦
Payables for other expenses at the beginning of the year	X
Other expenses in the year, excluding depreciation and amortisation	X
	X
Payables for other expenses at the end of the year	(X)
Cash paid for other expenses	X

Payables for other expenses should exclude accrued wages and salaries, accrued interest charges and taxation payable.

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Example:

The following information has been extracted from the financial statements of Company for the year ended 31 December 20X9.

	₦
Sales	1,280,000
Cost of sales	(400,000)
Gross profit	880,000
Wages and salaries	(290,000)
Other expenses (including depreciation ₦25,000)	(350,000)
	240,000
Interest charges	(50,000)
Profit before tax	190,000
Tax on profit	(40,000)
Profit after tax	150,000

Extracts from the statement of financial position:

	At 1 January 20X9	At 31 December 20X9
	₦	₦
Trade receivables	233,000	219,000
Inventory	118,000	124,000
Trade payables	102,000	125,000
Accrued wages and salaries	8,000	5,000
Accrued interest charges	30,000	45,000
Tax payable	52,000	43,000

Required

Present the cashflows from operating activities as they would be presented in a statement of cashflows using:

1 the direct method; and

2 the indirect method.

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Answer: Direct method

Statement of cashflows: direct method	₦
Cash flows from operating activities	
Cash receipts from customers (**W1)**	1,294,000
Cash payments to suppliers **(W3)**	(383,000)
Cash payments to employees (**W4)**	(293,000)
Cash paid for other operating expenses	(325,000)
Cash generated from operations	293,000
Taxation paid (tax on profits) (**W5)**	(49,000)
Interest charges paid **(W5)**	(35,000)
Net cash flow from operating activities	209,000

Workings

(W1) Cash from sales	₦
Trade receivables at 1 January 20X9	233,000
Sales in the year	1,280,000
	1,513,000
Trade receivables at 31 December 20X9	(219,000)
Cash from sales during the year	1,294,000

(W2) Purchases	₦
Closing inventory at 31 December 20X9	124,000
Cost of sales	400,000
	524,000
Opening inventory at 1 January 20X9	(118,000)
Purchases in the year	406,000

(W3) Cash paid for materials supplies	₦
Trade payables at 1 January 20X9	102,000
Purchases in the year **(W2)**	406,000
	508,000
Trade payables at 31 December 20X9	(125,000)
Cash paid for materials	383,000

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Answer: Direct method (continued)

(W4) Cash paid for wages and salaries	₦
Accrued wages and salaries at 1 January 20X9	8,000
Wages and salaries expenses in the year	290,000
	298,000
Accrued wages and salaries at 31 December 20X9	(5,000)
Cash paid for wages and salaries	293,000

(W5) Interest and tax payments	**Tax**	**Interest**
	₦	₦
Liability at the beginning of the year	52,000	30,000
Taxation charge/interest charge for the year	40,000	50,000
	92,000	80,000
Liability at the end of the year	(43,000)	(45,000)
Tax paid/interest paid during the year	49,000	35,000

Answer: Indirect method

Statement of cash flows: indirect method	₦
Cashflows from operating activities	
Profit before taxation	190,000
Adjustments for:	
Depreciation and amortisation charges	25,000
Interest charges in the statement of comprehensive income	50,000
	265,000
Decrease in receivables (233,000 – 219,000)	14,000
Increase in inventories (124,000 – 118,000)	(6,000)
Increase in trade payables (125,000 + 5,000) – (102,000 + 8,000)	20,000
Cash generated from operations	293,000
Taxation paid	(49,000)
Interest charges paid	(35,000)
Net cashflow from operating activities	209,000

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23.7 Cash flows from Investing Activities

23.7.1 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.

It is useful to remember the following relationship:

Illustration: Movement on non-current assets

	₦
Carrying amount at the start of the year	X
Depreciation	(X)
Disposals	(X)
Additions	X
Revaluation	X/(X)
Carrying amount at the end of the year	X

When there are no disposals or revaluations during the year

When there are no disposals or revaluations of non-current assets during the year, purchases of non-current assets (normally assumed to be the amount of cash paid for these purchases) may be calculated as follows:

Illustration:

Using cost:	₦
Non-current assets at the beginning of the year at cost	X
Additions to non-current assets (balancing figure)	X
Non-current assets at the end of the year at cost	X

Alternatively carrying amount (NBV) can be used	₦
Non-current assets at the beginning of the year at NBV	X
Depreciation	(X)
	X
Additions to non-current assets (balancing figure)	X
Non-current assets at the end of the year at NBV	(X)

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	At cost	Accumulated depreciation	Netbook value
	₦	₦	₦
Beginning of the year	180,000	(30,000)	150,000
End of the year	240,000	(50,000)	190,000

	Cost	or	NBV
Balance at the start of the year Less:	180,000		150,000
Depreciation charge for the year (50,000 – 30,000)			(20,000)
Additions (balancing figure)			130,000
	60,000		60,000
Balance at the start of the year	240,000		190,000

Note that in the above example it is assumed that the purchases have been made for cash. This might not be the case. If the purchases are on credit the figure must be adjusted for any amounts outstanding at the year end.

Example: Cash paid for property, plant and equipment

PM company has purchased various items of property, plant and equipment on credit during the year. The total purchased was ₦60,000.

The statements of financial position of PM company at the beginning and end of 20X9 include the following information:

Payables:	20X8(₦m)	20X9(₦m)
Suppliers of non-current assets	4,000	12,000

The cash paid to buy property, plant and equipment in the year can be calculated as follows:

	₦m
Additions	60,000
Less: increase in payables that relate to these items	(8,000)
Cash paid in the year	52,000

This can be thought of as the payment of the ₦4,000 owed at the start and a payment of ₦48,000 towards this year's purchases.

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If the payables had decreased the movement would be added to the additions figure to find the cash outflow.

Example: Cash paid for property, plant and equipment

PM company has purchased various items of property, plant and equipment on credit during the year. The total purchased was ₦60,000.

The statements of financial position of PM company at the beginning and end of 20X9 include the following information:

Payables:	20X8(₦m)	20X9(₦m)
Suppliers of non-current assets	14,000	4,000

The cash paid to buy property, plant and equipment in the year can be calculated as follows:

	₦m
Additions	60,000
Plus: decrease in payables that relate to these items	10,000
Cash paid in the year	70,000

This can be thought of as the payment of the ₦14,000 owed at the start and a payment of ₦56,000 towards this year's purchases.

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When there are disposals during the year

When there are disposals of non-current assets during the year, the purchases of non-current assets may be calculated as follows:

Illustration: Movement on non-current assets	₦
Assets at cost at the beginning of the year	X
Disposals during the year (cost)	(X)
	X
Additions to non-current assets (balancing figure)	X
Assets at cost 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)
	X
Additions to non-current assets (balancing figure)	X
Non-current assets at the end of the year at NBV	(X)

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Example: Cash paid for property, plant and equipment with disposals

The motor vehicles of PM Company at the beginning and the end of its financial year were as follows:

	At cost	Accumulated depreciation	Carrying amount
	₦	₦	₦
Beginning of the year	150,000	(105,000)	45,000
End of the year	180,000	(88,000)	92,000

During the year a vehicle was disposed of for again of ₦3,000. The original cost of this asset was ₦60,000. Accumulated depreciation on the asset was ₦45,000.

Additions may be calculated as follows:

	Cost	NBV
Balance at the start of the year	150,000	45,000
Disposals during the year:		
At cost	(60,000)	
At carrying amount: (60,000 – 45,000)		(15,000)
Depreciation (88,000 – (105,000 – 45,000)		(28,000)
	90,000	2,000
Additions (balancing figure)	90,000	90,000
Balance at the end of the year	180,000	92,000

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When there are revaluations during the year

When there are revaluations of non-current assets during the year, the purchases of non-current assets should be calculated 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)
Additions to non-current assets (balancing figure)	X
Non-current assets at the end of the year at NBV	(X)

Property, plant and equipment	**20X8**	**20X9**
	₦	₦
At cost/re-valued amount	1,400,000	1,900,000
Accumulated depreciation	350,000	375,000
Carrying value	1,050,000	1,525,000

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Example (continued)

Additions may be calculated as follows:

	Cost	Carrying amount
	₦	₦
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 the total for revaluation recognised in the year so you may have to add or net both of these amounts.

Revaluation accounting is explained in detail in chapter 7.

When there are other additions during the year

The above example showed the need to take revaluation into account when reconciling the opening and closing balances on non-current assets so as to find the additions figure as a balancing amount.

This applies to other additions too:

Transfers from capital work in progress

a) These are assets constructed by a company for its own use.

b) During the course of construction costs are accumulated in a capital work in progress account and these are transferred into the relevant category of non-current asset on completion.

c) The cash consequence of capital work in progress is estimated as a separate exercise.

d) Transfers into the relevant category of non-current asset on completion show as an addition and so must be taken into account when trying to estimate the cash additions.

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Example:

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 value	1,050,000	1,525,000
Capital work in progress	600,000	620,000

During the year:

Property was revalued upwards by ₦200,000.

An item of equipment was disposed of 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.

The company capitalised ₦200,000 as capital work in progress.

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Example (continued)

Additions may be calculated as follows:

	Cost	Carrying amount
	₦	₦
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
Additions – Transfer from capital WIP (W)	180,000	180,000
	1,520,000	1,145,000
Additions (balancing figure)	380,000	380,000
Balance at the end of the year	1,900,000	1,525,000

Capital work in progress	
Balance at the start of the year	600,000
New WIP capitalised	200,000
	800,000
Transfer to property, plant and equipment (balancing figure)	(180,000)
Balance at the end of the year	620,000

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23.7.2 Cash from disposals of property plant and equipment

A statement of cashflows 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**)	

If there is a gain on disposal, the net cash from the disposal is more than the net book value.

If there is a loss on disposal the net cash from the disposal is less than the net book value.

Example:

During an accounting period, an entity disposed of some equipment and made a gain on disposal of ₦6,000.

The equipment originally cost ₦70,000 and at the time of its disposal, the accumulated depreciation on the equipment was ₦56,000.

What was the amount of cash obtained from the disposal of the asset?

Disposal of equipment	₦
At cost	70,000
Accumulated depreciation, at the time of disposal	(56,000)
Net book value/carrying amount at the time of disposal	14,000
Gain on disposal	6,000
Net disposal value (assumed cashflow)	20,000

This cashflow would be included in the cashflows from investing activities.

Note that in the above example it is assumed that the cash received for the disposal has been received. This might not be the case. If the disposal was on credit the figure must be adjusted for any amounts outstanding at the year end.

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Practice question **3**

At 1 January 20X9, the property, plant and equipment in the statement of financial position of NC Company amounted to ₦329,000 at cost or valuation.

At the end of the year, the property, plant and equipment was ₦381,000 at cost or valuation.

During the year, a non-current asset that cost ₦40,000 (and has not been re-valued) was disposed of at a loss of ₦4,000. The accumulated depreciation on this asset at the time of disposal was ₦21,000.

Another non-current asset was re-valued upwards during the year from ₦67,000 (cost) to ₦102,000.

a) Calculate the following amounts, for inclusion in the cashflows from investing activities section of the company's statement of cashflows for 20X9:

i. Purchases of property, plant and equipment

ii. Proceeds from the sale of non-current assets

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23.7.3 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/(X)
Revaluation	X
Carrying amount at the end of the year	X

The issues to be considered in calculating cash paid for investments or cash received on the sale of investments are very similar to those for the purchase and sale of property, plant and equipment except for the absence of depreciation.

Example: Cash paid for investments

The statements of financial position of Grand Company at the beginning and end of 20X9 include the following information:

	20X8(₦m)	20X9(₦m)
Non-current asset investments	1,000	1,500

Additional information:

The investments were revalued upwards during the year. A revaluation gain of ₦150m has been recognised.

Investments sold for ₦250m resulted in a profit on the sale (measured as the difference between sale proceeds and carrying amount at the date of sale) of ₦50m

The cash paid to buy investments in the period can be calculated as a balancing figure as follows:

	₦m
Investments at the start of the year (given)	1,000
Disposal (carrying amount of investments sold = ₦250m – ₦50m)	(200)
Revaluation gains (given	150
	950
Additions (as balancing figure):	550
Investments at the end of the year (given)	1,500

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26.7.4 Non-cash purchases

IAS 7 states that investing and financing transactions that do not require the use of cash must be excluded from the statement of cash flows, but that details of these transactions should be disclosed somewhere in the financial statements, possibly as a note to the financial statements.

23.8 Cash flows from Financing Activities

23.8.1 Examples of cashflows from financing activities

Examples of cashflows 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

As explained earlier, payments of dividends are also usually included within cashflows from financing activities, in this part of the statement of cashflows. (Some entities may also include interest payments in this section, instead of including them in the section for cashflows from operating activities.)

23.8.2 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:

	₦
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

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Example:

The statements of financial position of Company Pat 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

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)
Cash obtained from issuing new shares in 20X9	450,000

The above example assumes that the only cause of movement on the share capital and share premium account was an issue of shares for cash. A question may provide information about a non-cash movement (e.g., a bonus issue or an issue of shares in exchange for shares in another company). All non-cash movements would need to be taken into account when calculating the cash movement.

Example:

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 x 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.

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23.7.3 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.

a) An increase in loans or bonds means there has been an inflow of cash.

b) 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:

	₦
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.

Example:
The statements of financial position of Company Q at 1 January and 31 December included the following items:

	1 January 20X9	31 December 20X9
	₦	₦
Loans repayable within 12 months	760,000	400,000
Loans repayable after 12 months	1,400,000	1,650,000

The cashflows relating to loans during the year are calculated as follows.

	₦
Loans outstanding at the end of 20X9	2,050,000
Loans outstanding at the beginning of 20X9	2,160,000
=Net loan repayments during the year (=cash outflow)	110,000

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23.8.4 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

	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 N420,000 for the year after taxation.

Required:

Calculate for 20X9, for inclusion in the statement of cashflows:

a) the cash from issuing new shares
b) the cashflows received or paid for loans
c) the payment of dividend to ordinary shareholders

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Suggested solution

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

Cashflows from financing activities can now be presented as follows.

Cashflows 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

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Group statement of cash flows

1. Objective of statements of cash flows

IAS 7 Statement of Cash flows provides guidance on the preparation of a statement of cash flows. The objective of a statement of cash flows is to provide information on an entity's changes in cash and cash equivalents during the period.

The statement of financial position and statement of profit or loss are prepared on an accruals basis and do not show how the business has generated and used cash in the reporting period. The statement of profit or loss may show profits even though the company is suffering severe cash flow problems. A statement of cashflows is therefore important because it enables users of the financial statements to assess the liquidity, solvency and financial adaptability of the business.

Definitions

a) Cash consists of cash in hand and deposits repayable upon demand, less overdrafts. This includes cash held in a foreign currency.

b) Cash equivalents are 'short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value' (IAS 7, para 6).

c) Cash flows are 'inflows and outflows of cash and cash equivalents' (IAS 7, para 6). Group statement of cashflows.

2 Classification of cash flows

IAS 7 does not prescribe a specific format for the statement of cashflows, although it requires that cashflows are classified under one of three headings:

a) **cashflows from operating activities,** defined as the entity's principal revenue earning activities and other activities that do not fall under the next two headings

b) **cashflows from investing activities,** defined as the acquisition and disposal of long-term assets and other investments (excluding cash equivalents)

c) **cashflows from financing activities,** defined as activities that change the size and composition of the entity's equity and borrowings.

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Proforma statement of cashflow per IAS 7

	₦	₦
Cashflows from operating activities		
Profit before tax	X	
Add: finance costs	X	
Less: investment income	(X)	
Less: income from associate	(X)	
Adjust for non-cash items dealt with in arriving at operating profit:		
Add: depreciation	X	
Less: gain on disposal of subsidiary	(X)	
Add: loss on disposal of subsidiary	X	
Add: loss on impairment charged to P/L	X	
Add: loss on disposal of non-current assets	X	
Add: increase in provisions	X	
	X/(X)	
Changes in working capital:		
Increase in inventory	(X)	
Increase in receivables	(X)	
Decrease in payables	(X)	
Cash generated/used from operations	X/(X)	
Interest paid	(X)	
Taxation paid	(X)	
Net cash Inflow/(outflow) from operating activities		X/(X)
Cashflows from investing activities		
Payments to purchase NCA	(X)	
Receipts from NCA disposals	X	
Net cash paid to acquire subsidiary	(x)	
Net cash proceeds from subsidiary disposal	X	
Cash paid to acquire associates	(X)	
Dividend received from associate	X	
Interest received	X	
Net cash inflow/(outflow) from investing activities		

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		X/(X)
Cashflows from financing activities		
Proceeds from share issue	X	
Proceeds from loan or debenture issue	X	
Cash repayment of loans or debentures	(X)	
Lease liability repayments	(X)	
Equity dividend paid by parent	(X)	
Dividend paid to NCI	(X)	
Net cash inflow/(outflow) from financing activities		
		X/(X)
Increase/(decrease) in cash and equivalents		X/(X)
Cash and equivalents brought forward		X/(X)
Cash and equivalents carried forward		X/(X)

Classification of cash flows

Cash flows from operating activities

The key figure within cash flows from operating activities is 'cash generated from operations'. There are two methods of calculating cash generated from operations:

a) The **direct method** shows operating cash receipts and payments, such as cash receipts from customers, cash payments to suppliers and cash payments to and on behalf of employees.

b) The **indirect method** (used in the proforma statement of cash flows presented earlier in the chapter) starts with profit before tax and adjusts it for non-cash charges and credits, deferrals or accruals of past or future operating cash receipts and payments, as well as for items that relate to investing and financing activities. The most frequently occurring adjustments required are:

i. finance costs and investment incomes;

ii. depreciation or amortisation charges in the year;

iii. impairment charged to profit or loss in the year;

iv. profit or loss on disposal of non-current assets;

v. change in inventories;

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vi. change in trade receivables; and

vii. change in trade payables.

IAS 7 permits either method, although encourages the use of the direct method. The methods differ only in respect of how the item 'cash generated from operating activities' is derived. A comparison between the direct and indirect method to arrive at cash generated from operations is shown below:

Direct method:	**₦'m**	**Indirect method:**	**₦'m**
Cash receipts from customers	15,424	Profit before tax	6,022
Cash payments to suppliers	(5,824)	Depreciation charges	899
Cash payments to and on behalf of Employees	(2,200)	Increase in inventories	(194)
Other cash payments	(511)	Increase in receivables	(72)
		Increase in payables	234
Cash generated from operations	6,889	Cash generated from operations	6,889

The principal advantage of the direct method is that it discloses operating cash receipts and payments. Knowledge of the specific sources of cash receipts and the purposes for which cash payments have been made in past periods may be useful in assessing and predicting future cashflows.

Cash flows from investing activities

Cash flows to appear under this heading include:

a) cash paid for property, plant and equipment and other non-current assets;

b) cash received on the sale of property, plant and equipment and other non-current assets;

c) cash paid for investments in or loans to other entities (excluding movements on loans from financial institutions, which are shown under financing); and

d) cash received for the sale of investments or the repayment of loans to other entities (again excluding loans from financial institutions).

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Cash flows from financing activities

Financing cashflows mainly comprise receipts or repayments of principal from or to external providers of finance.

a) receipts from issuing shares or other equity instruments

b) receipts from issuing debentures, loans, notes and bonds and from other long-term and short-term borrowings (other than overdrafts, which are normally included in cash and cash equivalents).

IAS 7 says that financing cash outflows include:

a) repayments of amounts borrowed (other than overdrafts)

b) the capital element of lease payments

c) payments to reacquire or redeem the entity's shares.

Interest and dividends

IAS 7 allows interest and dividends, whether received or paid, to be classified under any of the three headings, provided the classification is consistent from period to period.

The practice adopted in this text is to classify:

a) interest received as a cashflow from investing activities;

b) interest paid as a cashflow from operating activities;

c) dividends received as a cashflow from investing activities; and

d) dividends paid as a cashflow from financing activities.

3 Cash and cash equivalents

The statement of cashflows reconciles cash and cash equivalents at the start of the reporting period to the end of the reporting period.

a) Cash equivalents are **'short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value'** (IAS 7, para 6).

b) 'Cash equivalents' are held in order to meet short-term cash commitments. They are not held for investment purposes.

c) IAS 7 does not define 'readily convertible' but notes that an investment would qualify

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as a cash equivalent if it had a short maturity of **'three months or less from the date of acquisition'** (IAS 7, para 7).

d) Equity investments are generally excluded from being included in cash equivalents because there is a significant risk of a change in value. IAS 7 makes an exception for preference shares with a short period to maturity and a specified redemption date.

Example 1

The accountant for Minted, a company, is preparing a statement of cashflows. She would like advice about whether the following items can be included within 'cash and cash equivalents.

a) An overdraft of ₦100,000.

b) A balance of ₦500,000 held in a high-interest account. Minted must give 28 days' notice in order to access this money, which is held with the intention of meeting working capital shortages.

c) An investment in the ordinary shares of Moolah. The shares are listed and therefore could be sold immediately. The shares have a fair value of ₦1m.

Required:

Advise the accountant of Minted whether the above items qualify as 'cash and cash equivalents'.

SOLUTION 1

To qualify as a cash equivalent, an item must be readily convertible to cash and have an insignificant risk of a change in value. Furthermore, it should be held for the purpose of meeting short-term cash commitments.

Bank overdrafts are an integral part of most company's cash management. They are therefore generally treated as a component of cash.

The balance of ₦500,000 in a high-interest account is readily available (only 28 days' notice is required to access it). This money is also held to meet short-term needs. Assuming that there is not a significant penalty for accessing this money, it should be included within cash equivalents.

The shares are not a cash equivalent. Shares are investments rather than a way of meeting short-term cash requirements. Moreover, there is a significant risk that the value of the shares will change. Any cash spent on shares in the period should be shown within

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cashflows from investing.

Unusual items and non-cash transactions

Unusual cash flows

Where cash flows are unusual because of their size or incidence, sufficient disclosure should be given to explain their cause and nature.

For a cash flow to be unusual on the grounds of its size alone, it must be unusual in relation to cash flows of a similar nature.

Discontinued activities

Cash flows relating to discontinued activities are required by IFRS 5 to be shown separately, either on the face of the statement of cash flows or in a disclosure note.

Major non-cash transactions

Material transactions not resulting in movements of cash should be disclosed in the notes to the statement of cash flows if disclosure is necessary for an understanding of the underlying transactions.

Example 2

Calculate the required cashflows in each of the following scenarios:

(1)	**20X1**	**20X0**
Property, plant and equipment (PPE)	₦ 250	₦ 100

During the year depreciation charged was ₦20, a revaluation surplus of ₦60 was recorded, and PPE with a carrying amount of ₦15 was disposed of. The carrying amount of assets recognised through lease agreements and classified as PPE was ₦30.

Required: How much cash was spent on property, plant and equipment in the period?

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Example 3

	20X1 ₦	20X0 ₦
Deferred tax liability	100	50
Income tax liability	120	100

The income tax charge in the statement of profit or loss was ₦180.

Required:

How much tax was paid in the period?

(3)

	20X1 ₦	20X0 ₦
Retained earnings	300	200

The statement of profit or loss showed a profit for the period of ₦150.

Required:

How much was the cash dividend paid during the period?

Solution 2

i. Property, plant and equipment

	₦
Bal b/fwd.	**100**
Revaluation	**60**
Lease	**30**
Depreciation	**(20)**
Disposals	**(15)**
Additions (bal. fig.)	**95**
Bal c/fwd.	**250**

ii. Tax

	₦
Bal b/fwd. (50 + 100)	**150**
Profit or loss charge	**180**
Tax paid (bal. fig.)	**(110)**

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Bal c/fwd. (100 + 120)	**220**

iii. Retained earnings

	₦
Bal b/fwd.	**200**
Profit or loss	**150**
Dividend paid (bal. fig.)	**(50)**
Bal c/fwd.	**300**

Illustration – Single entity statements of cash flows

Below are the financial statements of Single for the year ended 30 September 20X2:

Statement of financial position as at 30 September 20X2 (including comparatives)

	20X1 ₦'m	20X0 ₦'m
Non-current assets		
Property, plant & equipment	90	60
Current assets		
Inventories	32	20
Trade receivables	20	27
Cash and cash equivalents	8	12
	150	119
Equity and liabilities		
Share capital (₦1 shares)	30	5
Retained earnings	60	35
	90	40
Non-current liabilities:		
Loans	10	29
Deferred tax	15	14
Current liabilities:		
Trade payables	23	25
Tax payable	12	11
	150	119

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Statement of profit or loss for the year ended 30 September 20X2

	₦'m
Revenue	**450**
Operating expenses	**(401)**
Profit from operations	**49**
Finance cost	**(3)**
Profit before tax	**46**
Tax	**(12)**
Profit for the period	**34**

Notes

a) Property, plant and equipment with a carrying amount of ₦9 million was disposed of for cash proceeds of ₦13 million. Depreciation for the year was ₦17 million.

b) Trade payables as at 30 September 20X2 includes accruals for interest payable of ₦4 million (20X1: ₦5 million).

Required:

Prepare the statement of cash flows for Single for the year ended 30 September 20X2.

Solution

Statement of cash flows

	₦m	₦m
Cashflows from operating activities		
Profit before tax	**46**	
Finance cost	**3**	
Depreciation	**17**	
Profit on disposal of PPE (₦13 – ₦9)	**(4)**	
Increase in inventories (₦32 – ₦20)	**(12)**	
Decrease in receivables (₦20 – ₦27)	**7**	
Decrease in payables ((₦23 – ₦4) – (₦25 – ₦5))	**(1)**	
	56	
Interest paid (W1)	**(4)**	
Tax paid (W2)	**(10)**	

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		42
Cashflows from investing activities		
Proceeds from sale of PPE	**13**	
Purchases of PPE (W3)	**(56)**	
		(43)
Cashflows from financing activities		
Proceeds from shares (₦30 – ₦5)	**25**	
Repayment of loans (₦10 – ₦29)	**(19)**	
Dividends paid (W4)	**(9)**	
		(3)
Decrease in cash and cash equivalents		**(4)**
Opening cash and cash equivalents		**12**
Closing cash and cash equivalents		**8**

Workings

(W1) **Interest**

	₦'m
Balance b/fwd.	**5**
Profit or loss	**3**
Cash paid (bal. fig.)	**(4)**
Balance c/fwd.	**4**

(W2) **Tax**

	₦'m
Balance b/fwd. (₦14 + ₦11)	**25**
Profit or loss	**12**
Cash paid (bal. fig.)	**(10)**
Balance c/fwd. (₦15 + ₦12)	**27**

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(W3) **PPE**

	₦'m
Balance b/fwd.	**60**
Depreciation	**17**
Disposal	**(9)**
Cash paid (bal. fig)	**56**
Balance c/fwd.	**90**

(W4) **Retained earnings**

	₦'m
Balance b/fwd.	**35**
Profit or loss	**34**
Cash dividends paid (bal. fig.)	**(9)**
Balance c/fwd.	**60**

Preparation of a consolidated statement of cash flows

A consolidated statement of cash flows shows the cash flows between a group and third parties. It is prepared using the consolidated statement of financial position and the consolidated statement of profit or loss. This means that intra-group transactions have already been eliminated.

When producing a consolidated statement of cashflows, there are three extra elements that need to be considered:

a) acquisitions and disposals of subsidiaries;

b) cash paid to non-controlling interests; and

c) associates.

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Acquisitions and disposals of subsidiaries

Acquisitions

a) In the statement of cashflows we must record the actual cashflow for the purchase of the subsidiary net of any cash held by the subsidiary that is now controlled by the group.

b) The assets and liabilities of the acquired subsidiary must be included in any workings to calculate the cash movement for an item during the year.

Illustration – Acquisition of a subsidiary

Sparkling buys 70% of the equity shares of Still for ₦500,000 in cash. At the acquisition date, Still had cash and cash equivalents of ₦25,000.

Although Sparkling paid ₦500,000 for the shares, it also gained control of Still's cash of ₦25,000. In the consolidated statement of cashflows, this would be presented as follows:

Cashflows from investing activities

	₦000
Acquisition of subsidiary, net of cash acquired (₦500,000 – ₦25,000)	(475)

Disposals

• The statement of cashflows will show the cash received from the sale of the subsidiary, net of any cash held by the subsidiary that the group has lost control over.

• The assets and liabilities of the disposed subsidiary must be included in any workings to calculate the cash movement for an item during the year.

Sparkling owned 80% of the equity shares of Fizzy. During the period, these shares were sold for ₦800,000 in cash. At the disposal date, Fizzy had cash and cash equivalents of ₦70,000.

Although Sparkling received ₦800,000 for the shares, it lost control of Fizzy's cash of ₦70,000. In the consolidated statement of cashflows, this would be presented as follows:

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Cash flows from investing activities

	₦000
Disposal of subsidiary, net of cash disposed of (₦800,000 – ₦70,000)	730

Illustration 1 – Acquisitions and disposals

Extracts from a group statement of financial position are presented below:

	20X8 ₦'000	20X7 ₦'000
Inventories	74,666	53,019
Trade receivables	58,246	62,043
Trade payables	93,678	86,247

During 20X8, Subsidiary A was acquired and all shares in Subsidiary B were disposed of. Details of the working capital balances of these two subsidiaries are provided below:

	Working capital of Subsidiary A at acquisition ₦'000	**Working capital of Subsidiary B at disposal ₦'000**
Inventories	4,500	6,800
Trade receivables	7,900	6,700
Trade payables	8,250	5,740

Required:

Calculate the movement in inventories, trade receivables and trade payables for inclusion in the group statement of cash flows.

Solution

The net assets of Subsidiary A are being consolidated at the end of the year, but they were not consolidated at the start of the year. Conversely, the net assets of Subsidiary B are not consolidated at the end of the year, but they were consolidated at the start of the year. The working capital balances brought forward and carried forward are therefore not directly comparable.

Comparability can be achieved by calculating the movement between the closing and opening figures and then:

• Deducing the subsidiary's balances at the acquisition date for a subsidiary acquired during

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the year.

• Adding the subsidiary's balances at the disposal date for a subsidiary disposed of during the year.

	Inventories ₦'000	Trade Receivables ₦'000	Trade payables ₦'000
Bal c/fwd	74,666	58,246	93,678
Bal b/fwd.	(53,019)	(62,043)	(84,247)
	21,647	3,787	7,431
Less: Sub acquired in year	(4,500)	(7,900)	(8,250)
Add: Sub disposed in year	6,800	6,700	5,740
Movement in the year	23,947	(4,997)	4,921
Impact on cash flow	Outflow	Inflow	Inflow

Cash paid to non-controlling interests

• When a subsidiary that is not wholly owned pays a dividend, some of that dividend is paid outside of the group to the non-controlling interest.

• Dividends paid to non-controlling interests should be disclosed separately in the statement of cash flows.

• To calculate the dividend paid, reconcile the non-controlling interest in the statement of financial position from the opening to the closing balance. You can use a T-account or a schedule to do this.

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Illustration 2 – Cash paid to NCI

The following information has been extracted from the consolidated financial statements of WG, which has a year end of the 31 December:

	20X7 ₦'000	20X6 ₦'000
Statement of financial position		
Equity:		
Non-controlling interest	**780**	**690**
Statement of profit or loss		
Profit for the period attributable to the non-controlling interest	**120**	**230**

During the year, WG bought a 70% shareholding in CC. WG uses the full goodwill method for all subsidiaries. The fair value of the non-controlling interest in CC at the acquisition date was ₦60,000.

During the year, WG disposed of its 60% holding in TT. At the acquisition date, the fair value of the NCI and the fair value of TT's net assets were ₦35,000 and ₦70,000 respectively. The net assets of TT at the disposal date were ₦100,000.

Required:

What is the dividend paid to non-controlling interest in the year ended 31 December 20X7?

Solution

	₦'000
NCI b/fwd.	690
NCI re sub acquired in year	60
NCI share of profit for the year	120
NCI derecognised due to subsidiary disposal (W1)	(47)
Cash dividend paid in year (bal. fig)	(43)
NCI c/fwd.	780

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(W1) **NCI at date of TT disposal**

	₦'000
FV of NCI at acquisition	35
NCI % of post-acquisition net assets 40% × (₦100,000 – ₦70,000)	12
	47

Associates

An associate is a company over which an investor has significant influence. Associates are not part of the group and therefore cash flows between the group and the associate must be reported in the statement of cash flows.

Cash flows relating to associates that need to be separately reported within the statement of cashflows are as follows:

• dividends received from an associate

• loans made to associates

• cash payments to acquire associates

• cash receipts from the sale of associates.

These cash flows should be presented as cash flows from investing activities.

Remember, associates are accounted for using the equity method. This means that, in the consolidated statement of profit or loss, the group records its share of the associate's profit for the year. This is a non-cash income and so must be deducted in the reconciliation between profit before tax and cash generated from operations.

Illustration 3 – Associates

The following information is from the consolidated financial statements of H:

Extract from consolidated statement of profit or loss for year ended 31 December 20X1

	₦'000
Profit from operations	734
Share of profit of associate	48
Profit before tax	782
Tax	(304)
Profit for the year	478

Extracts from consolidated statement of financial position as at 31 December 20X1 (with comparatives)

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	20X1 ₦'000	20X0 ₦'000
Non-current assets		
Investment in associate	466	456
Loan to associate	380	300

Required:

Calculate the relevant figures to be included in the group statement of cash flows for the year ended 31 December 20X1.

Solution

Extracts from statement of cash flows

	₦'000
Cash flows from operating activities	
Profit before tax	782
Share of profit of associate	(48)
Investing activities	
Dividend received from associate (W1)	38
Loan to associate (380 – 300)	(80)

(W1) **Dividend received from associate**

When dealing with the dividend from the associate, the process is the same as we have already seen with the non-controlling interest.

Set up a schedule or T account and include all the balances that relate to the associate. The balancing figure will be the cash dividend received from the associate.

	₦'000
Balance b/fwd.	456
Share of profit of associate	48
Cash dividend received **(Bal fig)**	(38)
Balance c/fwd.	466

Test your understanding 3 – The Z group

The following information is from the consolidated financial statements of Z:

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Extract from consolidated statement of profit or loss for year ended 31 December 20X1

	₦'000
Profit from operations	900
Share of profit of associate	15
Profit before tax	915
Tax	(200)
Profit for the year	715

Extracts from consolidated statement of financial position as at 31 December 20X1 (with comparatives)

	20X1 ₦'000	20X0 ₦'000
Non-current assets:		
Investment in associate	600	580

During the year, Z received dividends from associates of ₦5,000.

Required:

Based on the above information, prepare extracts showing relevant figures to be included in the group statement of cash flows for the year ended 31 December 20X1.

Test your understanding 3 – The Z group

Extracts from statement of cash flows

	₦'000
Cashflows from operating activities	
Profit before tax	915
Share of profit of associate	(15)
Cashflows from investing activities	
Dividend received from associate	5
Cash paid to acquire associates (W1)	(10)

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(W1) **Associate**

	₦'000
Balance b/fwd	580
Share of profit of associate	15
Cash dividend received	(5)
Cash spent on investments in associates (bal. fig)	10
Balance c/fwd	600

Practice Questions

Calculate the required cash flows in each of the following scenarios:

1.

	20X1 ₦	20X0 ₦
Non-controlling interest	840	440

The group statement of profit or loss and other comprehensive income reported total comprehensive income attributable to the non-controlling interest of ₦500.

Required:

How much was the cash dividend paid to the non-controlling interest?

2.	20X1 ₦	20X0 ₦
Non-controlling interest	850	500

The group statement of profit or loss and other comprehensive income reported total comprehensive income attributable to the non-controlling interest of ₦600.

Required:

How much was the cash dividend paid to the non-controlling interest?

	20X1 ₦	20X0 ₦
Investment in associate	500	200

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The group statement of profit or loss reported 'share of profit of associates' of ₦750.

Required:

How much was the cash dividend received by the group?

	20X1 ₦'000	20X0 ₦'000
Investment in associate	3,200	600

The group statement of profit or loss reported 'share of profit of associates' of ₦4,000.

In addition, the associate revalued its non-current assets during the period. The group share of this gain is ₦500.

Required:

How much was the cash dividend received by the group?

	20X1 ₦'000	20X0 ₦'000
Property, plant and equipment (PPE)	500	150

During the year depreciation charged was ₦50, and the group acquired a subsidiary which held PPE of ₦200 at the acquisition date.

Required:

How much cash was spent on property, plant and equipment in the period?

Solution

(1) **Non-controlling interest**

	₦
Bal b/fwd.	**400**
Total comprehensive income	**500**
Dividend paid (bal. fig.)	**(100)**
Bal c/fwd.	**840**

(2) **Non-controlling interest**

	₦
Bal b/fwd.	**500**
Total comprehensive income	**600**

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Dividend paid (bal. fig.)	**(250)**
Bal c/fwd.	**850**

(3) **Associate**

	₦
Bal b/fwd.	**200**
Profit or loss	**750**
Dividend received (bal. fig.)	**(450)**
Bal c/fwd.	**500**

(4) Associate

	₦
Bal b/fwd.	**600**
Profit or loss	**4,000**
Revaluation	**500**
Dividend received (bal. fig.)	(1,900)
Bal c/fwd.	3,200

(5) Property, plant and equipment

	₦
Bal b/fwd.	**150**
New subsidiary	**200**
Depreciation	**(50)**
Additions (bal. fig.)	200
Bal c/fwd.	500

23.9 Chapter review

Chapter review

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

a) prepare extracts from a statement of cash flow; and

b) prepare a statement of cash flow.

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SOLUTIONS TO PRACTICE QUESTIONS

Solutions 1

(a) In the adjustments to get from the operating profit to the cash flows from operations, the loss on disposal of ₦8,000 should be added.

(b) Under the heading 'Cash flows from investing activities', the sale price of the vehicle of ₦22,000 should be included as a cash inflow.

Workings:

Original cost of vehicle	50,000
Accumulated depreciation at date of disposal	(20,000)
Net book value at the time of disposal	30,000
Loss on disposal	(8,000)
Therefore, net sales proceeds	22,000

Solutions 2

	₦
Profit before taxation	
Adjustments for: Depreciation	
Interest charges	
Gain on disposal of non-current asset	
Reduction in trade and other receivables	
Increase in inventories	
Reduction in trade payables	
Taxation paid Interest charges paid	
Cash flows from operating activities	49,000

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Solutions **3**

Property, plant and equipment purchases	₦
At cost or valuation at the end of the year	381,000
At cost or valuation at the beginning of the year	329,000
	52,000
Add: Cost of assets disposed of in the year	40,000
Subtract: Asset revaluation during the year (102,000 – 67,000)	(35,000)
Purchases during the year	57,000

Disposal of equipment	₦
At cost	40,000
Accumulated depreciation, at the time of disposal	(21,000)
Net book value/carrying amount at the time of disposal	19,000
Loss on disposal	4,000
Net disposal value (= assumed cash flow)	15,000

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23.10 End of chapter questions and suggested solutions

23.10.1 Questions

Question 1

Financial statements and extract from the cashbook of Obudu Nigeria Limited for the year ended December 31, 2020 are summarised below:

Obudu Nigeria Limited
Statement of profit or Loss for the year ended December 31, 2020

	₦'000
Revenue	169,314
Cost of sales	(102,798)
Gross profit	66,516
Investment income	15,000
Expenses:	
Depreciation	(7,650)
Salaries and wages	(4,712)
Other cash expenses	(7,594)
Loss on disposal of equipment	(2,061)
Interest expense	(3,375)
Profit before taxation	56,124
Income tax expense	(16,988)
Profit for the year	39,136

Obudu Nigeria Limited

Statement of financial position as at December 31

	2020	2019
Non-current assets:	**₦'000**	**₦'000**
Property, plant and equipment	98,550	86,400
Current assets:		
Inventories	21,308	11,363
Trade receivables	22,703	14,063
Cash and bank	5,940	7,088
Trade investments	675	1,238
	149,176	120,152
Equity and liabilities:		
Ordinary share capital of ₦1 each	28,125	22,500
Retained earnings	40,111	21,600
	68,236	44,100
Non-current liabilities		
8% loan notes	33,750	40,500
Current liabilities		
Trade payables and accruals	35,375	30,240
Taxation	11,815	5,312
	149,176	120,152

Obudu Nigeria Limited

Cash book extract for the year ended December 31, 2020

	Bank	Cash
Receipts:	**₦'000**	**₦'000**
Opening balance b/f	5,500	1,588
Receipts from customers	153,602	8,087
Sale of investment	563	-
Transfer from cash	4,500	-
Disposal of equipment	1,600	1,019
Proceeds from issue of shares	5,625	-
	171,390	10,694
Payments:		
Salaries and wages	2,000	2,712
Other expenses	5,462	2,132
Payment to trade suppliers	108,623	-
Purchase of motor vehicles	22,230	-
Dividends paid	9,000	-
Transfer to bank	-	4,500
Interest paid	2,250	-
Tax paid	10,485	-
Redemption of 8% loan notes	6,750	-
Balance c/f	4,590	1,350
	171,390	10,694

Other Information

(i) The 8% loan notes have been partly redeemed. It is expected that the full redemption will be made in five years time.

(ii) A cash payment for insurance of ₦1million was omitted in the cash book and other records.

(iii) The investments are not easily realisable.

Required:

a. Prepare the statement of cash flows for the year ended December 31, 2020 using the direct method in accordance with IAS 7. (9 Marks)

b. Prepare a statement of reconciliation of the operating profit to cash flow from operations. (5 Marks)

c. Discuss the benefits of statement of cash flows information to users of financial statements. (6 Marks)

Question 2

AH Group

Extracts from the consolidated financial statements of the AH Group for the year ended 30 June 20X5 are given below:

Consolidated statement of profit or loss for the year ended 30 June 20X5

	₦'000
Revenue	85,000
Cost of sales	(60,750)
Gross profit	24,250
Operating expenses	(5,650)
Profit from operations	18,600
Finance cost	(1,400)
Profit before disposal of property	17,200
Disposal of property (note 2)	1,250
Profit before tax	18,450
Tax	(6,250)
Profit for the period	12,200
Attributable to:	
Non-controlling interest	405
Owners of the parent	11,795
	12,200

Note: There were no items of other comprehensive income.

Statement of financial position, with comparatives, at 30 June 20X5

	₦'000	20X5 ₦'000	₦'000	20X4 ₦'000
Non-current assets				
Property, plant and equipment	50,600		44,050	
Goodwill (note 3)	5,910		4,160	

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		56,510		48,210
Current assets				
Inventories	33,500		28,750	
Trade receivables	27,130		26,300	
Cash and cash equivalents	1,870		3,900	
		62,500		58,950
		119,010		107,160
Equity and liabilities	₦'000	₦'000	₦'000	₦'000
Equity shares	20,000		18,000	
Share premium	12,000		10,000	
Retained earnings	24,135		18,340	
		56,135		46,340
Non-controlling interest		3,875		1,920
Total equity		60,010		48,260
Non-current liabilities				
Interest-bearing borrowings		18,200		19,200
Current liabilities				
Trade payables	33,340		32,810	
Interest payables	1,360		1,440	
Tax	6,100		5,450	
		40,800		39,700
		119,010		107,160

Notes:

(a) Several years ago, AH acquired 80% of the issued equity shares of its subsidiary, BI. The NCI at the acquisition date was valued using the proportion of net assets method. Several years ago, AH acquired 80% of the issued equity shares of its subsidiary, BI. The NCI at the acquisition date was valued using the proportion of net assets method.

On 1 January 20X5, AH acquired 75% of the issued equity shares of CJ in exchange for a fresh issue of 2 million of its own ₦1 equity shares (issued at a premium of ₦1 each) and ₦2 million in cash. The net assets of CJ at the date of acquisition were assessed as having the following fair values:

	₦'000
Property, plant and equipment	4,200
Inventories	1,650
Trade receivables	1,300
Cash and cash equivalents	50
Trade payables	(1,950)
Tax	(250)
	5,000

Goodwill relating to the acquisition of entity CJ during the year was calculated on the full goodwill basis. On 1 January 20X5 when CJ was acquired, the fair value of the non-controlling interest was ₦1,750,000.

Any impairments of goodwill during the year have been accounted for within operating expenses.

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(2) During the year, AH disposed of property, plant and equipment for proceeds of ₦2,250,000. The carrying value of the asset at the date of disposal was ₦1,000,000. There were no other disposals of property, plant and equipment. Depreciation of ₦7,950,000 was charged to the consolidated statement of profit or loss in the year.

Required:
Prepare the consolidated statement of cashflows of the AH Group for the year ended 30 June 20X5 using the indirect method.

23.10.2 Suggested solutions

Solution 1

(a) **Obudu Nigeria Limited**

Statement of cash flows for the year ended December 31, 2020 using the direct method

Operating Activities:	**₦000**	**N'000**
Cash received from customers (153,602 + 8,087)		161,689
Cash paid to suppliers		(108,623)
Cash paid to employees (2,000 + 2,712)		(4,712)
Cash paid for other expenses (5,462 + 2,132 + 1,000)		(8,594)
Cash flows from operations		39,760
Interest paid		(2,250)
Taxation paid		(10,485)
Net cash flows from operating activities		27,025
Investing activities:		
Proceeds from disposal of investment	563	
Proceeds from disposal of equipment (1,600 + 1,019)	2,619	
Purchase of motor vehicles by cash	(22,230)	
Net cash flows from investing activities		(19,048)
Financing activities:		
Proceeds from issue of shares	5,625	
Redemption of 8% loan notes	(6,750)	
Dividend paid by cash	(9,000)	
Net cash flows from financing activities		(10,125)
Net Increase in cash and cash equivalents for the year		(2,148)
Cash and cash equivalents at the beginning (5,500 + 1,588)		7,088
Cash and cash equivalent at the end (4,590 + 1,350 - 1,000)		4,940

	₦'000
Note I – cash/bank balance in statement of financial position	5,940
Less – Omitted payment for Insurance	(1,000)
	4,940

(b) Obudu Nigeria Limited

Reconciliation of operating profit to cash flow from operation

Operating activities:	₦000	₦000
Profit before taxation		56,124
Add (Less) Adjustments:		
Insurance expenses omitted	(1,000)	
Investment income	(15,000)	
Interest expenses	3,375	
Depreciation	7,650	
Loss on disposal of equipment	2,061	(2,914)
Cashflows from operations before working capital		53,210
Working capital changes:		
Increase in inventories (11,363 - 21,308)	(9,945)	
Increase in trade receivables (14,063 - 22,703)	(8,640)	
Increase in trade payables and accruals (35,375 - 30,240)	5,135	(13,450)
Cash flows from operations		39,760
Interest paid		(2,250)
Taxation Paid		(10,485)
Net cashflows from operating activities		27,025

(c) Benefits of statement of cashflows information to users of financial statements

i. Where the direct method is used in preparing the statement of cashflows, it reveals information which are not available in any other financial statement.

ii. A statement of cashflows provides information which helps users to evaluate changes in the net assets of an entity and in its financial structure (including its liquidity and solvency).

iii. It provides information that helps users to assess the ability of the entity to determine the amount and timing of its cashflows in order to adapt to changing circumstances and unexpected opportunities.

iv. It is useful in assessing the ability of the entity to generate cash and cash equivalents.

v. It helps users of accounts to compare the performance of different entities because unlike profits, comparisons of cashflows are not affected by the different accounting policies used by different entities.

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vi. Historical cashflows are often a fairly reliable indicator of the amount, timing and certainty of future cashflows.

vii. The statement brings into sharp contrast the entity's earning capacity with its spending activity.

viii. Focus on cashflows explains the nature of the events which have affected the cash movements.

SOLUTION 2
AH Group
Consolidated statement of cash flows for the year ended 30 June 20X5

	₦'000	₦'000
Cash flows from operating activities		
Profit before tax	18,450	
Less: profit on disposal of property (2,250 – 1,000)	(1,250)	
Add: finance cost	1,400	
Adjustment for non-cash items dealt with in arriving at operating profit:		
Depreciation	7,950	
Decrease in trade receivables (27,130 – 26,300 – 1,300)	470	
Increase in inventories (33,500 – 28,750 – 1,650)	(3,100)	
Decrease in trade payables (33,340 – 32,810 – 1,950)	(1,420)	
Goodwill impaired (W5)	1,000	
Cash generated from operations	23,500	
Interest paid (W1)	(1,480)	
Income taxes paid (W2)	(5,850)	
Net cash from operating activities		16,170
Cash flows from investing activities		
Acquisition of subsidiary net of cash acquired (2,000 – 50)	(1,950)	
Purchase of property, plant, and equipment (W3)	(11,300)	
Proceeds from sale of property	2,250	
Net cash used in investing activities		
Cash flows from financing activities		
Repayment of long-term borrowings (18,200 – 19,200)	(1,000)	
Dividend paid by parent (W7)	(6,000)	
Dividends paid to NCI (W6)	(200)	
Net cash used in financing activities		(7,200)
Net decrease in cash and cash equivalents		(2,030)
Cash and cash equivalents at 1 July 20X4		3,900
Cash and cash equivalents at 30 June 20X5		1,870

(W1) **Interest paid**

	₦'000
Bal b/fwd.	1,440
Profit or loss	1,400
Interest paid (bal. fig.)	(1,480)
Bal c/fwd.	1,360

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(W2) **Income taxes paid**

	₦'000
Bal b/fwd.	5,450
Profit or loss	6,250
New subsidiary	250
Tax paid (bal. fig.)	(5,850)
Bal c/fwd.	6,100

(W3) **Property, plant and equipment**

	₦'000
Bal b/fwd.	44,050
New subsidiary	4,200
Depreciation	(7,950)
Disposals	(1,000)
Additions (bal. fig.)	11,300
Bal c/fwd.	50,600

(W4) **Goodwill arising on acquisition of subsidiary**

	₦'000
Fair value of shares issued (2m × ₦2)	4,000
Cash consideration	2,000
	6,000
Fair value of NCI at acquisition	1,750
	7,750
Fair value of net assets at acquisition	(5,000
Goodwill at acquisition	2,750

(W5) **Goodwill**

	₦'000
Bal b/fwd.	4,160
Goodwill on sub acquired (W4)	2,750
Impairment in year (bal. fig.)	(1,000)
Bal c/fwd.	5,910

(W6) **Non-controlling interest**

	₦'000
Bal b/fwd.	1,920
NCI arising on subsidiary acquired	1,750
Profit or loss	405
Dividend paid (bal. fig.)	(200)
Bal c/fwd.	3,875

(W7) **Retained earnings**

	₦'000
Bal b/fwd.	18,340
Profit or loss	11,795
Dividend paid (bal. fig.)	(6,000)
Bal c/fwd.	24,135

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Skills Level
Financial Reporting

CHAPTER 24

IAS 33: EARNINGS PER SHARE

Contents

24.0 Learning objective
24.1 Learning outcomes
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24 Earnings Per Share

24.0 Learning objective

This chapter covers the computation of Earnings Per Share in accordance with IAS 33.

24.1 Learning outcomes

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

a) explain why a standard calculation of earnings per share is important;

b) calculate basic earnings per share; and

c) calculate diluted earnings per share.

24.2 P/E ratio and earnings per share (EPS)

24.2.1 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

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that investors can obtain a reliable comparison between the EPS and P/E ratios of different companies.

24.2.2 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:

a) the calculation of EPS; and

b) 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:

a) different entities in the same reporting period; and

b) the same entity for different reporting periods overtime.

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

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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 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:

a) financial liabilities or equity instruments that are convertible into new ordinary shares at some time in the future (convertible debentures, convertible preference shares);

b) 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;

c) 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.

24.3 Calculating Basic Eps

24.3.1 Basic EPS

The calculation of the basic 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

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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.

24.3.2 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 the profit or loss from continuing operations as stated above.

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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 is already deducted from the profit or loss from continuing operations 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 share holders	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 31 December Year 1 are as follows if the preference shares are classified as liabilities:

	Earning (₦)	Number of shares	EPS (₦)
Profit from continuing operations	3,000,000	1,000,000	3.0
Profit attributable to ordinary share holders	3,500,000	1,000,000	3.5

X Ltd's basic EPS calculations for the year ended 31 December 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 attributable to ordinary shareholders (3,500,000 – 65,000)	3,435,000	1,000,000	3.44

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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:

$$EPS = \frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

$$= \frac{₦3{,}500{,}000 - ₦\ 100{,}000}{1{,}000{,}000} = ₦3.4 \text{ per share}$$

23.3.3 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:

a) Issues for full consideration (issue (or redemption) of shares at a full market price).

b) Issues for no consideration (issue (or redemption) of shares with no change in net assets), for example:

   i. bonus issues;

   ii. share splits (where one share is split into several others);

   iii. reverse share splits;

   iv. bonus elements in other issues (see later discussion on rights issues).

   v. 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.

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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	x 3/12	1,250,000
New issue on the 1 April	1,000,000		
1 April to 30 June	6,000,000	x 3/12	1,500,000
New issue on the 1 July	1,000,000		
1 July to 31 October	7,000,000	x 4/12	2,333,333
New issue on the 1 November	500,000		
1 November until 31 December	7,500,000	x 2/12	1,250,000
			6,333,333

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24.3.4 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	x 3/12	1,500,000
New issue on the 1 April	1,000,000		
1 April to 31 December	7,000,000	x 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.

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24.3.5 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 or 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 x 5/4 = 5,000,000

The above example is very straightforward, but it illustrates an approach of wider applicability.

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Example: Bonus issue

Company C has a 31 December financial year end. On 1January

Year 5 it has 4,000,000 shares in issue. On1July 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.

	Year5	Year4
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.

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:

Weighted

Date	**Number of shares**	**Time factor**	**Bonus fraction**	**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 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: ₦20,000,000/5,000,000shares = ₦4 per share.

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In the above example nothing changed between Year 4 and Year 5 except for the number of shares yet the EPS figures calculate indicate a 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:

a) the current period's shares are adjusted as if the bonus shares were issued on the first day of the year; and

b) 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 x 4/5= ₦4 per share

The figures presented in Company C's Year 5 accounts would be:

	Year5	Year4
Earnings per share		₦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 31March Year 2, it issued 500,000 ordinary shares, at full market price. On 1JulyYear 2, Company D made a 1 for 2 bonus issue.

In Year 1, the EP Shad 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 Year1.

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24.3.6 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.

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Example:

Company E had 3,600,000 shares in issue on 1 January Year 2.

It made a 1for 4 rights issue on1JuneYear 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

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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 31December Year 7, total earnings were ₦17,468,750. In Year 6 EP Shad 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.

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24.4 Diluted Eps

24.4.1 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.

24.4.2 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.

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The weighted average number of shares must also be adjusted. The method of making this adjustment is different for:

a) convertible bonds or convertible preference shares; and

b) share options or warrants.

24.4.3 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.

a) For **convertible preference shares**, add back the preference dividend paid in the year. Total earnings will be increased by the preference dividend saved.

b) 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.

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Example: Diluted EPS (convertible bonds)

Company G has12,000,000 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 31December 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 x 30/100	1,200,000		
Add back interest:			
5% x ₦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.

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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 31December 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 x 25/100 x 9/12	375,000		
Add back interest: 6% x ₦2,000,000 x 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

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24.4.3 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.

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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 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 x ₦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= ₦4.85pershare

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).

a) When the exercise price of the option is less than the share price they are said to be ***in the money***.

b) 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).

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24.4.5 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 K 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 ₦100ofbonds
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%	

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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
	₦		₦	
Option	0	150,000	0.00	1st
Convertible bonds				
4%×₦5,000,000	200,000			
less tax 30%	(60,000)			
	140,000			
₦5,000,000 x 40/100		2,000,000		
	140,000	2,000,000	0.07	2nd
Preference shares				
7% × ₦1,000,000	70,000			
100,000 x 1/20		5,000		
	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

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The convertible preference shares are not dilutive, and the reported diluted EPS should be ₦2.12 (and not ₦2.13).

24.5 IAS33: Presentation and Disclosure Requirements

24.5.1 Presentation requirements

The following must be presented in the statement of comprehensive income:

a) basic EPS and diluted EPS for profit (or loss) attributable to the ordinary shareholders; and

b) 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:

a) the EPS and diluted EPS should be shown in this statement, and

b) not in the statement of profit or loss and other comprehensive income.

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).

24.5.2 Disclosure requirements

IAS 33 also requires disclosure in a note to the financial statements of the following:

a) 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

b) 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.

24.5.2 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.

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If an alternative EPS figure is presented, IAS 33 states that:

a) 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

b) the alternative EPS must use the same weighted average number of shares as the IAS 33 calculation

c) basic and diluted EPS should both be disclosed with equal prominence, and

d) the alternative figure must only be shown in the notes, **not** on the face of the statement of profit or loss.

24.6 Earnings Per Share ss a Performance Measure

24.6.1 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 this make it difficult for users 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.

a) 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.

b) 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.

c) 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.

d) Diluted EPS can provide an 'early warning' of any changes to an investor's potential return on their investment due to future share issues.

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.

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However, EPS can have serious limitations:

a) Not all entities use the same accounting policies. It may not always be possible to make meaningful comparisons between the EPS of different entities.

b) EPS does not take account of inflation, so that growth in EPS over time might be misleading.

c) 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.

d) 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.

The problem is mitigated in a number of ways.

a) Rules in IFRS require disclosure of significant accounting policies and the standardisation of the calculation of IFRS. This means that users have access to information about the basis of the calculation of the EPS figure.

b) It is difficult to imagine that a company would publish EPS information prepared by anyone other than a qualified accountant. Users can take comfort from the fact that members of ICAN are governed by a strict ethical code which, if followed, would prevent the use of creative accounting techniques. Members of other institutes are bound by ethical requirements.

c) The problem could be further mitigated by educating users not to rely on this single measure. Note that investment professionals would not base advice and decisions on a single measure.

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Chapter review

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

a) explain why a standard calculation of earnings per share is important;

b) calculate basic earnings per share; and

c) calculate diluted earnings per share.

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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 1October to the end of the year (three months) is12,000,000. 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= ₦24pershare.

TheYear1EPS restated as: ₦30×2/3= ₦20.

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Solution **3**

After the rights issue, there will be 1 new share for every 2 shares previously in issue

		₦
Theoretical ex-rights price		
1 existing shares have a 'cum rights' value of	(2 ×₦50)	100
1 new share is issued for		20
2 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.

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24.8 End the chapter questions and suggested solutions

24.8.1 Questions

QUESTION 1

In the evaluation of a company's financial performance, investors rely on a range of key indicators to assess profitability, valuation, and future growth potential. Among these, **Earnings Per Share (EPS)** and the **Price-Earnings Ratio (PE Ratio)** stand out as fundamental metrics that provide critical insights into a company's financial health and market perception.

(a) Explain the following, stating their importance to investors in the evaluation of financial performance:

i. Earnings per share (EPS)

ii. Price earnings ratio (PE-ratio)

(b) The issued and fully paid share capital of Almond Nigeria Limited which has remained unchanged since the date of incorporation until the financial year ended March 31, 2015 include the following:

i. 2,400,000,000 ordinary shares

ii. 600,000,000 6% participating preference share of ₦1 each.

(c) The company has been operating at a profit for a number of years. As a result of a very conservative dividend policy in the previous years, there is a large accumulated profit balance on the statement of financial position.

On July 1, 2015, the directors decided to issue to all ordinary shareholders two bonus shares for every one previously held.

The following is the extract of group statement of profit or loss and other comprehensive income for the year ended March 31, 2016.

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Almond Nigeria Limited
Extract of Group Statement of Profit or Loss and other Comprehensive Income for the year ended March 31, 2016

	2016	2015
	₦'000	₦'000
Profit for the year	740,000	540,000
Other comprehensive income	--	(20,000)
Total comprehensive income	740,000	520,000
Total comprehensive income attributable to:		
Owners of parent	680,000	480,000
Non-controlling interest	60,000	40,000
	740,000	520,000

The following dividend have been paid or declared at the end of the period.

	2016	2015
	₦'000	₦'000
Ordinary	330,000	240,000
Preference	69,000	60,000

The participating preference shareholders are entitled to share profit in the same ratio in which they share dividends after payment of fixed preference dividend. The preference shareholders will share the same benefit as the ordinary shareholders of the company should the company be liquidated.

Required:

a) Calculate the earnings per share (EPS) in accordance with IAS 33 and the dividend per share (DPS) for the year ended March 31, 2015 and 2016. (10 Marks)

b) What are the limitations of earnings per share (EPS) as a measure of a company's performance? (4 Marks)

c. IAS 33 allows an entity to disclose an alternative measure of EPS in addition to the EPS calculated.

Required:
Identify and explain **TWO** conditions that are required in accordance with IAS 33 to be complied with where an alternative measure of EPS is shown in the financial statements of an entity.

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QUESTION 2

IAS 33 requires publicly-traded companies to calculate a diluted Earning Per Share (EPS) in addition to their basic EPS for the current year (with a comparative diluted EPS for the previous year), allowing for the effect of all dilutive potential ordinary shares.

Required:

a. Explain the purpose of the dilutive measures and discuss THREE types of dilution.

b. The statement of financial position (extracts) for Ebonyi Limited for the year ended December 31, 2022 is as follows:

Equity and liabilities	
	₦'000
Ordinary shares (₦1 each)	12,000
Retained earnings	36,000
Equity	48,000
Non-current liabilities:	
5% convertible loan notes	4,000

Additional information:

a) As at December 31, 2022, there has been no new issue of shares or loan notes for several years.

b) The loan notes are convertible into ordinary shares in year 2023 or year 2024 at the following rates.

c) At 30 shares for every ₦100 of loan notes if converted at December 31, 2023.

d) At 25 shares for every ₦ 100 of loan notes if converted at December 31, 2024.Company income tax rate is 30% on profit.

Required:

Calculate the basic EPS and diluted EPS for year 2022.

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24.8.2 Suggested solutions

Solution 1

(a) i. **Earnings Per Share**

- Earnings are profits available for equity holder. Earnings per share is a measure of the amount of earnings in a financial period for each equity share.

$$EPS = \frac{\text{Net profit attributable to ordinary shareholders}}{\text{Weighted average no of ordinary shares outstanding during the period}}$$

Importance

- EPS is used by investors as a measure of the performance of companies in which they invest or wish to invest.
- It reveals a lot about the financial health of the company.
- It helps in the choice of shares or stocks to acquire.
- It serves as input in the calculation of Price Earnings Ratio.
- It gives a more accurate picture of the actual returns to investors than reported profits.
- EPS can have a significant effect on a company's share price.
- EPS serves as a means of assessing the stewardship and management of the company.

ii. **Price Earnings Ratio (P/E) Ratio**

- Price Earnings Ratio is a measure of the company's current share price (market price) in relation to the EPS.

$$P/E\ Ratio = \frac{\text{Market Price of Share}}{EPS}$$

Importance

- It can be used by investors to determine whether the share is expensive or cheap.
- It is an indication of the future strength of the company's performance.
- A high P/E Ratio gives the investors confidence in the stock, and they are prepared to pay high price for the stock.
- Higher P/E Ratio is an indication of a strong corporate governance in a company.
- It indicates the ability of the company to pay high and stable dividends to shareholders.

b. i. **EARNINGS PER SHARE (EPS)**

	March, 31 2016	March 31, 2015
	₦'000	₦'000
Profit attributable to ordinary shareholders (wk 2)	640,000	440,000
Weighted No of shares (w3)	7,800,000	3,000,000
Earnings per share (EPS)	₦0.082	₦0.147
Dividend Per Share (DPS)		
Ordinary Shares:		
Dividend (w1)	330,000	240,000
No of Ordinary Shares (w3)	7,200,000	2,400,000
DPS	₦0.046	₦0.1
Preference shares:		
Dividend (w1)	69,000	60,000
No. Or ordinary shares (w3)	600,000	600,000
DPS	₦0.115	₦0.10

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W1 Percentage of Profit attributable to class of equity shares

	2016	2015
	₦'000	₦'000
Total pref. Dividend	69,000	60,000
Fixed portion (6% of 600,000)	(36,000)	(36,000)
	33,000	24,000
Dividend paid to ordinary shareholders	330,000	240,000

Therefore, the participating preference shareholders will share profit in the ratios of 1:10 (33,000 : 330,000) or (24,000 : 240,000) with ordinary shareholders after payment of the fixed preference dividend out of the profit.

W2
Earning per each class of share

	2016	2015
	₦'000	₦'000
Net profit for the year	740,000	520,000
Fixed Pref. Dividend	(36,000)	(36,000)
	704,000	484,000

	2016		2015
	₦'000		₦'000
Net profit attributable to ordinary shareholders ($^{10}/_{11}$ of 704,000)	640,000	($^{10}/_{11}$ of 484,000)	440,000
Net profit attributable to participating shareholders ($^{1}/_{11}$ of 704,000)	64,000	($^{1}/_{11}$ of 484,000)	44,000
Fixed dividend	36,000		36,000
	100,000		80,000

W 3

Weighted number of shares in issue

Ordinary shares:	2016	2015
	'000	'000
Balance April 1, 2014	2,400,000	2,400,000
Capitalization (Bonus)	4,800,000	-
	7,200,000	2,400,000
Participating Preference shares	600,000	600,000
	7,800,00	300,000

c. Limitations of Earnings Per Share (EPS)

Not all entities use the same accounting policies. It may not always be possible to make **meaningful comparison between EPS of different companies.**

i. EPS does not take account of inflation, so that, growth in EPS over time might be misleading.

ii. EPS measures an entity's profitability, but this is only part of an entity's overall performance.

iii. Diluted EPS is based on current and not on forecast earnings, therefore not a reliable predictor of future EPS.

iv. EPS is relied on by investors as the main measure of an entity's performance. Hence, management try to make EPS appear as high as possible by attempting to manipulate the figures using "creative accounting" as well as making decisions which will increase EPS in the short term, but which damage the entity in the longer term.

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SOLUTION 2

a. Purpose of dilutive measures

i. Diluted EPS act as warning sign for investors in that, it shows what EPS could become if all potential shares were actually in issue.

ii. The purpose of presenting diluted EPS is to reflect the maximum potential dilution of current basic EPS as if the dilution took place at the later of:

iii. The beginning of the current period (for comparatives); and

iv. The date of issue of the potential ordinary shares (applicable only where potential ordinary shares have been issued in the current year of comparative year presented.

Types of dilution

There are effectively three (3) types of dilution:

i. Convertible instruments

Earnings are adjusted positively to reflect saving in interest or dividends incurred net of tax and shares as are adjusted positively to reflect additional number of shares as a result of the conversion.

Examples include convertible preference and convertible loan notes.

The calculation entails adjusting basic earnings and the weighted average number of shares outstanding.

ii. Options to acquire ordinary shares

The issue of these incentives to directors, senior staff or occasionally other parties will entail adjustments to the weighted average number of shares outstanding only.

Earnings are not adjusted, shares are adjusted positively to reflect the number of shares that will be issued for no consideration as a result of being issued at below the market price.

iii. Contingently issuable shares

These are ordinary share issuable for little or no consideration, upon the satisfaction of certain condition pursuant to a contingent share. The contingent event could be, for example:

The maintenance of a specified level of earnings;

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The future market place of ordinary shares; and or

The opening of additional distribution of outlets

Contingently issuable shares are only included in the computation of diluted EPS if the condition are satisfied (that is the contingent events have occurred).

b. **Basic Earning Per Share (EPS) for the year ended December 31, 2022**

$$EPS = \frac{\text{Earnings}}{\text{No of ordinary shares}}$$

$$= \frac{36{,}000}{12{,}000}$$

₦3 per share

Diluted EPS for the year ended December 31, 2022

	No of Shares	Earnings	EPS
Basic EPS	12,000,000	36,000,000	₦3
Dilution			
4,000,000 x 30/100	1,200,000		
Add back interest:			
5% x ₦4,000,000		200,000	
Tax at 30%			
(200,000 x 30%)		(60,000)	
	13,200,000	36,140,000	₦2.74

Diluted EPS = $\frac{36{,}140{,}00}{13.2\text{million}}$ = ₦2.74 per share

Note:

The number of potential shares is calculated using the conversion rate of 30 shares for every N100 of loan notes, because this conversion rate produce more new shares than the other conversion rate of 25 shares for every 100 bonus.

c. If an alternative EPS figure is presented. IAS 33 states that:

i. A reconciliation must be shown between the earnings figure used in the alternative measure and the amount shown in the statement of profit or loss;

ii. The alternative EPS must use the same weighted average number of shares as the IAS 33 calculations;

iii. Basic and diluted EPS should both be disclosed with equal prominence; and

iv. The alternative figure must only be shown in the notes and NOT on the face of the statement of profit or loss.

Skills Level
Financial Reporting

CHAPTER 25

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

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25.0 Learning objectives
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25 Analysis and interpretation of financial statements

25.0 Learning objective

This chapter covers the computation and interpretation of performance and position ratios.

25.1 Learning Outcomes

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

a) calculate and interpret return on capital employed and similar ratios;

b) calculate and interpret profitability ratios, working capital ratios, liquidity ratios debt ratios and gearing ratios;

c) analyse performance of a company from information provided; and

d) explain the limitations of financial statements and interpretation.

25.2 Purpose of Financial Ratio Analysis

25.2.2 Financial Statements Analysis

There is no single definition of financial statement analysis. One possible definition is as follows.

> **Definition**
>
> **Financial statements analysis** is the process of understanding the risk and profitability of a firm through analysis of reported financial information, by using different accounting tools and techniques.

The above definition refers to accounting tools and techniques. Ratios are one such tool.

Financial statements are used to make decisions. They are used by shareholders and investors, and 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, the figures can be analysed and interpreted by calculating financial ratios.

Financial ratios can help the user of the financial statements to assess:

a) The financial position of the entity, and

b) Its financial performance

25.2.3 Using ratios: comparisons

Financial ratios can be used to make comparisons:

a) 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

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used to make comparisons over time, and to identify changes or trends

b) Comparisons with the similar ratios of other, similar companies for the same period.

c) In some cases, perhaps, comparisons with 'industry average' ratios.

25.2.3 Categories of financial ratios

The main financial ratios can be classified as:

a) Financial performance: return on capital, profitability and use of assets

b) Working capital 'turnover' ratios

c) Liquidity ratios

d) Debt ratios

e) Investors' ratios.

Users of the financial statements and their information needs

IAS 1 defines general purpose financial statements.

> **Definition**
>
> **General purpose financial statements** (referred to as ' financial statements') are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

Some users (including management and perhaps lenders are in a position to require the preparation of tailored reports. However, there are several groups of people who are not in this position and may use general purpose financial statements:

a) investors and potential investors;

b) lenders;

c) employees;

d) suppliers;

e) customers;

f) government and government agencies;

g) the general public.

All these groups are 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.

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For example:

a) 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).

b) 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.

c) 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.

d) 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?

25.3 Return on Capital, Profitability and Asset Turnover

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.

25.3.1 Return on capital employed

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.

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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)** x 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.

25.3.2 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

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proportion of total capital employed, including the non-controlling interest.

25.3.3 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

$$ROSC = \frac{\text{Profit after taxation and preference dividend}}{\text{Share capital and reserves}} \times 100$$

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)** x 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

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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

$$ROSC = \frac{\text{Profit after taxation and non-controlling interest}}{\text{Equity attribute able to equity holders of the parent company}} \times 100$$

The share capital and reserves should not include the non-controlling interest in the equity reserves.

25.3.4 Return on assets

Formula: Return on assets

$$ROA = \frac{\text{Profit before interest and taxation}}{\text{Assets}} \times 100\%$$

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.

25.3.5 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:

a) the profitability of the goods or services that the entity has sold; and

b) 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.

25.3.6 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.

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The definition of profit can be any of the following:

a) Profit before interest and tax

b) Gross profit (sales minus the cost of sales) = 'gross profit ratio'

c) 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 x 100 = 4.14%

(b) If profit is defined as profit after interest and tax:

= 145,000 **(W1)**/5,800,000 x 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:

a) Cost of sales/Sales) ×100%

b) Administration costs/Sales) ×100%

c) Selling and distribution costs/Sales) ×100%

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25.3.7 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 ₦1of 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 x 100=20% (as given before)

Asset turnover

Asset turnover ratio = ₦5,800,000/ ₦1,200,000 = 4.83times.

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
240,000 / 1,200,000	=	240,000 / 5,800,000	×	5,800,000 / 1,200,000
20%	=	4.14%	×	4.83 times

25.3.8 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%.

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25.4 Working Capital Efficiency Ratios

25.4.1 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).

25.4.2 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.

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25.4.3 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.

25.4.4 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.

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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 totaled ₦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] ×365days =66.9days

Average time to pay = [165,000/1,800,000] ×365days=33.5days.

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.

25.4.5 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

$$\text{Receivables turnover} = \frac{\text{Credit sales}}{\text{Trade receivables}}$$

$$\text{Inventory turnover} = \frac{\text{Cost of sales Inventory}}{\text{Inventory}}$$

$$\text{Payables turnover} = \frac{\text{Purchases}}{\text{Trade payables}}$$

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25.4.6 Cash operating cycle/working capital cycle

The cash operating cycle or working capital cycle is the average time of one cycle of business operations:

a) From the time that suppliers are paid for the resources they supply

b) 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	XX
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.

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Example: Constructing a cash operating cycle

The following figures have been extracted from a company's accounts:

Statement of profit or		₦
Sales		1,200,000
Cost of sales:		
Opening inventory	250,000	
Purchase	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:

Cash operating cycle:	Days
Average inventory holding period	91
Average trade receivables collection period	122
Average period of credit taken from suppliers	(61)
	152

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25.5 Liquidity Ratios

25.5.1 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:

a) cash in hand or in the bank, plus

b) 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:

a) Current ratio

b) 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.

25.5.2 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:

a) Changes in the ratio overtime

b) The liquidity ratios of other companies in the same period

c) The industry average ratios.

Liquidity should be monitored by looking at changes in the ratio over time.
ratio =Current assets excluding inventory Current liabilities

25.5.3 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

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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.

25.5.4 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.

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25.6 Solvency/debt ratios

Debt ratios are used to assess whether the total debts of the entity are within control and are not excessive.

25.6.1 Gearing (leverage) ratios

Gearing (also called leverage), measures the total long-term debt of a company as a percentage of either:

a) The equity capital in the company: or

b) 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.

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A high level of gearing may indicate the following:

a) 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.

b) 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.

25.6.2 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).

25.6.3 Interest cover ratio

Interest cover measures the ability of the company to meet its obligations to pay interest.

Formula: Interest cover

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges in the year}}$$

Profits before interest and taxation is calculated by adding the interest charges for the year to the figure for profit before taxation.

A low interest cover ratio suggests that the company could be at risk from too much debt in relation to the amount of profits it is earning.

Note that what constitutes low or high gearing very much depends on the type of company. For example:

a) Companies with high levels of physical assets (e.g., property companies) are able to borrow because they can offer assets as security to lenders.

b) Companies with low levels of physical assets (e.g., advertising companies) might be expected to have lower levels of borrowing because they cannot offer assets as security to a lender.

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Example: Gearing ratios

The following information is available for Company Z for Year

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).

Debt to equity ratio: 1,500/3,600 x100 = 41.7%

Gearing ratio: 1,500/5,100 x100 = 29.4%

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25.7 Investors' Ratios

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.

25.7.1 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

$$\frac{\text{Net profit (or loss) attribute able to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

25.7.2 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

$$\text{P/E ratio} = \frac{\text{Market value of share}}{\text{Earnings per share}}$$

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25.7.3 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:

a) 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.

b) 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.

25.7.4 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.

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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 are1.2million ₦1equity shares in issue.

Earnings per share= $\frac{1,400,000}{1,200,000}$ = ₦1.17.

P/E ratio = $\frac{5.50}{1.17}$ = 4.7

Dividend per share= $\frac{450,000}{1,200,000}$ = 0.38

Dividend yield = $\frac{0.38}{5.50}$ x100% = 6.9%

Dividend cover = $\frac{1,400,000}{450,000}$ = 3.1 times or $\frac{1.17}{0.38}$ = 3.1 times

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25.8 Limitations of interpretation techniques

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.

25.8.1 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:

a) Entities might have different policies about the revaluation of non-current assets.

b) Entities might use different methods of depreciation.

c) Entities might use different judgements in estimating the expected profitability on incomplete construction contracts.

d) 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.

25.8.2 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.

a) 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.

b) 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.

c) 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.

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d) 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.

25.8.3 Using historical information

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.

Historical cost accounts can also be misleading because they do not accurately show the effects of inflation over time. The result of this is that in times of inflation:

a) Assets might be understated; and

b) Profit tends to be overstated (up to date revenues are matched with costs incurred earlier. For example inventory and depreciation).

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 and 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 fore seen at the time the most recent financial statements were issued.

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25.8.4 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:

a) **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.

b) **'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.

c) **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.

d) **Profit smoothing:** manipulating reported profits by recognising (usually) artificial assets or liabilities and releasing them to profit or loss as required.

e) **Aggressive earnings management**: artificially improving earnings and profits by recognising sales revenue before it has been earned.

f) **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.

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25.8.5 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.

a) The carrying value of non-current assets is unusually high, because cost has increased, but a full year's depreciation has not been charged.

b) 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.

25.8.6 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:

a) 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.

b) 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.

c) 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.

d) 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.

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25.8.7 Useful non-financial information

Useful non-financial information could include the following:

a) a description of the business, objectives and strategies of the entity

b) a narrative review of the performance of the business during the period

c) a description of the main risks and uncertainties facing the entity and the ways in which these risks are managed

d) details of any significant factors or events that may have an impact on the entity's performance in future

e) details of any significant factors or events that may have an impact on the entity's cashflows in future

f) information about key relationships with other entities and transactions with related parties, including management

g) a description of the entity's research and development activities (if any) and of any material intangible assets, including internally generated in tangible assets that have not been recognised in the balance sheet

h) additional explanations of amounts included in the financial statements, where appropriate (for example, where these are based on estimates)

i) information about the entity's policies in relation to environmental matters, in relation to its employees and on social and community issues.

25.9 Earnings per share as a performance measure

25.9.1 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.

a) 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.

b) 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.

c) 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.

d) Diluted EPS can provide an 'early warning' of any changes to an investor's

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potential return on their investment due to future share issues.

25.9.2 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:

a) Not all entities use the same accounting policies. It may not always be possible to make meaningful comparisons between the EPS of different entities.

b) EPS does not take account of inflation, so that growth in EPS over time might be misleading.

c) PS 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

d) 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.

The problem is mitigated in a number of ways.

a) Rules in IFRS require disclosure of significant accounting policies and the standardisation of the calculation of IFRS. This means that users have access to information about the basis of the calculation of the EPS figure.

b) It is difficult to imagine that a company would publish EPS information prepared by anyone other than a qualified accountant. Users can take comfort from the fact that members of ICAN are governed by a strict ethical code which, if followed, would prevent the use of creative accounting techniques. Members of other institutes are bound by ethical requirements.

c) The problem could be further mitigated by educating users not to rely on this single measure. Note that investment professionals would not base advice and decisions on a single measure.

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25.10 Using cash flow Information

25.10.1 The statement of cashflows and the statement of profit or loss

A cash flow statement can provide a different view of the entity's activities from that shown by the statement of profit or loss. An entity's profit for a period differs from its cash flow for a period because:

a) the statement of profit or loss and statement of financial position are prepared on an accrual basis; and

b) Cashflows are not affected by an entity's accounting policies or accounting estimates.

Reasons why cash flow information is useful

a) Cash flows are a matter of fact and are therefore difficult to manipulate.

b) Cash flow information for the current period can often help users to predict the amount, timing and likelihood of cashflows in future periods.

c) Cash flow is easier to understand than profit, particularly for users with little knowledge of business or accounting.

d) If the statement of cash flows is prepared using the indirect method, it shows the relationship between an entity's profit and its cash generating ability. It reconciles net profit before tax or operating profit to cash generated from operations.

e) The statement of cashflows shows all cash inflows and outflows for a period, from all activities.

However, cash flow information has some limitations. One of the main ones is that cash balances are measured at a point in time. Management can:

a) deliberately arrange receipts and payments of cash, for example by delaying the payment of suppliers until after the year-end; and

b) arrange transactions so that the cash balance is affected as little as possible, for example, by leasing an asset rather than by purchasing it outright.

Management has a duty to safeguard an entity's cash and to use it properly. The practices above are legitimate ways of doing this, but it is also possible to arrange transactions deliberately so that the entity has a much higher cash balance than usual at a particular time. For example, an asset may be sold and almost immediately repurchased.

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There are other limitations:

a) The statement of cashflows is based on historical information and therefore does not provide complete information for assessing future cash flows.

b) Cashflow is not the same as earnings. Although an entity needs cash to survive in the short term, it must eventually be profitable or cease trading.

Neither the statement of cash flows nor the statement of profit or loss provides a complete picture of a company's performance. The main financial statements (the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows) reflect different aspects of the same transactions and should be considered together.

25.10.2 Interpreting the statement of cashflows

As well as preparing a statement of cashflows, you may be asked to comment on the cash inflows and outflows of the entity and its cash position. The easiest way to do this is to start at the beginning of the statement and work through it.

Cash generated from operations

Compare this figure to profit before tax/operating profit. How different are the two figures? Why are they different? Look at the items in the first part of the statement, particularly the movements in inventories, receivables and payables. If cash generated from operations is about the same as, or higher than operating profit, there is probably no cause for concern.

If cash generated from operations is much lower than profit, this may be a worrying sign. If there are also large increases in inventories, receivables and payables, possible reasons are that:

a) the entity is expanding very rapidly and this is absorbing cash generated from operations; and

b) working capital management is poor.

Interest paid, taxation paid and dividends paid

Compare these with cash generated from operations. Remember that the entity **has** to meet its liabilities for interest and tax, but it does not have to pay an equity dividend.

Are tax, interest and dividend payments covered by cash generated from operations? The answer should normally be yes.

Investing activities

The main items here are usually the purchase of new non-current assets (an outflow) and the sale of non-current assets (an inflow). Has the entity invested a significant amount of cash during the year? If so, how has the purchase been financed? From existing cash balances, a share issue, long term borrowing or a combination of all three?

Capital investment is usually a good sign; the new assets will generate increased profits and cashflows in future. However, if the entity has financed the purchase mainly or wholly from short-term sources, such as an overdraft, this is normally not a good sign. It means that the entity may become dangerously short of cash to meet its normal day-to-day needs.

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Financing activities

Has the entity raised finance during the year? If so, was this by a share issue, or by borrowing, or a combination of the two? The reason for raising finance is often clear; usually it is to finance investment and/or an expansion of the business.

If borrowings have increased, will the entity have enough cash available to meet additional interest payments in future?

Has the entity repaid borrowings during the year? When do the entity's existing borrowings have to be repaid? How easily will the entity be able to make repayments?

Increase/decrease in cash and cash balances

The overall increase or decrease in cash needs to be considered in the context of the statement of cash flows as a whole. A decrease is not necessarily a bad sign. For example, the entity may have had surplus cash in the previous year or may have repaid a loan.

In the same way, an increase in cash or a huge cash balance is not always a good sign, if the cash could have been invested elsewhere to generate profit.

Does the entity have a positive cash balance or a bank overdraft? If an overdraft, how close is it to its overdraft limit?

Does the entity have enough cash to meet both its immediate and its longer-term needs? Consider:

a) current liabilities (especially income tax and interest)

b) the current level of dividends

c) any plans for expansion of the business

d) any other spending commitments

e) any liability to repay borrowings within the next twelve months.

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25.11 Specialised, Not-For-Profit and Public Sector Entities

25.11.1 Types of entity

Most of this study text is about the financial statements of profit-making entities, such as limited liability companies.

Other types of entity also prepare and publish financial statements. These entities include:

a) **Not-for-profit entities**: such as charities, clubs and societies. Each of these organisations is set up for a specific purpose. For example, a charity might be set up to campaign for the protection of the natural environment or to help the poor.

b) **Public sector entities**: these include central government bodies; local government bodies; and other organisations that operate for the benefit of the general public, such as state schools and hospitals. A public sector entity is owned by the state or by the general public.

Many different types of entity could be described under these headings. These entities are different from limited liability companies, partnerships and sole traders in one vital respect. They do not primarily exist to make a profit.

In practice, the terms '**specialised entity'**, '**not-for-profit entity'** and '**public benefit entity'** are often used inter-changeably.

25.11.2 Objectives of specialised entities

The main objective of large commercial entities is to maximise their profits in order to provide a return to their owners (investors) in the form of a dividend. This may not be their only objective (for example, they may provide employment to the local community or aim to operate in a socially responsible way), but it is their **main** objective.

The objective of owner-managed businesses (small privately owned entities) is also to make a profit.

In contrast, the main objective of a specialised entity is to carry out the activities for which it has been created. Again, this may not be the only objective, because all entities need some form of income. Many large charities, for example, carry out trading activities. However, making a profit is not the **main** aim. In fact, most not-for-profit entities will aim to break even, rather than to generate a surplus of income over expenditure.

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25.11.3 Interpretation and specialised entities

All not-for-profit entities prepare financial statements. These may not be structured and presented in the same way as those of a profit-making entity, but most of the interpretation techniques described above are still relevant.

As usual, the starting point is the needs of the user.

a) What do they need to know?

b) What are they most interested in?

c) What decision do they need to make?

25.11.4 Users of the financial statements

Several different groups of people may be interested in the financial statements, including:

a) members (of a club or society);

b) donors and potential donors (to a charity);

c) those who benefit or could benefit from the activities of the entity;

d) lenders;

e) the general public, as voters, as taxpayers or in some other capacity;

f) central government (in the case of other public sector bodies);

g) employees and others involved in the work of the entity; and

h) pressure groups.

The most important users of the financial statements are likely to be either: providers

of finance or potential providers of finance; or

persons to whom the entity's management are accountable for the way in which money and other resources are used.

25.11.5 The needs of users

Users of the financial statements of a not-for-profit entity are almost always interested in the way that the entity manages and uses its resources.

For example:

a) A charity may be managed by Trustees on behalf of its supporters and those who benefit from its activities.

b) A public sector organisation is managed by elected officials on behalf of the general public.

Typically, users will want to know whether:

a) the entity has enough finance to achieve its objectives;

b) the money raised is being spent on the activities for which it was intended;

c) the public are receiving value for money (in the case of a public sector entity);

d) services are being provided economically, efficiently and effectively (in the

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case of a public sector entity); and

e) the level of spending is reasonable in relation to the services provided.

25.11.6 Non-financial ratios

Most of the ratios covered earlier in this chapter could be relevant to a not-for- profit entity.

However, a public sector entity may also use non-financial ratios. These measure the efficiency with which services have been provided.

Examples include:

a) the average time that hospital patients wait for treatment;

b) the number of schools built in an area;

c) serious crimes per 1,000 of the population; and

d) number of complaints by members of the public in a given period;

25.12 Chapter review

Before moving on to the next chapter, check that you are able to:

a) Calculate and interpret return on capital employed and similar ratios;

b) Calculate and interpret profitability ratios, working capital ratios, liquidity ratios, debt ratios and gearing ratios;

c) Analyse performance of a company from information provided; and

d) Explain the limitations of financial statements and interpretation.

25.13 End of chapter questions and suggested solutions

25.13.1 Questions

QUESTION 1

There has been agitation to stop importation of containers from China, to increase patronage of local industries. The Board of Favour PLC is planning to acquire 75% controlling interests in either Grace Limited or Blessing Limited which produce better and cheaper containers locally. As a trainee working in Obokun Chartered Accountants, the Managing Partner has requested you to carry out performance score cards of the companies using accounting ratios to assess the viability of the acquisition.

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Statement of comprehensive income for the year ended December 31, 2020:

	Favour Plc	Grace Ltd	Blessing Ltd
	₦ 000	₦ 000	₦ 000
Revenue	250,000	100,000	100,000
Cost of sales	(105,000)	(30,000)	(40,000)
Gross profit	145,000	70,000	60,000
Administrative expenses	(39,000)	(19,000)	(27,000)
Profit before interest and taxation	106,000	51,000	33,000
Finance costs: Interest on 10% loan notes	(6,000)	(3,000)	(30,000)
12% Preference share dividends	(1,200)	(600)	(1,800)
Profit before taxation	98,800	47,400	1,200
Income tax expense	(29,640)	(14,220)	(360)
Profit for the year	69,160	33,180	840

Statement of financial position as at December 31, 2020:

	Favour Plc	Grace Ltd	Blessing Ltd
Assets:	₦ 000	₦ 000	₦ 000
Non-current assets:			
Property, plant and equipment (PPE) at cost	680,000	330,000	350,000
Accumulated depreciation	(90,000)	(50,000)	(60,000)
Carrying amounts	590,000	280,000	290,000
Current assets:			
Inventories	100,000	90,000	160,000
Trade receivables	70,000	40,000	60,000
Bank	230,000	100,000	50,000
	400,000	230,000	270,000
Total assets	990,000	510,000	560,000
Equity and liabilities:			
Ordinary shares of ₦1.25 each	480,000	200,000	110,000
Retained earnings	323,160	237,180	12,840
Equity	803,160	437,180	122,840
Non-current liabilities:			
10% loan notes	60,000	30,000	300,000
12% preference shares	10,000	5,000	15,000
	70,000	35,000	315,000
Current liabilities:			
Trade payables	109,640	34,220	90,360
10% loan notes interest	6,000	3,000	30,000
12% preference shares dividends	1,200	600	1,800
	116,840	37,820	122,160
Total equity and liabilities	990,000	510,000	560,000

Additional Information:

i. Inventories as at December 31, 2019 were N60 million, N30 million and N50 Million and the current market prices, 30 kobo, 28 kobo and 10 kobo for Favour Plc, Grace Limited and Blessing Limited respectively.

ii. Purchases for cash within 365 days in the year 2020 were 10%, 20% and 40% of cost of sales for Favour Plc, Grace Limited and Blessing Limited respectively.

Required:

(a) Calculate the following ratios for Grace Limited and Blessing Limited.

a) Net profit margin

b) Quick ratio

c) Debt equity ratio

d) Proprietary ratio

e) Earnings yield

f) Net asset per share

(b) Draft a technical report titled "Performance Scorecard" of Blessing Limited and Grace Limited and advise Favour Plc in which of the two companies it should acquire 75% controlling interests.

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Solution 1

(a) Computation of relevant accounting ratios for Grace Limited & Blessing Limited

		Grace Limited	Blessing Limited
i.	Net profit margin = Profit before interest and tax x 100 / Revenue	51,000 x 100 / 100,000 = 51%	33,000 x 100 / 100,000 = 33%
ii.	Quick ratio/acid test = Current assets – inventory / current liabilities	230,000 – 90,000 / 37,820 = 3.70:1	270,000 – 160,000 / 122,160 = 0.90:1
iii.	Debt to equity ratio = Long-term debt x 100 / Total Equity 1	35,000 x 100 / 437,180 = 8.01%	315,000 x 100 / 122,840 = 256.43%
iv.	Proprietory ratio = Shareholder's fund / Tangible assets	437,180 / 510,000 = 0.86:1 or 86%	122,840 / 560,000 = 0.22:1 or 22%
v.	Earnings yield = EPS x 100 / MPS	20.7 x 100 / 28 = 73.93%	0.95 x 100 / 10 = 9.50%
	Earnings per share (EPS) = PAT x 100 / No. of Ord Share	33,180 x 100 / 160,000 ord. = 20.7 kobo	840 x 100 / 88,000 ord. = 0.95 kobo
vi.	Net asset per share = Net asset / No. of Ord Share	437,180 / 160,000 = 273 kobo OR ₦2.73k	122,840 / 88,000 = 140 kobo OR ₦1.40k

Obokun & Co.
(Chartered Accountants)

Lagos, Nigeria

FROM: Trainee Accountant TO: Managing Partner

November 15, 2021

SUBJECT: Analysis of financial performance scorecard of Blessing Limited and Grace Limited

Further to the request to carry out performance scorecard of the above two companies, using accounting ratios, to assess the viability of their acquisition, the following findings have been made:

Profitability performance of the two companies

a) Based on the computed net profit margin of the two companies, the net profit margin of Grace Ltd is 51% while that of Blessing Ltd shows 33%, indicating that Grace Ltd is more profitable than Blessing Ltd.

b) The profitability level of Blessing Ltd is seen to be too low. This was probably due to poor control of overhead by Blessing Ltd since the two companies almost have the same gross profit.

c) In addition, the earnings yield of Grace Ltd is high, 73.93% while that of

d) Blessing Limited is 9.5%. This is an indication that Grace Ltd is likely to provide shareholders of Favour Plc more returns than Blessing Ltd.

Liquidity position of the two companies

a) With reference to the computed quick ratio of the two companies, it can be deduced that Grace Ltd is more liquid than Blessing Ltd. The quick ratio of Grace Ltd is 3.7:1 while that of Blessing Ltd is 0.9:1.

b) This indicates that Grace Ltd will be more comfortable in meeting its short-term debt obligations than Blessing Ltd.

Gearing and solvency position of the two companies

- Based on the computed debt to equity ratio, it is obvious that the gearing level of Grace Ltd is better than that of Blessing Ltd. Grace Ltd"s gearing ratio is 8.01%

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which is within the acceptable range, while Blessing Ltd's gearing ratio is 256.43%. This shows that Blessing Ltd is highly geared and high risk to invest in.

- In addition, the proprietary ratio computed for the two companies indicates that the shareholders in Grace Ltd would be more secured and protected in the case of liquidation, compared to Blessing Ltd that has a lower proprietary ratio of 22%. Furthermore, the net asset per share of Grace Ltd is higher than that of Blessing Ltd, indicating that Grace Ltd is more solvent and financially stable.

Conclusion

However, in view of the fact that Grace Ltd will be capable of utilising its resources more efficiently and considering the fact that it is a highly profitable company with a fairly suitable liquidity position we would advise that, the directors of Favour Plc should acquire 75% interest in Grace Ltd.

Recommendations

Further information that may be useful to the board of directors of Favour Plc when making acquisition decisions are:

a) In this case, the analysis has been made on the draft financial statements. These may be unreliable or change when finalised. Audited financial statements would add credibility;

b) Other relevant information should be considered, for example profit forecasts, cash budgets, capital expenditure budget and future prospects;

c) There would be need to ascertain current (fair) value of assets to be acquired;

d) The level of risks and uncertainties within the business industry should be considered;

e) The purchase consideration and mode of payment for the acquisition should also be considered;

f) Tax implication should also be considered; and

g) Competitive advantage; and management quality of the target entity.

Do not hesitate to contact me for any area of this report that requires further clarification.

Thank you.

Trainee Accountant

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Question 2

Shown below are the financial statements of Kobape Limited for its most recent two years.

Extract from statement of profit or loss for the year ended 30 April

	2019	2018
	₦'000	₦'000
Revenue	224,000	195,000
Cost of sales	(169,200)	(136,500)
Gross profit	54,800	58,500
Administrative costs	(32,700)	(38,040)
Distribution costs	(10,900)	(12,680)
Finance cost – loan note interest	(1,900)	(1,380)
	9,300	6,400

Statement of financial position as at 30 April

	2019		2018	
Assets	₦'000	₦'000	₦'000	₦'000
Non-current assets		37,000		28,600
Current assets:				
Inventory	12,800		9,800	
Trade receivables	24,600		21,600	
Cash balance	1,600		2,400	
		39,000		33,800
Total assets		76,000		62,400
Equity and liabilities				
Ordinary share capital		16,000		16,000
Retained earnings		26,200		18,600
		42,200		34,600
Non-current liabilities:				
10% loan notes		16,000		12,000
Current liabilities:				
Bank overdraft	2,200		1,600	
Trade payables	15,000		13,800	
Taxation	600		400	
		17,800		15,800
Total equity and liabilities		76,000		62,400

The following are the ratios calculated for Kobape Limited based on the financial statements of the previous year and also the latest industry average ratios:

	Kobape Ltd 30 April 2018	Industry Average
Net profit margin	3.99%	4.73%
ROCE (Capital employed = equity + loan notes)	16.69%	18.50%
Asset turnover	4.19times	3.91times
Current ratio	2.14:1	1.90:1
Quick ratio	1.52:1	1.27:1
Gross profit margin	30.0%	35.23%
Account receivables collection period	40days	52days
Account payables payment period	37days	49days
Inventory turnover (Times)	13.9times	18.3times
Gearing ratio	25.75%	32.71%

Required:

a) Calculate the cash operating cycle of Kobape Limited for the year ended 30 April, 2018 and 2019.

b) Calculate the comparative ratio(s) (to two decimal places where appropriate) for Kobape Limited for the year ended 30 April, 2019.

c) Draft a report addressed to the board of directors of Kobape Limited, analysing the performance of the company for the year 2019 based on the result of the previous year and the industry average.

Solution 2

(a)

Kobape Limited		
Computation of cash operating cycle for the year ended 30 April, 2018 and 2019		
	April 30, 2019	April 30, 2018
Inventory days period	28 days	26 days
Receivable collection period	40 days	40 days
Payable payments period	(32 days)	(37 days)
Cash operating cycle (in days)	36 days	29 days

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Workings		
Inventory days period = Inventory x 365 days / Cost of Sales	12,800 x 365 days / 169,200 = 28days	9,800 x 365 days / 136,500 = 26days
Receivable collection period = Trade rec. x 365 days / Revenue	24,600 x 365 days / 224,000 = 40days	21,000 x 365 days / 195,000 = 40days
Payable payments period = Trade payable x 365 days / Purchases	15,000 x 365 days / 169,200 = 32days	13,800 x 365 days / 136,500 = 37days

(b)

Kobape Limited

Computation of comparative ratios for the year ended 30 April, 2019

	2019
Net profit margin = PBIT x 100 / Revenue	(9,300+1,900) x 100 / 224,000 = 5%
Return on capital employed (ROCE) = Profit before interest and tax x 100 / Capital Employed (Equity + loan note)	(9,300+1,900) x 100 / (42,200+16,000) = 19.24%
Asset turnover = Revenue / Capital employed	224,000 / 58,200 = 3.85 times
Current ratio = Current assets / Current liabilities	39,000 / 17,800 = 2.19:1
Quick ratio = Current assets – Inventory / Current liabilities	39,000 – 12,800 / 17,800 = 1.47:1
Gross profit margin = Gross profit x 100 / Revenue	54,800 x 100 / 224,000 = 24.46%
Account receivable collection period = Trade rec. x 365 days / Revenue	24,600 x 365 days / 224,000 = 40days
Account payable payments period = Trade payable x 365 days / Purchases	15,000 x 365 days / 169,200 = 32days
Inventory turnover = Cost of sales / Average inventory	169,200 / 12,800 = 13.2times
Gearing ratio = Long term debt x 100 / Long term fund 1	16,000 x 100 / (42,200+16,000) = 27.49%

c)

To: Board of directors

From: Accountant Date: xx/xx/xx

Subject: **Analysis of performance of Kobape Limited**

This report should be read in conjunction with the appendix attached, which shows the relevant ratios.

(i) Trading and profitability

Return on capital employed has improved considerably between 2018 and 2019 and is now higher than the industry average.

Net profit as a proportion of sales has also improved noticeably between the years and is also now marginally ahead of the industry average. Gross margin, however, is considerably lower than in the previous year and is only about 70% of the industry average. This suggests, either that there has been a change in the cost structure of Kobape Limited or that there has been a change in the method of cost allocation between the periods. Either way, this is a marked change that requires investigation. The company may be in a period of transition as sales have increased by nearly 15% during the year and it would appear that new non-current assets have been purchased.

Asset turnover has declined between the periods although the 2019 figure is in line with the industry average. This reduction might indicate that the efficiency with which assets are used has deteriorated or it might indicate that the assets acquired in 2019 have not yet fully contributed to the business. A longer term trend would clarify the picture.

(ii) Liquidity and working capital management

The current ratio has improved slightly during the year and is marginally higher than the industry average. It is also in line with what is generally regarded as satisfactory (2:1).

The quick ratio has declined marginally but is still better than the industry average. This suggests that Kobape Limited has no short-term liquidity problems and should have no difficulty in paying its debts as they become due.

Receivables as a proportion of sales is unchanged from 2018 and are considerably lower than the industry average. Consequently, there is probably little opportunity to reduce this further and there may be pressure in the future from customers to increase the period of credit given. The period of credit taken from suppliers has fallen from 37 days purchases to 32 days and is much lower than the industry average; thus, it may be possible to finance any additional purchases by negotiating better credit terms from suppliers.

Inventory turnover has fallen slightly, and it is much slower than the industry average, this

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may partly reflect stocking up ahead of a significant increase in sales. Alternatively, there is some danger that the inventory could contain certain obsolete items that may require writing off. The relative increase in the level of inventory has been financed by increased overdraft which may be reduced if the inventory levels can be brought down.

(iii) Gearing

The level of gearing has increased only slightly during the year and is below the industry average. Since the return on capital employed is nearly twice the rate of interest on the loan notes, profitability is likely to be increased by a modest increase in the level of gearing.

Signed: Accountant

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Skills Level
Financial Reporting

26

ETHICS AND CURRENT DEVELOPMENTS

Contents

26.0 Learning objective
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26.2 ICAN professional code
26.3 Preparation and reporting of information
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26.5 Application of Technology in financial reporting
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26 Ethics and Current Developments

26.0 Learning objective

This chapter covers the application of ethics to the accountancy profession and current issues in the developments of IFRS standards.

26.1 Learning outcomes

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

a) list and explain the fundamental ethical principles to be followed by members and student members of ICAN;

b) identify and recommend solutions to ethical issues; and

c) explain major current issues in IFRS.

26.2 ICAN Professional Code

26.2.1 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 public interest.

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

ICAN has a code of conduct called the ***Professional Code of Conduct for Members*** which members and student members must follow.

Generally, a member of a profession owes certain duties to the public at large, including those who retain or employ him; to the profession itself and to all other members of that profession, even though such duties may at times be at variance with his own personal interests.

*This **Professional Code of Conduct** serves as a guide to members of the Institute and require strict observance as a condition for continuing membership.*

Professional Code of Conduct for Members

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 professional code and it applies to both accountants in practice and in business.

This chapter explains ethical issues surrounding the preparation of financial

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statements and other financial information.

26.2.2 The fundamental principles

ICAN's Professional code 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 behaviour.

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

c) 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.

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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.

26.2.3 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:

a) Self-interest;

b) Self-review;

c) Advocacy;

d) Familiarity; and

e) 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:

a) Incentive compensation arrangements.

b) Concern over employment security.

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c) Commercial pressure from outside the employing organisation.

Example:

Bako 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 at rigger level.

Bako 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:

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

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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 the 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:

a) 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.

b) Long association with business contacts influencing business decisions.

c) 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:

a) 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.

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

26.3 Preparation and reporting of information

26.3.1 Members in business

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

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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.

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:

a) forecasts and budgets;

b) financial statements;

c) management discussion and analysis; and

d) 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:

a) describes clearly the true nature of business transactions, assets or liabilities.

b) classifies and records information in a timely and proper manner; and

c) represents the facts accurately and completely in all material respects.

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 the 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.

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

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them or reduce them to an acceptable level. Such safeguards may include consultation with superiors within the employing organization, 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.

26.3.2 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:

a) Act contrary to law or regulation.

b) Act contrary to technical or professional standards.

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

   i. the auditors of the employing organisation; or

   ii. regulators.

   iii. 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:

a) obtaining advice where appropriate from within the employing organisation, or an independent professional advisor or a relevant professional body.

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b) the existence of a formal dispute resolution process within the employing organisation.

c) Seeking legal advice.

Example: Potential conflicts

Bako is member of ICAN and works 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 at rigger level.

Bako has been reviewing working papers prepared to support this year's financial statements. He has found a logic error in a spread sheet 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:

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

Bako 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.

Bako must make the necessary adjustment even though it would lead to a loss to himself.

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Example: Potential conflicts

Edosio is a chartered accountant who works in a team that reports to Ganiru, the finance director of Calabar Holdings.

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

Calabar 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 property (with no single property being more than 4% different). A downward revaluation was not recognized 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.

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

Ganiru 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

Edosio 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 IAS16's revaluation model. IAS16 allows the use of a revaluation 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 Ganiru is correct because there is insufficient information to judge materiality in this circumstance. However, a 15% discrepancy does sound significant).

Edosio 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 the records maintained represent the facts accurately and completely in all material respects.

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Example continued

Possible course of action

Edosio should arrange a meeting with Ganiru to try to explain Ganiru's misapplication of the IAS 16 guidance and to try to persuade Gani ruth at a change might be necessary.

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

Edosio 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 Ganiru refuses to allow the necessary changes to the information Edosio should report the matter to the audit committee or the other directors.

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

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

26.4 Current Issues

26.4.1 Introduction

"Better communication in financial reporting" is a central theme of the IASB agenda and will be for the next few years. Work in this area includes the following:

a) disclosure initiative projects (aims to improve disclosures in the notes to the financial statements);

b) primary financial statements project (aims to make improvements to structure and content with a focus on financial performance); and

c) the IFRS taxonomy (aims to allow structured electronic reporting of IFRS financial information).

26.4.2 Background to the disclosure initiative

The IASB launched the Disclosure Initiative in 2013 with the aim of improving the effectiveness of disclosures in financial statements.

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Disclosure Initiative projects	
Amendments to IAS1 to remove barriers to the exercise of judgement.	Completed (reflected in Chapter 4)
Amendments to IAS7 to improve disclosures about liabilities from financing activities	Completed (reflected in Chapter 22)
Materiality implementation projects: Materiality Practice Statement project The Definition of "material"	Practice Statement published (covered in Chapter 3). Exposure Draft (ED) – not covered
Research projects: Principles of Disclosure project The Standards-level Review of Disclosures project	Discussion Paper (DP) (covered below) Research phase – DP will be released in the future

26.4.3 Discussion paper: Disclosure initiative — Principles of disclosure

The need for principles of disclosure

The disclosure problem arises because entities have difficulty judging what information to disclose in financial statements and how best to disclose it.

An entity might apply a disclosure requirement mechanically without considering why it is useful to the users of financial statements. A lack of guidance in IFRS coupled with lists of prescriptive disclosure requirements can discourage entities from using their own judgement.

A set of disclosure principles could encourage preparers to apply better judgement in order to allow them to communicate information more effectively to users of the financial statements.

The discussion paper has the following content:

a) principles of effective communication;

b) principles on where to disclose information;

c) principles to address specific disclosure concerns expressed by users; and

d) principles for improving disclosure objectives and requirements.

26.4.4 Principles of effective communication

Information in financial statements should be

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a) entity specific;

b) clear and simple;

c) organised to highlight important matters;

d) linked to related information;

e) free from unnecessary duplication;

f) comparable;

g) in an appropriate format.

There may be trade-offs between some of these principles to maximise the usefulness of information for users of the financial statements. For example, making information entity specific might mean it is relevant and easier to understand, but could reduce comparability between entities and between accounting periods.

26.4.5 Principles on where to disclose information

Roles of primary financial statements and notes

Sometimes an entity can have difficulty in deciding what information to present in the primary financial statements and what information to disclose in the notes.

Evidence suggests that users of financial statements pay more attention to the primary financial statements than to the notes. This implies that the role of the primary financial statements differs from the role of the notes in meeting the objective of financial statements.

The DP identifies what constitutes the primary financial statements and considers their role and the implications of that role and explores the role and the content of the notes with a view to helping entities decide where to include information within the financial statements.

Location of information

Information necessary to comply with IFRS can be placed outside financial statements but within the annual report, provided the following are met

a) annual report more understandable;

b) financial statements understandable; and

c) information faithfully represented, clearly identified and cross-referenced.

Information labelled as 'non-IFRS' can be placed inside the financial statements if it is:

a) listed, together with a statement of compliance with IFRS;

b) identified as not in accordance with IFRS;

c) identified as unaudited (if applicable); and

d) accompanied by explanation of why it is useful.

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26.4.6 Principles to address specific disclosure concerns expressed by users

Use of performance measures

The term 'performance measure' refers to any summary financial measure of financial performance, financial position or cash flows.

An entity might present a performance measure that is not described in IFRS (e.g., many entities publish EBITDA). Such a performance measure is sometimes referred to as non-IFRS or a non-GAAP performance measure.

The DP suggests that performance measures should be:

a) clearly labelled with an explanation of the irrelevance;

b) neutral;

c) measured and presented consistently;

d) no more prominent than IFRS information; and

e) reconciled to IFRS measures.

The DP is also seeking feedback on presentation of unusual or infrequently occurring items and the use of EBIT and EBITDA ratios.

Disclosure of accounting policies

Entities sometimes provide irrelevant information in accounting policy disclosures or depict the information in a confusing way.

The DP outlines three categories of accounting policies as follows: **Category 1**—always necessary to understand the financial statements. The accounting policy relates to material items, transactions or events and:

a) is selected from alternatives in IFRS;

b) reflects a change from a previous period;

c) is developed by the entity in the absence of specific requirements; and/or

d) requires use of significant judgements or assumptions.

Category 2—not in Category 1 but relates to material items, transactions and events so is necessary to understand the financial statements

Category 3—not in Categories 1 and 2 but is used in preparing the financial statements (all other accounting policies used).

The DP and suggests that only accounting policies necessary to understand financial statements need be disclosed. However, an entity would not be prohibited from disclosing Category 3 accounting policies provided that relevant information is not obscured.

26.4.7 Principles for improving disclosure objectives and requirements

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Feedback suggests that the absence of clear disclosure objectives in IFRS, coupled with lists of prescriptive disclosure requirements, may be contributing to the disclosure problem.

The lack of clear disclosure objectives can make it difficult for entities to:

a) understand the purpose of some disclosure requirements; and

b) apply judgement in deciding what information to disclose to meet the objective of financial statements.

The DP discusses whether a central set of disclosure objectives (centralised disclosure objectives) should be developed to inform the development of disclosure requirements.

26.5 Application of technologies in financial reporting

26.5.1 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) have 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

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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.

25.5.2 Cloud computing technology:

There are quite a good number of accounting softwares 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 on 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.

a) Artificial intlligence 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) softwares have been demonstrated to be effective in

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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 on higher 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 commonplace 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, 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.

b) Blockchain technology: Block chain technology became popular globally through the advancements in digital currency transactions such as Bitcoin. Many businesses now leverage on 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 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 processes 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.

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 technological 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:

a) MySQL Workbench.
b) Data pine;
c) R-Studio;
d) SAS Forecasting for Desktops;
e) Erwin Data Modeler;
f) Talend;
g) Apache Spark; and
h) Rapid Miner.

Navigating the transition from IAS 1 to IFRS 18

a) Introduction
b) Core objectives and scope
c) Structure: IAS 1 versus IFRS 18
d) Transparency requirements
e) Key difference between IAS 1 and IFRS 18
f) Conclusion

a) **Introduction**

IFRS 18 – Presentation and Disclosure in Financial Statements, is a new accounting standard issued by the International Accounting Standards Board (IASB) as part primary financial statements project.

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i. It sets out how companies must present and disclose their financial performance, especially in the statement of profit or loss.

ii. The standard is designed **to replace** key elements of IAS 1- Presentation of Financial Statements, and establish a **consistent structure** that **improves** transparency, comparability, and usefulness of financial statements.

iii. IFRS 18 - Presentation and Disclosure in Financial Statements was issued on the **9 April 2024.**

iv. Effective for an entity's first annual IFRS financial statements for periods beginning on or after **1 January 2027**. Early adoption is permitted.

v. Applies to all entities preparing general-purpose financial statements under IFRS

b) Core objectives and scope

a) The introduction of **IFRS 18** marks a pivotal shift in how financial performance is presented and interpreted across industries.

b) At its core, the standard responds to long-standing concerns from investors, regulators, and analysts about the inconsistency and opacity of current income statement presentations.

c) While **IAS 1** offered flexibility that same flexibility led to comparability challenges varied use of subtotals, and inconsistent treatment of management-defined metrics.

d) **IFRS 18** seeks to establish a globally consistent framework that enhances the **clarity**, **transparency**, and **usefulness** of financial information.

e) By setting out a clear structure and disclosure principles, the standard aims to enable stakeholders to better understand how a company earns its profits, how it defines performance, and how sustainable those results are over time.

Needs for IFRS 18

(a) Responds to Investors' demand for better information about companies' financial performance

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(b) Improves how information is communicated in the financial statements

(c) Gives investors a better basis for analysing and comparing companies' performance

Key aims of IFRS 18

(a) Introducing **new required** subtotals in the statement of profit or loss (e.g., Operating Profit).

(b) Disclosures about **Management-Defined Performance Measures (MPMs).** Making them auditable and transparent

(c) Provides enhanced guidance on grouping of information (**Aggregation and Disaggregation**)

Structure and presentation requirements

IFRS 18 mandates a structured approach to the income statement by requiring **three defined subtotals:**

a) operating profit

b) profit before financing and income taxes

c) profit before income taxes

It also introduces three consistent categories for presenting income and expenses:

a) **Operating**

b) **Investing**

c) **Financing**

Others:

(a) Income Tax

(b) Discontinued Operations

This replaces the flexible format under IAS 1 with a more comparable and consistent presentation of financial performance.

c) Structure: IAS 1 vs IFRS 18

IAS 1

Revenue	XX
Cost of Sales	XX

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Gross Profit	**XX**
Other Income	XX
Operating Expenses:	
- Administrative Expenses	(XX)
- Selling & Distribution Expenses	(XX)
- Impairment Losses (if applicable)	(XX)
Operating Profit	**XX**
Finance Income	XX
Finance Costs	(XX)
Share of profit/loss from associates (if any)	XX/(XX)
Profit Before Tax	**XX**
Income Tax Expense	(XX)
Profit After Tax	**XX**
Profit/Loss on Discontinued operation	XX/(XX)
Profit for the Year	**XX**

IFRS 18

Operating Category:	
Revenue	XX
Cost of Sales	(XX)
Selling & Administrative Expenses	(XX)
Other Operating Income/Expense	(XX)

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Operating Profit ← Mandatory subtotal	**XX**
Investing Category:	
Income from equity investments	XX
Fair value gains/losses on non-operating assets	XX/(XX)
Financing Category:	
Interest Income/Expense on debt	XX/(XX)
Lease liabilities interest	(XX)
Other financing costs	(XX)
Profit Before Financing & Income Taxes ← Mandatory subtotal	**XX**
Income Tax Category:	
Income Tax Expense	(XX)
Profit After Tax ← Required subtotal	**XX**
Discontinued operation	***XX***
Profit for the Year	**XX**

d) Transparency requirements – MPMs

i. Subtotals of Income and Expenses not required or specifically exempted by IFRS Accounting Standards

ii. Included in public communications outside financial statements

iii. Measures that communicate management's view of a company's financial performance

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Disclosures for Management-defined Performance Measures (MPMs)

IFRS 18 introduces requirement to disclose in a single note:

i. reconciliation back to IFRS-defined subtotal;

ii. explanation of why the MPM is reported;

iii. explanation of how the MPM is calculated; and

iv. explanation of any changes to the MPM.

Investors' Concern

i. Investors find MPMs very useful, but they have concerns about lack of transparency of how these measures are calculated.

ii. Examples of Non-GAAP or Alternative Performance Measures (APMs)

- Adjusted Operating Profit
- Adjusted Profit or Loss
- Adjusted EBITDA
- Free Cash Flow
- Return on Equity

iii. Grouping - Aggregation and Disaggregation – of Information

IFRS 18 introduces stricter requirements for breaking down income and expense lines.

Entities must disaggregate material items and explain the nature and function of each line.

IFRS 18 introduces:

a) Enhanced requirements for grouping of information, including requirements for presenting and disclosing operating expenses

b) Guidance on whether information should be in the primary financial statements or the notes

c) Disclosures about items labelled as 'Other'

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Unusual items must be separately disclosed, including:

a) Their nature

b) Amount

c) Justification

d) Labels such as “non-recurring” are not permitted unless clearly supported by evidence.

e) Key differences and Impact between IAS1and IFRS 18

From IAS 1 to IFRS 18 – What’s changing?

FEATURE		IAS 1		IFRS 18
Standard Title		Presentation of Financial Statements		Presentation and Disclosure in Financial Statements
Subtotals (Income Statement)		Optional; entities define their own		Mandatory: Operating Profit, Profit Before Financing & Income Taxes, Profit Before Tax
Income/Expense Categories		No defined categories		Five mandatory categories: Operating, Investing, Financing, Income Tax, Discontinued Operations
Use of Management Performance Measures		Not addressed		Formally defined and disclosed with reconciliations and comparatives
Treatment of Unusual Items		No explicit requirement; flexible labelling		Required disclosure of nature, amount, and reason; labels like "non-recurring" must be justified
‘Other’ Line Items		Widely used without disclosure		Strong disaggregation requirements; must explain use of 'Other'

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Presentation Format		Flexible, principles-based		Structured, rules-based with consistent format across entities
Audit Implication on MPMs		Not subject to audit		Included in audited financial statements
Comparability Between Entities		Limited due to flexibility		Enhanced via standardised structure and categories
Effective Date		Already in effect		January 01, 2027. Early adoption is permitted

Impact of IFRS 18

i. Entities must update financial systems, restate comparatives, and train reporting teams.

ii. Ultimately, IFRS 18 will improve investors' confidence and elevate the reliability and consistency of financial disclosures.

f) Conclusion

The Road Ahead with IFRS 18

a) IFRS 18 brings structure, clarity, and greater discipline to financial reporting.

b) It closes long-standing gaps in presentation and disclosure, aligning reported performance more closely with investor expectations.

c) For preparers, it means adapting systems and revisiting reporting practices. For users, it offers clearer, more comparable insights into company performance.

d) More than a compliance shift, IFRS 18 is a chance to modernise financial storytelling and build lasting trust with stakeholders.

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26.6 Chapter review

Chapter review

Before moving on to the next chapter, check that you are able to:

a) list and explain the fundamental ethical principles to be followed by members and student members of ICAN;

b) identify and recommend solutions to ethical issues; and

c) explain major current issues in IFRS.

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Skills Level
Financial Reporting

CHAPTER 27

SUSTAINABILITY REPORTING FRAMEWORK

Contents

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27 Sustainability Reporting Framework

27.0 Learning objective

This chapter covers the evolution of sustainability reporting and its framework in compliance with IFRS S1.

27.1 Learning outcomes

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

a) movement from social and environmental accounting to sustainability reporting;

b) sustainability reporting and method of reflecting its impact in financial statement and narratives for investors;

c) principle and Content Elements of GRI, SASB, Nigeria Exchange Group's Guidelines for Sustainability Reporting; and

d) international Sustainability Standard Issued by ISSB: IFRS S1 – General Requirements for Disclosure of Sustainability-related Financial Information.

27.2 Movement from social and environmental accounting to sustainability reporting

The progression from **social and environmental accounting** to **sustainability reporting** reflects the expanding scope and expectations of corporate accountability and transparency over time. This evolution is rooted in the changing priorities of stakeholders, particularly investors, regulators, and the public—towards more integrated and forward-looking disclosures that align financial performance with environmental and social impacts.

a) Social and Environmental Accounting (SEA) – The Foundation

Social and Environmental Accounting emerged in the 1970s and 1980s as part of **Corporate Social Responsibility (CSR)** efforts. It focused on:

a) **social accounting:** Reporting on human resources, employee welfare, community engagement, diversity, and human rights.
b) **environmental accounting:** Disclosing environmental impacts such as pollution, resource depletion, and waste management.

These early forms of reporting were mostly **voluntary**, qualitative, and **non-standardised**, often appearing in stand-alone CSR reports.

Limitations of SEA
Despite its positive intentions, SEA faced several limitations:

a) lack of standardized metrics and reporting frameworks;
b) disconnection from financial statements and business strategy;
c) minimal influence on investor decisions or capital allocation; and
d) perception as a public relations or compliance exercise rather than strategic risk

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management.

27.2.1 Emergence of Sustainability Reporting

With the growing awareness of **climate change**, **biodiversity loss**, **inequality**, and the **UN Sustainable Development Goals (SDGs)**, companies and investors began demanding a more holistic and integrated view of corporate performance. This led to the emergence of **sustainability reporting**, which:

a) integrates **environmental, social, and governance (esg)** dimensions;
b) links sustainability risks and opportunities directly to business models, strategy, and financial outcomes;
c) provides **quantitative metrics, targets**, and forward-looking insights; and
d) seeks to inform **capital providers** and improve long-term decision-making.

Key Milestones in the Transition

Period	Development
1990s	Voluntary CSR disclosures grow; Global Reporting Initiative (GRI) is formed
2000s	Integrated Reporting and triple bottom line concepts gain traction
2010s	Rise of ESG investing; frameworks like TCFD, SASB, CDP emerge
2021	IFRS Foundation launches the **International Sustainability Standards Board (ISSB)** to unify global reporting standards

27.2.2 Sustainability Reporting Today

Today, sustainability reporting is:

a) Becoming **mandatory** in many jurisdictions.
b) Closely tied to **financial materiality**, with increasing scrutiny by investors, regulators, and rating agencies.
c) Aligned with frameworks like **IFRS S1/S2**, **GRI (Global Reporting Initiative)**, **SASB (Sustainability Accounting Standards Board)**, and **TCFD (Task Force on Climate-related Financial Disclosures)**.
d) Seen as essential to **risk management**, **corporate governance**, and **long-term value creation**.

Hence, the shift from social and environmental accounting to sustainability reporting signifies a move from isolated, qualitative, and voluntary disclosure practices to a **strategic, integrated, and investor-relevant approach**. It positions sustainability not as an externality but as a **core determinant of financial and operational performance** in the 21st century.

27.3 Sustainability reporting and methods of reflecting its impacts in financial statements and

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narratives for investors

27.3.1 What is Sustainability Reporting?

Sustainability reporting is the structured disclosure of an entity's **environmental, social, and governance (ESG)** performance, risks, and opportunities that affect its long-term ability to create value. It provides stakeholders, especially investors—with insights into how an entity is responding to sustainability-related challenges and aligning its strategy with sustainable development.

The goal is to present **comparable, verifiable, and material information** that helps users assess the **impact of sustainability risks on financial performance** and decision-making.

Key Features of Sustainability Reporting

a) **Forward-looking**: Includes scenario analysis, forecasts, and strategy alignment.
b) **Materiality-driven**: Focuses on ESG (Environmental, Social and Governance) issues that could affect enterprise value.
c) **Quantitative and qualitative**: Combines KPIs – Key Performance Indicators (e.g., emissions, water use) with narratives (e.g., governance practices).
d) **Integrated with financial information**: Increasingly aligned with financial reporting standards (e.g., IFRS S1/S2).

27.3.2 Methods of Reflecting Sustainability Impacts in Financial Statements

Although sustainability-related issues may initially seem non-financial, they can have **direct and indirect financial consequences**, which should be reflected in both narrative and quantitative parts of the financial report.

Narrative Disclosures (Management Commentary/Notes)

a) Discuss **how ESG risks affect business models, cash flows, and access to capital**.
b) Explain sustainability strategies, governance structures, and risk management practices.
c) Provide forward-looking statements about **climate adaptation**, **emission targets**, and **compliance risks**.

27.3.3 Financial Statement Impacts

ESG factors can lead to recognition, measurement, or disclosure in core financial statements. Examples include:

ESG Factor	Financial Statement Impact
Climate-related asset impairments	IAS 36 (Impairment of Assets)
Carbon taxes or emission trading obligations	IAS 37 (Provisions)

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ESG Factor	Financial Statement Impact
Decommissioning/environmental liabilities	IAS 16 (PPE) + IAS 37
Supply chain disruptions	Inventory write-downs under IAS 2
Restructuring due to sustainability strategy	IAS 1 and IAS 10 disclosures
ESG-related investments (e.g., renewables)	IAS 38, IFRS 9 (Financial Instruments)

27.3.4 Metrics and Targets (IFRS S1/S2 Frameworks)

a) Disclose **key performance indicators (KPIs)** such as greenhouse gas emissions, energy use, water intensity, and waste levels.
b) Provide **progress against sustainability targets** (e.g., net-zero goals).
c) Show **financial implications** of ESG risks (e.g., cost increases, capex allocations).

Scenario Analysis

a) Use structured models (e.g., 1.5°C and 2°C climate scenarios) to assess resilience and stress-test financial assumptions.
b) Help investors evaluate the **plausibility and adaptability** of corporate strategies.

27.3.5 International Standards Promoting Integration

Frameworks that guide the integration of sustainability into financial and narrative reporting include:

a) **IFRS S1** – General Requirements for Disclosure of Sustainability-related Financial Information.
b) **IFRS S2** – Climate-related Disclosures.
c) **Integrated Reporting** – Emphasizes linkages between ESG and value creation.
d) **GRI** – Focuses on stakeholder impact.
e) **SASB** – Sector-specific financial materiality metrics.
f) **TCFD** – Recommends narrative and quantitative disclosures on climate risk.

Importance of Sustainability Reporting to Investors
Investors rely on sustainability reporting to:

a) Assess **enterprise risk**, resilience, and long-term value.
b) Align portfolios with ESG standards or sustainability indices.
c) Understand how ESG issues influence **capital expenditure**, **regulatory exposure**, and **reputational risks**.

Conclusively, sustainability reporting is not just a reputational tool, it is a vital mechanism for **communicating value-relevant ESG information**. Through **narrative disclosures**, **quantitative metrics**, and **financial integration**, it enables investors to make informed decisions that balance **profitability with long-term sustainability**.

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a) Factors Responsible for the Increasing Demand for Sustainability Reporting — Internationally and Locally

The demand for sustainability reporting has surged globally and within individual countries due to growing awareness of environmental, social, and governance (ESG) risks and their impact on long-term business viability. Both **international** and **local** drivers are compelling organizations to adopt transparent, structured, and forward-looking sustainability disclosures.

a) International Factors Driving the Demand

i. Climate Change and Global Environmental Crises

- Climate-related risks such as extreme weather, rising sea levels, and water scarcity have profound financial implications.
- Organisations are expected to disclose their resilience to environmental disruptions and mitigation strategies.

ii. Investor and Capital Market Expectations

- Institutional investors and asset managers increasingly integrate ESG factors into investment decisions.
- ESG-related funds and sustainable finance instruments (e.g., green bonds) require robust sustainability disclosures.

iii. Regulatory Developments and Mandatory Disclosure Rules

d) Jurisdictions like the EU (CSRD – Corporate Sustainability Reporting), USA (SEC climate disclosure rules), and UK (TCFD mandates) are implementing **mandatory sustainability reporting**.
e) Global convergence efforts through the **International Sustainability Standards Board (ISSB)** aim to harmonize disclosure frameworks (e.g., IFRS S1/S2).

iv. Rise of ESG Ratings and Indices

a) Companies are assessed by ESG rating agencies (e.g., MSCI, Sustainalytics) which influence investment decisions.
b) Inclusion in sustainability indices (e.g., Dow Jones Sustainability Index) depends on transparent ESG performance reporting.

v. Corporate Accountability and Stakeholder Pressure

a) Civil society, consumers, and NGOs demand ethical, transparent, and socially responsible business practices.
b) Issues like diversity, inclusion, and supply chain ethics are now central to corporate reputation and survival.

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vi. Sustainable Development Goals (SDGs)

a) The UN SDGs have redefined how companies must align their strategies with global sustainability objectives.
b) Reporting frameworks now encourage mapping corporate ESG impacts to the SDGs.

27.3.6 Local (Nigeria/Africa) Factors Driving the Demand Nigeria Exchange Group (NGX) Sustainability Guidelines

a) NGX mandates listed companies to disclose ESG practices, focusing on governance, ethics, environmental performance, and social responsibility.
b) NGX's rulebook encourages alignment with GRI, UNGC, and other global standards.

Financial Reporting Council of Nigeria (FRC) Roadmap for IFRS S1 and S2 Adoption

a. The **Financial Reporting Council of Nigeria** has issued a clear roadmap requiring phased adoption of ISSB standards.
b. Entities must now undergo **readiness assessments**, submit **implementation plans**, and develop **ESG frameworks**.

Access to International Capital and Donor Funding

a) Development finance institutions (e.g., AfDB, IFC) require sustainability disclosures as part of funding criteria.
b) Nigerian companies seeking foreign investment are compelled to adopt global best practices in ESG reporting.

Public Awareness and Media Scrutiny

a) Rising social consciousness about pollution, corruption, and human rights in Nigeria is pressuring companies to be more accountable.
b) Local media and civil society organizations increasingly highlight ESG lapses.

Sector-Specific ESG Risks (e.g., Oil & Gas, Agriculture)

a) Nigerian industries like oil & gas, extractives, and agriculture face acute environmental and social risks.
b) These sectors are subject to both **domestic regulations** and **international stakeholder expectations** for transparent sustainability performance.

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National Policy and Regulatory Incentives

a) Environmental laws (e.g., National Environmental Standards and Regulation Enforcement Agency (NESREA) guidelines), energy efficiency mandates, and anti-corruption campaigns support the push for ESG integration.
b) Sustainability reporting is becoming a compliance requirement for various government and public procurement schemes.

Therefore, increasing demand for sustainability reporting is being driven by a convergence of **international imperatives**, such as climate accountability and investor activism, and **local realities**, such as regulatory reform, reputational risk, and economic necessity. For organisations—especially in Nigeria and emerging markets—embracing sustainability reporting is essential to ensure **business continuity, access to finance**, and **global competitiveness**.

Evaluation of the problems and limitations of sustainability reporting

While sustainability reporting has gained global momentum and is increasingly recognized as essential for transparent, responsible business practices, several **problems and limitations** hinder its full effectiveness. These challenges exist across all levels strategic, technical, and operational and vary by region, industry, and organizational capacity.

27.3.7 Key problems and limitations
Lack of Standardisation and Global Uniformity

a) Multiple frameworks exist (e.g., GRI, SASB, TCFD, CDSB, and now ISSB), leading to inconsistent reporting.
b) Without harmonized standards, users (e.g., investors, regulators) find it difficult to compare disclosures across entities or jurisdictions.
c) Differences in interpretations of materiality and disclosure boundaries further reduce comparability.

Data Quality, Availability, and Reliability Issues

a) Many companies, especially in developing countries lack robust data systems for tracking ESG metrics.
b) ESG data may be incomplete, unaudited, or manually collected, raising concerns about **accuracy, completeness, and credibility**.
c) In some cases, companies may **cherry-pick data** to present a positive image (green washing).

Subjectivity and ambiguity in measurement

a) Certain ESG factors (e.g., social impact, governance quality, biodiversity) are **difficult to quantify**.
b) There is often no universally agreed method to measure non-financial performance.
c) Entities may use subjective assumptions or models in scenario analysis or emissions

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estimation, reducing reliability.

Green washing and Reputational Risk

a) Some companies publish **superficial or misleading sustainability reports** to appear responsible without making substantive changes.
b) Green washing undermines trust in the reporting process and can mislead investors or regulators.

Cost and resource constraints

a) Preparing comprehensive sustainability reports can be **expensive and time-consuming**, particularly for small and medium enterprises (SMEs).
b) Requires sstaff, software systems, ESG consultants, and third-party assurance.

Lack of enforcement and assurance

a) In many jurisdictions, sustainability reporting is **voluntary** or lacks **regulatory enforcement**, leading to poor-quality or no disclosures.
b) Where assurance is performed, it is often limited in scope (e.g., limited vs. reasonable assurance) and not mandatory.

Inadequate Internal Capacity and Expertise

a) Many organisations do not have trained personnel who understand sustainability issues, global frameworks, and reporting requirements.
b) Boards and management may lack ESG competence, which affects governance and internal control over sustainability reporting.

Disconnect Between Sustainability Reports and Financial Statements

a) In some companies, sustainability reports are not aligned or reconciled with financial data.
b) This lack of **connectivity** undermines the usefulness of the reports in assessing long-term value creation and risk.

Contextual challenges in emerging markets (e.g., Nigeria)

a) **Regulatory frameworks** are still evolving, and sustainability disclosures are often not mandatory or well-policed.
b) **Infrastructure and digital systems** needed to collect and track ESG data are lacking.
c) Cultural and institutional barriers may limit stakeholder engagement and transparency.
d) **Weak governance** structures and low ESG literacy at the board level can hinder meaningful adoption.

Summary Table: Problems and Limitations

Category	Key Challenges

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Category	Key Challenges
Framework	Fragmentation, lack of harmonisation
Data	Poor quality, unaudited, inconsistent
Cost	High cost of reporting and assurance
Expertise	Lack of internal ESG knowledge
Regulation	Voluntary nature, weak enforcement
Integrity	Greenwashing, lack of assurance
Measurement	Subjectivity and qualitative bias

Conclusively, sustainability reporting, while valuable, is limited by practical, institutional, and methodological challenges. To overcome these limitations, there is a need for:

a) **Global convergence of standards** (e.g., through IFRS S1/S2 by ISSB)
b) **Mandatory reporting regulations**
c) **Capacity building** within organizations
d) **Robust internal controls and independent assurance**
e) **Stakeholder engagement** and ethical corporate behavior

As sustainability reporting matures, addressing these limitations will be crucial to ensure it truly enhances transparency, investor confidence, and sustainable development.

27.4 Principles and Content Elements of GRI, SASB, and Nigeria Exchange Group's Guidelines for Sustainability Reporting

Sustainability reporting frameworks provide the structure, guidance, and standards that organizations use to disclose their environmental, social, and governance (ESG) performance. Among the most prominent frameworks are the **Global Reporting Initiative (GRI)**, the **Sustainability Accounting Standards Board (SASB)**, and the **Nigeria Exchange Group (NGX)** guidelines.

27.4.1 Global Reporting Initiative (GRI)

Overview

The GRI is one of the most widely used international standards for sustainability reporting. It is a **stakeholder-oriented** framework focused on an organization's **impact on the economy, environment, and society**, regardless of whether such impacts are financially material.

GRI Reporting Principles

a) **Stakeholder Inclusiveness** – Identify and respond to the expectations of all key stakeholders.
b) **Sustainability Context** – Present performance in the wider context of environmental

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and social limits.

c) **Materiality** – Focus on issues that reflect significant impacts and stakeholder concerns.
d) **Completeness** – Ensure the report includes all relevant topics across time and boundaries.
e) **Balance** – Present both positive and negative performance aspects.
f) **Comparability** – Allow stakeholders to compare performance over time and across entities.
g) **Accuracy** – Disclose accurate, reliable data.
h) **Timeliness** – Report regularly and on time.
i) **Clarity** – Present information clearly and understandably.
j) **Reliability** – Ensure verifiable and credible data.

GRI Content Elements

GRI Standards are modular and include:

a) **universal standards (GRI 1–3):** Foundation, disclosures, and principles;
b) **topic-specific standards:** Cover environmental (e.g., GRI 302 – Energy), social (e.g., GRI 401 – Employment), and economic topics (e.g., GRI 201 – Economic Performance); and
c) **sector standards:** Industry-specific ESG issues (e.g., oil & gas, agriculture).

Disclosures Categories:
General Disclosures

27.5 Management Approach

27.5.1 Topic-specific Metrics and Indicators

United States Sustainability Accounting Standards Board (SASB)
Overview

SASB provides **sector-specific**, financially material sustainability disclosure standards tailored for use by **investors and capital markets**. Unlike GRI, which focuses on stakeholders, SASB focuses on **investor relevance and financial materiality**.

SASB Principles

a) **Financial Materiality** – Focus on ESG issues likely to impact financial performance.
b) **Industry Specificity** – 77 industry standards tailored to unique sector risks.
c) **Decision-Usefulness** – Designed for investors and analysts making capital allocation decisions.
d) **Cost-Effectiveness** – Metrics designed to avoid undue reporting burdens.
e) **Evidence-Based** – Developed through research and market engagement.

f) SASB Content Elements

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Each industry standard includes:

a) **Disclosure Topics:** Key ESG issues (e.g., GHG emissions, water management, human capital)
b) **Accounting Metrics:** Quantitative/qualitative performance measures
c) **Technical Protocols:** Guidance on how to calculate and disclose metrics
d) **Activity Metrics:** Operational data for normalization (e.g., production volume, employees)

Example:
For the automobile industry, SASB may require disclosure of product fuel efficiency and regulatory compliance costs, as these are financially material in that sector.

27.5.2 Nigeria Exchange Group (NGX) Guidelines on Sustainability Reporting

Overview
The **NGX** has issued **Sustainability Disclosure Guidelines** for companies listed on the Nigerian Exchange. These guidelines are aligned with global standards such as GRI, UNGC, and ISO 26000, and aim to improve transparency, attract sustainable investment, and encourage responsible business practices.

NGX Reporting Principles
Materiality and Relevance
Stakeholder Inclusiveness
Accuracy and Integrity
Consistency and Comparability
Transparency and Accountability
NGX Content Elements

The guidelines recommend disclosures across the following core areas:

a) **Governance and Ethics:**
   i. Board oversight of ESG matters
   ii. Anti-corruption and compliance policies

b) **Environmental Management:**
   i. Emissions, waste, energy, and biodiversity
   ii. Environmental risks and mitigation strategies

c) **Value Creation and Marketplace:**
   i. Sustainable products and services
   ii. Customer satisfaction and innovation

d) **Workplace:**
   i. Employee welfare, diversity, health and safety

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ii. Capacity building and staff development

e) **Community Investment and Human Rights:**
   i. CSR programs and impact
   ii. Human rights due diligence and grievance mechanisms

Reporting Format:

a) The NGX allows for **stand-alone sustainability reports**, **integrated reports**, or **sections within annual reports**.
b) Large companies (especially premium board-listed entities) are **mandated** to report, while others are encouraged.

Comparison of GRI, SASB, and NGX Guidelines

Feature	GRI	SASB	NGX
Focus	Stakeholder impact	Investor materiality	National ESG priorities
Scope	Global and broad	Industry-specific	Nigeria-focused
Materiality	Impact materiality	Financial materiality	Hybrid
Metrics	Qualitative and quantitative	Quantitative and comparable	Flexible and principles-based
Audience	Stakeholders (society, regulators)	Investors	Regulators, investors, public

Hence, each of these frameworks, **GRI, SASB, and NGX** plays a vital role in advancing sustainability transparency. While GRI provides a broad, stakeholder-oriented approach, SASB targets financially material ESG issues at the industry level. NGX bridges both approaches by offering national guidelines tailored to Nigeria's sustainability landscape. Companies often adopt a **hybrid reporting approach** to meet the expectations of both international and local stakeholders.

27.5.3 Evaluation of the Impact of Sustainability Reporting on Corporate Performance Measures

Sustainability reporting plays a critical role in shaping how companies **measure, manage, and communicate** their performance beyond traditional financial metrics. By integrating **environmental, social, and governance (ESG)** dimensions into performance evaluation, sustainability reporting significantly influences **corporate strategy, risk management, investor relations, and long-term value creation**.

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Positive impacts of sustainability reporting on corporate performance

Enhanced risk management and resilience

a) By identifying and disclosing ESG risks (e.g., climate change, social unrest, regulatory changes), companies are better prepared to **anticipate and mitigate threats** to their operations and value chains.

b) This leads to **improved operational continuity** and strategic agility.

Improved Access to Capital

a) Companies with transparent and credible sustainability disclosures are more attractive to **ESG-conscious investors** and development finance institutions.

b) Sustainability reporting can influence **credit ratings** and reduce **cost of capital**, especially through green bonds or sustainable financing instruments.

Strengthened Stakeholder Trust and Reputation

a) Transparency in sustainability performance fosters **stakeholder confidence**, enhancing customer loyalty, supplier relationships, and employee morale.

b) This reputational capital often translates into **market competitiveness and brand equity**.

Alignment with Long-term Value Creation

a) Sustainability reporting encourages long-term planning by integrating **non-financial KPIs** (e.g., carbon emissions, energy efficiency, social impact) with strategic goals.

b) It supports companies in aligning with frameworks like the **UN SDGs**, which may unlock new business opportunities and markets.

Enhanced Corporate Governance

a) The process of ESG reporting often leads to the **institutionalization of internal controls**, board oversight, and performance monitoring systems that improve governance quality.

b) Boards and management are more likely to integrate **sustainability KPIs** into executive compensation and strategic decision-making.

Better Performance Measurement and Benchmarking

a) Sustainability reporting introduces **quantifiable non-financial metrics** that complement traditional financial indicators.

b) Enables companies to benchmark their ESG performance against peers or sectoral averages.

Empirical Evidence of Performance Linkages

Several studies and investor surveys have shown that companies with strong sustainability practices and transparent reporting tend to:

a) Outperform peers in **stock price performance**.

b) Demonstrate **lower volatility and higher profitability**.

c) Exhibit greater **operational efficiency and employee productivity**.

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27.5.4 Limitations and Challenges in Performance Impact

Despite its benefits, sustainability reporting also faces certain limitations in impacting corporate performance:

Short-Term Cost Burden

a) Implementing sustainability reporting frameworks can be expensive and resource-intensive, especially for **SMEs**.
b) Return on investment (ROI) may take time to materialize.

Ambiguity in Measuring Non-Financial Outcomes

a) Some ESG metrics are **qualitative or subjective**, making it difficult to establish a direct link with performance outcomes.
b) Lack of **standardised measurement** may lead to inconsistent interpretations.

Risk of Greenwashing

a) Companies may exaggerate their sustainability credentials without actual performance improvement.
b) This can erode stakeholder trust and diminish the credibility of reporting efforts.

Weak Enforcement and Assurance

In jurisdictions where sustainability reporting is **voluntary** or lacks strong regulatory oversight, the impact on performance may be minimal or symbolic.

Sustainability Reporting and Financial Performance: A Balanced View

Performance Area	Potential Impact of Sustainability Reporting
Revenue Growth	Opens new markets, builds customer loyalty
Cost Management	Reduces energy/waste costs, improves efficiency
Risk Mitigation	Enhances resilience and compliance
Investor Relations	Improves valuations and access to capital
Governance	Strengthens oversight and ethical culture
Reputation	Enhances brand value and stakeholder loyalty

Thus, sustainability reporting has a **measurable and multifaceted impact** on corporate performance. While it requires investment and institutional commitment, its long-term benefits—ranging from enhanced financial performance and stakeholder trust to improved risk management and governance—are increasingly recognized by forward-thinking organizations. To fully unlock these benefits, companies must ensure that sustainability reporting is **authentic, material, standardised, and embedded** within their core performance measurement frameworks.

27.5.5 Emergence of the International Sustainability Standards Board (ISSB)

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Background and Rationale

The **International Sustainability Standards Board (ISSB)** was established to respond to the **growing global demand for consistent, comparable, and reliable sustainability-related disclosures** that are relevant to investors and capital markets. Prior to the ISSB's creation, the sustainability reporting landscape was fragmented with multiple frameworks and standards, including GRI, SASB, TCFD, CDP, and others, leading to confusion and inconsistent disclosures across entities and jurisdictions.

The ISSB represents a strategic shift towards **harmonizing sustainability reporting** with mainstream financial reporting under the umbrella of the International Financial Reporting Standards (IFRS) Foundation.

Establishment of the ISSB

a) The **IFRS Foundation** officially launched the ISSB in **November 2021** at the United Nations Climate Change Conference (**COP26**) in Glasgow.
b) The move was supported by global leaders, regulators, standard setters (e.g., IOSCO, TCFD), and financial institutions who called for a unified sustainability disclosure framework.
c) The ISSB consolidates the **Climate Disclosure Standards Board (CDSB)** and the **Value Reporting Foundation** (which housed the SASB Standards and Integrated Reporting Framework).

Mission and Objectives of the ISSB

The ISSB's primary mission is to **develop IFRS Sustainability Disclosure Standards** that provide a **global baseline** for sustainability reporting focused on investor needs.

Key objectives include:

a) **Enhancing transparency** in sustainability-related risks and opportunities.
b) Promoting **comparability and consistency** across jurisdictions and industries.
c) Supporting **decision-making by investors** through reliable, material, and forward-looking ESG information.
d) Enabling **connectivity between financial and sustainability reporting**.

ISSB's Key Standards and Frameworks

As of now, the ISSB has issued two foundational standards:

(a) **IFRS S1** – *General Requirements for Disclosure of Sustainability-related Financial Information*

Establishes overall disclosure requirements for sustainability related risks and opportunities.

(b) **IFRS S2** – *Climate-related Disclosures*

Provides detailed requirements for disclosing climate-related risks and opportunities,

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aligned with the TCFD framework.

These standards are designed to be applied together and to be interoperable with jurisdiction-specific requirements such as the European **CSRD/ESRS (European Sustainability Reporting Standards)** and the **SEC climate disclosure rules** in the U.S.

Global Reception and Adoption

a) **IOSCO (International Organisation of Securities Commissions)**, the international body of securities regulators, has endorsed the ISSB standards.
b) Countries like **Nigeria**, the **UK**, **Canada**, **Australia**, **Singapore**, and **Japan** are taking steps toward adopting or aligning local regulations with ISSB standards.
c) The **Financial Reporting Council (FRC) of Nigeria** has developed a roadmap for phased adoption of IFRS S1 and S2.

Governance and Structure

a) The ISSB operates under the **IFRS Foundation**, which also governs the **International Accounting Standards Board (IASB)**.
b) It has a **global multi-stakeholder representation**, including board members with expertise in accounting, sustainability, finance, and public policy.
c) Headquarters are in **Frankfurt, Germany**, with regional offices in Montreal, London, San Francisco, and Beijing.

Importance of ISSB to Global Sustainability Reporting

a) Provides a **single authoritative source** of sustainability disclosure standards for capital markets.
b) Reduces the reporting burden on multinational companies by aligning standards.
c) Promotes **trust, accountability, and efficiency** in ESG data used by investors, lenders, and regulators.
d) Enables effective integration of **sustainability performance into financial decision-making**.

Conclusively, the emergence of the **ISSB marks a transformative milestone** in the evolution of corporate reporting. It addresses long-standing challenges of fragmentation and lack of comparability in sustainability disclosures. Through IFRS S1 and S2, the ISSB aims to elevate sustainability reporting to the same rigor, relevance, and consistency as traditional financial reporting—ushering in a new era of **integrated, global, and investor-focused corporate transparency**.

27.6 International Sustainability Standard Issued by ISSB: IFRS S1 – General Requirements for Disclosure of Sustainability-related Financial Information

27.6.1 Overview of IFRS S1

IFRS S1, issued by the **International Sustainability Standards Board (ISSB)** in June 2023, is

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the foundational standard that sets out the **general requirements** for disclosing sustainability-related financial information.

It provides a comprehensive **baseline** for entities to communicate how sustainability-related risks and opportunities affect their **enterprise value**, business strategy, and future cash flows, thereby enabling **investors and capital providers** to make informed decisions.

Objectives of IFRS S1

a) **Provide transparency** on sustainability-related risks and opportunities over the short, medium, and long term.
b) Enable disclosures that are **comparable, consistent, and decision-useful** for investors.
c) Enhance **connectivity between financial statements and sustainability disclosures**.
d) Serve as a **global baseline**, adaptable to regional regulations (e.g., ESRS, SEC).

Key components of IFRS S1

a) **Disclosure of Material Information** – Only sustainability-related risks and opportunities that could reasonably influence investors' decisions must be disclosed.
b) **Governance, Strategy, Risk Management, and Metrics & Targets** – These four core content pillars (aligned with TCFD) form the structure of sustainability disclosures.
c) **Industry-based and General Disclosures** – Leverages SASB Standards and other industry-specific frameworks for sector-relevant information.
d) **Forward-Looking Information** – Includes scenario analysis, targets, and transition plans.
e) **Timing and Location** – Sustainability-related financial disclosuresmust be published **at the same time** and in the **same report** as financial statements.
f) **Consistency with Financial Reporting** – Disclosures should use the same financial reporting entity and reporting period.

27.6.2 Nigeria's Roadmap for Adoption of IFRS S1 and S2 (by the Financial Reporting Council – FRC)

To ensure a structured transition to the new sustainability standards, the **FRC of Nigeria** issued a **roadmap** in 2024 outlining **phased implementation** of IFRS S1 (General Requirements) and IFRS S2 (Climate-related Disclosures). The roadmap categorizes entities into different levels of adoption:

Early Adopters

a) **Applicable for accounting periods ending on or before December 31, 2023**
b) Entities that voluntarily choose to comply early, often multinational companies or those with strong ESG frameworks already in place.
c) Required to submit readiness documents to the FRC and follow assurance

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protocols.

Voluntary Adopters

a) **Applicable for accounting periods ending on or before December 31, 2026**
b) Companies that elect to implement IFRS S1 and S2 ahead of the mandatory deadline.
c) Encouraged to use this period to build capacity, assess gaps, and test disclosures.

Mandatory Adopters

a) **Effective for accounting periods beginning on or after January 1, 2027**
b) All applicable private sector entities in Nigeria will be **required** to adopt and report in line with IFRS S1 and S2.
c) Mandatory for all listed companies and entities subject to regulatory oversight.

Public Sector Entities

a) **Implementation details to be communicated later** by the FRC and relevant public financial management institutions.
b) Likely to be aligned with IPSASB developments on sustainability disclosures in the public sector.

Strategic Importance of the Roadmap

a) **Enables gradual capacity building** among preparers, auditors, and regulators.
b) Allows **stakeholder engagement** and training before mandatory compliance.
c) Provides a platform for **regulatory alignment** and assurance development.

Furthermore, the introduction of **IFRS S1** by the ISSB represents a significant step toward **global sustainability disclosure convergence**. With Nigeria's FRC roadmap, the country has positioned itself as a leader in Africa's ESG transformation. Entities are encouraged to **engage early**, conduct readiness assessments, and align their governance and internal control frameworks to meet the rigorous requirements of IFRS S1 and S2.

27.6.3 Documents and Timeline for Submission to the Financial Reporting Council (FRC) of Nigeria for IFRS S1 and S2 Readiness

Test Assessment

Entities in Nigeria intending to adopt **IFRS S1** (*General Requirements for Disclosure of Sustainability-related Financial Information*) and **IFRS S2** (*Climate-related Disclosures*) must comply with a structured readiness test as outlined by the **Financial Reporting**

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Council (FRC) of Nigeria. This process includes submitting specified documents within prescribed timelines before and after the start of the reporting date.

27.6.4 To be submitted at least three (3) months before the beginning of the reporting date

Entities must demonstrate board-level commitment and planning through the following submissions:

Board Resolution Approving the Adoption of IFRS Sustainability Disclosure Standards

a) A formal document showing that the entity's board has **approved the implementation** of IFRS S1 and S2.
b) This validates organizational readiness and accountability at the governance level.

Gap analysis report

a) A comprehensive report that **assesses the difference** between the entity's current ESG reporting practices and the requirements of IFRS S1 and S2.
b) It identifies **compliance gaps**, required data sets, personnel needs, and control systems.

Implementation Plan

a) A detailed roadmap outlining **steps, timelines, responsibilities, and resources** needed to meet IFRS S1 and S2 requirements.
b) It should include internal training schedules, systems integration plans, and stakeholder engagement strategies.

27.6.5 To be submitted not more than three (3) months after the beginning of the reporting date

After initiating the reporting period, the following technical and governance documents must be submitted:

a) **IFRS Sustainability Disclosure Policies**
A policy document outlining the **principles, processes, and methods** the entity will use for sustainability disclosures in compliance with IFRS S1/S2.

b) **Identification and Application of Transitional Reliefs**
A statement detailing which **transitional provisions or exemptions** (if any) provided by ISSB standards are being utilized during the initial reporting phase.

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c) **Enterprise Risk Management (ERM) and Sustainability Framework**
A formal framework integrating **ESG risk identification, mitigation, and monitoring** into the entity's overall risk management strategy.

d) **Evidence of Board Approval of the IFRS Sustainability Disclosure Policies**
Proof (e.g., board minutes or resolution) confirming that the **board has reviewed and approved** the sustainability disclosure policies.

e) **Evidence of Board Approval of the ERM and Sustainability Framework**
Documentation showing that the board has **approved the integration of ESG considerations** into the entity's risk governance system.

f) **Evidence of Sustainability and ESG-Specific Training for Board Members, Management, and Preparers**
Certificates, attendance records, or reports from **FRC-accredited training providers** showing that relevant personnel have been trained on IFRS S1/S2 and ESG practices.

27.6.6 To be submitted not more than six (6) months after the beginning of the reporting date

Entities must submit detailed disclosures and evidence of embedded ESG systems:

(a) Evidence of Registration of Entity and Professionals with FRC
Proof that both the **entity and engaged sustainability professionals** are duly registered with the FRC, ensuring compliance oversight.

(b) Description of Models Used for Scenario Analysis
Technical documentation of **climate or ESG scenario models** used to assess resilience, risks, and strategy alignment (e.g., 1.5°C climate scenario).

(c) Identification of Sustainability and Climate-related Risks and Opportunities
A structured disclosure identifying key ESG risks and opportunities relevant to the business strategy and external operating environment.

(d) Evidence of the Establishment of a Governance Structure for Sustainability Reporting
Organisational chart, committee mandates, or terms of reference proving that **sustainability reporting is governed** within a formal structure (e.g., ESG Committee, Sustainability Office).

(e) Targets and Metrics Set to Manage and Measure Identified Risks and Opportunities

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Documented **KPI frameworks and targets**, including baseline measurements and monitoring processes, in line with IFRS S1/S2.

(f) **Identification of Aspects of Financial Reports Requiring Updates**
Statement outlining which areas of the entity's **financial reporting will need revision or integration**, e.g., asset valuation, provisions, contingent liabilities.

Additional Required Disclosures

These two crucial elements must also be addressed by the six-month deadline:

a) identification of current and anticipated effects of sustainability-related risks and opportunities on the entity's business model and value chain; and
b) a clear narrative and data-based analysis of how ESG issues impact operations, strategy, and long-term value creation.

Internal Control over Sustainability Reporting

Description of the **systems, controls, and procedures** put in place to ensure the **reliability, accuracy, and verifiability** of ESG disclosures.

Summary Table: Timeline and Submission Requirements

Timeline	Document	Purpose
3 months **before** reporting date	Board Resolution	Commitment and governance approval
	GAP Analysis Report	Identify ESG compliance gaps
	Implementation Plan	Action plan to adopt IFRS S1/S2
3 months **after** reporting date	Sustainability Disclosure Policies	Disclosure methods and scope
	Transitional Reliefs	Disclosure of adopted reliefs
	ERM & Sustainability Framework	Integration of ESG into risk management
	Evidence of Board Approvals	Validation of governance role
	ESG Training Evidence	Demonstrate personnel competence

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Timeline	Document	Purpose
6 months **after** reporting date	Registration Evidence	Legal and professional compliance
	Scenario Analysis Models	Risk modeling and planning tools
	ESG Risk & Opportunity Assessment	Business exposure and resilience
	Governance Structure Evidence	Oversight and reporting accountability
	ESG Targets & Metrics	Performance measurement and monitoring
	Updated Financial Reporting Aspects	Integrated financial-ESG disclosures
	Impact on Business Model & Value Chain	Strategic alignment with sustainability
	Internal Control Framework	Reliability of sustainability data

Conclusion

Entities intending to adopt **IFRS S1 and S2** must treat the FRC's **readiness test assessment** as both a compliance and strategic opportunity. Timely submission of all required documents, supported by evidence of board engagement, training, and robust systems, is essential to gain approval and demonstrate genuine commitment to sustainability leadership.

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27.7 IFRS S1 - General Requirements for Disclosure of Sustainability-related Financial Information

27.7.1 Objective

The objective of IFRS S1 is to require an entity to disclose information about its sustainability-related risks and opportunities that is useful to the primary users of general purpose financial reports in making decisions relating to providing resources to the entity.

Information about sustainability-related risks and opportunities is useful to primary users because an entity's ability to generate cash flows over the short, medium and long term is inextricably linked to the interactions between the entity and its stakeholders, society, the economy and the natural environment throughout the entity's value chain. Together, the entity and the resources and relationships throughout its value chain form an interdependent system in which the entity operates. The entity's dependencies on those resources and relationships and its impacts on those resources and relationships give rise to sustainability-related risks and opportunities for the entity.

The value chain is defined in IFRS S1 as the full range of interactions, resources and relationships related to a reporting entity's business model and the external environment in which it operates. A value chain encompasses the interactions, resources and relationships an entity uses and depends on to create its products or services from conception to delivery, consumption and end-of-life, including interactions, resources and relationships in the entity's operations, such as human resources; those along its supply, marketing and distribution channels, such as materials and service sourcing and product and service sale and delivery; and the financing, geographical, geopolitical and regulatory environments in which the entity operates.

IFRS S1 requires an entity to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term.

IFRS S1 prescribes how an entity prepares and reports its sustainability-related financial disclosures. It sets out general requirements for the content and presentation of those disclosures so that the information disclosed is useful to primary users in making decisions about providing resources to the entity.

27.7.2 Scope

An entity is required to apply IFRS S1 in preparing and reporting sustainability-related financial disclosures in accordance with IFRS Sustainability Disclosure Standards. An entity may apply IFRS Sustainability Disclosure Standards irrespective of whether the entity's related general purpose financial statements are prepared in accordance with IFRS Accounting Standards or other generally accepted accounting principles or practices (GAAP).

27.7.3 Conceptual foundations

For sustainability-related financial information to be useful, it must be relevant and faithfully represent what it purports to represent. These are fundamental qualitative characteristics of useful sustainability-related financial information. The usefulness of sustainability-related financial information is enhanced if the information is comparable,

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verifiable, timely and understandable. These are enhancing qualitative characteristics of useful sustainability-related financial information.

27.7.4 Fair presentation

A complete set of sustainability-related financial disclosures presents fairly all sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects.

Fair presentation requires disclosure of relevant information about sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects, and their faithful representation in accordance with the principles set out in IFRS S1. To achieve faithful representation, an entity is required to provide a complete, neutral and accurate depiction of those sustainability-related risks and opportunities.

Fair presentation also requires that an entity:

a) to disclose information that is comparable, verifiable, timely and understandable; and

b) to discloses additional information if compliance with the specifically applicable requirements in IFRS Sustainability Disclosure Standards is insufficient to enable users of general purpose financial reports to understand the effects of sustainability-related risks and opportunities on the entity's cash flows, its access to finance and cost of capital over the short, medium and long term

Applying IFRS Sustainability Disclosure Standards, with additional information disclosed when necessary, is presumed to result in sustainability-related financial disclosures that achieve fair presentation.

Materiality

An entity is required to disclose material information about the sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects.

In the context of sustainability-related financial disclosures, information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific reporting entity.

When an entity applies IFRS Sustainability Disclosure Standards, it is required to consider all facts and circumstances and decide how to aggregate and disaggregate information in its sustainability-related financial disclosures. The entity is not permitted to reduce the understandability of its sustainability-related financial disclosures by obscuring material information with immaterial information or by aggregating material items of information that are dissimilar to each other.

Law or regulation might specify requirements for an entity to disclose sustainability-related information in its general purpose financial reports. In such circumstances, the entity is permitted to include in its sustainability-related financial disclosures

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information to meet legal or regulatory requirements, even if that information is not material. However, such information should not obscure material information.
If an entity determines that information about a sustainability-related opportunity is commercially sensitive, the entity is permitted in limited circumstances to omit that information from its sustainability-related financial disclosures. Such an omission is permitted even if information is otherwise required by an IFRS Sustainability Disclosure Standard and the information is material.

Reporting entity and connected information

An entity's sustainability-related financial disclosures are required to be for the same reporting entity as the related financial statements.
An entity is required to provide information in a manner that enables users of general purpose financial reports to understand the following types of connections

(a) the connections between the items to which the information relates—such as connections between various sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects; and
(b) the connections between disclosures provided by the entity:

i. within its sustainability-related financial disclosures—such as connections between disclosures on governance, strategy, risk management and metrics and targets; and

ii. across its sustainability-related financial disclosures and other general purpose financial reports published by the entity—such as its related financial statements.

An entity is required to identify the financial statements to which the sustainability-related financial disclosures relate.
Data and assumptions used in preparing the sustainability-related financial disclosures are required to be consistent—to the extent possible considering the requirements of IFRS Accounting Standards or other applicable GAAP—with the corresponding data and assumptions used in preparing the related financial statements.
When currency is specified as the unit of measure in the sustainability-related financial disclosures, the entity is required to use the presentation currency of its related financial statements.

Core content

Unless another IFRS Sustainability Disclosure Standard permits or requires otherwise in specified circumstances, an entity is required to provide disclosures about:

a) governance—the governance processes, controls and procedures the entity uses to monitor and manage sustainability-related risks and opportunities;

b) strategy—the approach the entity uses to manage sustainability-related risks and opportunities;

c) risk management—the processes the entity uses to identify, assess, prioritise and monitor sustainability-related risks and opportunities; and

d) metrics and targets—the entity's performance in relation to sustainability-related risks and opportunities, including progress towards any targets the entity has set, or is

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required to meet by law or regulation.

IFRS S1 sets out objectives for each of these aspects, and disclosure requirements to achieve those objectives.

General requirements

Sources of guidance

Identifying sustainability-related risks and opportunities

In identifying sustainability-related risks and opportunities that could reasonably be expected to affect an entity's prospects, an entity **is required to** apply IFRS Sustainability Disclosure Standards

In addition to IFRS Sustainability Disclosure Standards:

a) an entity **is required to** refer to and consider the applicability of the disclosure topics in the SASB Standards; and

b) an entity **may** refer to and consider the applicability of:

   i. the CDSB Framework Application Guidance for Water- and Biodiversity-related Disclosures;

   ii. the most recent pronouncements of other standard-setting bodies whose requirements are designed to meet the information needs of users of general purpose financial reports; and

   iii. the sustainability-related risks and opportunities identified by entities that operate in the same industry(s) or geographical region(s).

Identifying applicable disclosure requirements

In identifying applicable disclosure requirements about a sustainability-related risk or opportunity that could reasonably be expected to affect an entity's prospects, an entity **is required to** apply the IFRS Sustainability Disclosure Standard that specifically applies to that sustainability-related risk or opportunity.

In the absence of an IFRS Sustainability Disclosure Standard that specifically applies to a sustainability-related risk or opportunity, an entity **is required to** apply judgement to identify information that:

a) is relevant to the decision-making of users of general purpose financial reports; and

b) faithfully represents that sustainability-related risk or opportunity.

In making that judgement, an entity:

   i. is required to refer to and consider the applicability of the metrics associated with the disclosure topics included in the SASB Standards

   ii. may—to the extent that these sources do not conflict with IFRS Sustainability Disclosure Standards—refer to and consider the applicability of:

      - the CDSB Framework Application Guidance for Water- and Biodiversity-

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related disclosures;

- the most recent pronouncements of other standard-setting bodies whose requirements are designed to meet the information needs of users of general purpose financial reports; and
- the information, including metrics, disclosed by entities that operate in the same industry(s) or geographical region(s).

iii. may—to the extent that these sources assist the entity in meeting the objective of IFRS S1 and do not conflict with IFRS Sustainability Disclosure Standards—refer to and consider the applicability of the Global Reporting Initiative (GRI) Standards and the European Sustainability Reporting Standards (ESRS)

An entity is required to identify:

a) the specific standards, pronouncements, industry practice and other sources of guidance that the entity has applied in preparing its sustainability-related financial disclosures, including, if applicable, identifying the disclosure topics in the SASB Standards; and

b) the industry(s) specified in the IFRS Sustainability Disclosure Standards, the SASB Standards or other sources of guidance relating to a particular industry(s) that the entity has applied in preparing its sustainability-related financial disclosures, including in identifying applicable metrics.

Location of disclosures and timing of reporting

An entity is required to provide disclosures required by IFRS Sustainability Disclosure Standards **as part of its general purpose financial reports**.

Subject to any regulation or other requirements that apply to an entity, there are various possible locations in its general purpose financial reports in which to disclose sustainability-related financial information. Sustainability-related financial disclosures could be included in an entity's management commentary or a similar report when it forms part of an entity's general purpose financial reports. Management commentary or a similar report is a required report in many jurisdictions. It might be known by or included in reports with various names, such as 'management report', 'management's discussion and analysis', 'operating and financial review', 'integrated report' or 'strategic report'.

An entity is required to report its sustainability-related financial disclosures at the same time as its related financial statements. The entity's sustainability-related financial disclosures are required to cover the same reporting period as the related financial statements.

Comparative information

Unless another IFRS Sustainability Disclosure Standard permits or requires otherwise, an entity is required to disclose comparative information in respect of the preceding period for all amounts disclosed in the reporting period. If such information would be useful for an understanding of the sustainability-related financial disclosures for the reporting period, the entity is also required to

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disclose comparative information for narrative and descriptive sustainability-related financial information.

Statement of compliance

An entity whose sustainability-related financial disclosures comply with all the requirements of IFRS Sustainability Disclosure Standards is required to make an explicit and unreserved statement of compliance. An entity is not permitted to describe sustainability-related financial disclosures as complying with IFRS Sustainability Disclosure Standards unless they comply with all the requirements of IFRS Sustainability Disclosure Standards.

Judgements, uncertainties and errors

An entity is required to disclose information to enable users of general purpose financial reports to understand the judgements, apart from those involving estimations of amounts, that the entity has made in the process of preparing its sustainability-related financial disclosures and that have the most significant effect on the information included in those disclosures.

In addition, an entity is required to disclose information to enable users of general purpose financial reports to understand the most significant uncertainties affecting the amounts reported in its sustainability-related financial disclosures.

An entity is required to:

a) identify the amounts that it has disclosed and that are subject to a high level of measurement uncertainty; and

b) in relation to each amount identified, disclose information about:

   i. the sources of measurement uncertainty—for example, the dependence of the amount on the outcome of a future event, on a measurement technique or on the availability and quality of data from the entity's value chain; and

   ii. the assumptions, approximations and judgements the entity has made in measuring the amount.

Furthermore, an entity is required to correct material prior period errors by restating the comparative amounts for the prior period(s) disclosed unless it is impracticable to do so.

Effective date and transition

An entity is required to apply IFRS S1 for annual reporting periods beginning on or after 1 January 2024. Earlier application is permitted. If an entity applies IFRS S1 earlier, it is required to disclose that fact and apply IFRS S2 at the same time.

An entity is not required to provide the disclosures specified in IFRS S1 for any period before the beginning of the annual reporting period in which an entity first applies IFRS S1. Accordingly, an entity is not required to disclose comparative information in the first annual reporting period in which it applies IFRS S1.

In the first annual reporting period in which an entity applies IFRS S1, the entity is permitted to report its sustainability-related financial disclosures after it publishes its related financial statements. In applying this transition relief, an entity is required to report its sustainability-related financial disclosures:

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a) at the same time as its next second-quarter or half-year interim general purpose financial report, if the entity is required to provide such an interim report;

b) at the same time as its next second-quarter or half-year interim general purpose financial report, but within nine months of the end of the annual reporting period in which the entity first applies IFRS S1, if the entity voluntarily provides such an interim report; and

c) within nine months of the end of the annual reporting period in which the entity first applies IFRS S1, if the entity is not required to and does not voluntarily provide an interim general purpose financial report;

In the first annual reporting period in which an entity applies IFRS S1, the entity is permitted to disclose information on only climate-related risks and opportunities (in accordance with IFRS S2) and consequently apply the requirements in IFRS S1 only insofar as they relate to the disclosure of information on climate-related risks and opportunities. If an entity uses this transition relief, it is required to disclose that fact.
If an entity uses that transition relief:

a) in the first annual reporting period in which the entity applies IFRS S1, it is not required to disclose comparative information about its climate-related risks and opportunities; and

b) in the second annual reporting period in which the entity applies IFRS S1, it is not required to disclose comparative information about its sustainability-related risks and opportunities, other than its climate-related risks and opportunities.

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Sample of Report

ABC Industries Plc
SUSTAINABILITY REPORT

For the Financial Year Ended December 31, 2024

1. Introduction

At ABC Industries Plc, we are committed to integrating sustainability into every facet of our business operations. This report outlines our approach, performance, and impact in managing environmental, social, and governance (ESG) issues in alignment with **IFRS S1**, **Global Reporting Initiative (GRI)** Standards, and the **Nigeria Exchange Group (NGX)** Sustainability Disclosure Guidelines.

2. Governance of Sustainability

Our Board of Directors provides strategic oversight of sustainability through the **Sustainability and Risk Committee**, chaired by an independent director.

Key highlights:

a) Sustainability integrated into enterprise risk management.
b) ESG-specific training for board and senior management completed in Q2 2024.
c) Sustainability goals linked to executive performance bonuses.

Strategy and Materiality
Sustainability Strategy
Our sustainability strategy is aligned with our corporate vision to "build value through responsible growth." It covers five pillars: energy efficiency, waste management, employee empowerment, community investment, and governance.

Materiality Assessment
In 2023, we conducted a double materiality assessment, identifying key material issues:

a) Climate change and emissions
b) Occupational health and safety
c) Corporate governance and transparency
d) Product quality and innovation

Sustainability Risks and Opportunities

We identified the following key sustainability-related risks and opportunities:

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Risks	Opportunities
Regulatory carbon pricing	Energy efficiency innovation
Water scarcity in our Northern plants	Investment in rainwater harvesting
Supply chain disruption due to climate impacts	Diversification and supplier training
Reputational risk due to ESG scrutiny	ESG branding and investor attraction

Performance Metrics and Targets
Environmental Performance

Indicator	2023	2024	Target 2026
GHG Emissions (Scope 1 & 2, tonnes CO_2e)	65,000	58,000	40,000
Energy Intensity (kWh/unit produced)	9.5	8.7	7.0
Water Consumption (m^3/year)	310,000	295,000	270,000

Social Performance

Indicator	2023	2024	Remarks
Employee Training Hours	24,000	26,500	Digital skills emphasized
Lost Time Injury Frequency (LTIFR)	1.5	0.9	Exceeded industry benchmark
Female Employees in Leadership	18%	22%	Target 30% by 2026

Governance Performance

a) 100% of board members completed ESG governance training.
b) Anti-corruption and whistleblower policies updated in line with NGX guidelines.
c) Annual ESG risk review conducted by independent auditors.

Stakeholder Engagement

We engaged over 15 stakeholder groups, including:

a) Employees through surveys and town halls.
b) Communities via local development committees.

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c) Investors via our Q3 ESG Investor Call.
d) Regulators via compliance workshops.

Sustainability integration into financial reporting
As part of our IFRS S1 adoption:
a) We conducted a **gap analysis** and published an **implementation plan**.
b) ESG disclosures are integrated into the **annual report**, audited and assured.
c) Scenario analyses were conducted using 1.5°C and 2°C climate pathways.
d) ESG-related risks are reflected in provisions and asset impairment reviews.

Internal controls and assurance
a) Internal Audit reviewed ESG controls quarterly.
b) External assurance was conducted on GHG data and water efficiency metrics.
c) Data integrity is maintained via an automated ESG data capture system across plants.

Community investment and CSR highlights
a) ₦120 million invested in education, health, and clean water projects.
b) Launched "Green Jobs for Youth" initiative, training 500 local youths on solar installation.

Outlook and future commitment
ABC Industries Plc remains committed to achieving:
a) Net-zero carbon emissions by 2040.
b) Full alignment with **IFRS S2** by 2026.
c) Continual stakeholder dialogue and ESG innovation.

Appendix
a) GRI Content Index
b) ISSB S1 Compliance Checklist
c) FRC Nigeria Submission Timeline and Evidence Log
d) Auditor's Limited Assurance Statement

Signed:
Mr. Bamidele Eze Haruna
Managing Director/CEO
ABC Industries Plc
Date: March 30, 2025

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27.8 End of chapter questions and suggested solutions

27.8.1 Questions

Set 1

Question 1

In response to the growing demand for consistent and comparable sustainability-related financial information, the International Sustainability Standards Board (ISSB) introduced **IFRS S1**, which sets out the general requirements for disclosure of sustainability-related financial information. Central to IFRS S1 are four **core content pillars.**

Required:

Discuss the four core content pillars required for disclosure under IFRS S1.

Question 2

As sustainability considerations increasingly influence investor decisions and corporate strategy, the International Sustainability Standards Board (ISSB) has introduced **IFRS S1** to guide entities in disclosing relevant sustainability-related financial information. A cornerstone of IFRS S1 is the concept of **materiality**, which ensures that only information capable of influencing the decisions of primary users—such as investors, lenders, and creditors—is disclosed.

Required:

Explain how an entity should determine material sustainability-related information under IFRS S1.

Question 3

Identify and describe the governance and internal control processes expected in sustainability reporting under IFRS S1.

27.8.2 Suggested solutions

Solution 1

IFRS S1 requires entities to structure their sustainability-related financial disclosures using four core content pillars. These pillars, adapted from the Task Force on Climate-related Financial Disclosures (TCFD), are:

1. Governance

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This pillar focuses on the oversight role of the board and management in identifying, assessing, and managing sustainability-related risks and opportunities.

Key disclosures include:

a) The governance processes, controls, and procedures used to monitor and manage sustainability-related risks.
b) The role of the board of directors and any sub-committees in overseeing sustainability matters.
c) How the board is informed about sustainability risks and how frequently these topics are discussed.
d) The role of management and how responsibilities are delegated.

2. Strategy

This involves disclosing how sustainability-related risks and opportunities affect the entity's business model, strategy, and financial performance.

Entities must disclose:

a) The sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, access to finance, or cost of capital over the short, medium, and long term.
b) How these factors affect the entity's strategy and business model.
c) The resilience of the strategy considering different climate or sustainability scenarios.

3. Risk Management

This addresses how an entity identifies, assesses, and manages sustainability-related risks and how these processes are integrated into overall risk management systems.

Required disclosures include:

(a) The processes used to identify sustainability-related risks and opportunities.
(b) How the entity assesses the likelihood and magnitude of such risks.
(c) How these risks are prioritized and monitored over time.
(d) The integration of sustainability risks with enterprise-wide risk management.

4. Metrics and Targets

This pillar focuses on the disclosure of quantitative and qualitative measures used to monitor and manage sustainability risks and opportunities.

Entities must disclose:

(a) The metrics used to assess and manage sustainability-related risks and opportunities.

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(b) The targets set to manage these risks and opportunities.
(c) Historical data, progress against targets, and explanations for any changes in metrics or targets.
(d) Industry-specific metrics where relevant (as guided by standards like IFRS S2 or SASB).

Solution 2

Under IFRS S1, material sustainability-related information is defined similarly to financial materiality principles in financial reporting.

Key considerations for determining materiality:

(a) Influence on Investor Decisions:
a. Information is considered material if its omission, misstatement, or obscuring could reasonably be expected to influence the decisions of **primary users** of general-purpose financial reports—mainly existing and potential investors, lenders, and creditors.
(b) Entity-Specific Judgment:
a. Materiality is **entity-specific** and depends on the nature and magnitude of sustainability-related risks and opportunities in the context of the entity's circumstances.
(c) Short-, Medium-, and Long-Term Effects:
a. Entities must consider not just immediate impacts but also the potential financial effects over the **short, medium, and long term**.
(d) Qualitative and Quantitative Aspects:
a. Both the **qualitative nature** (e.g., reputational damage, regulatory compliance) and **quantitative magnitude** (e.g., cost implications, revenue shifts) are evaluated in determining materiality.
(e) Dynamic Assessment:
a. Materiality is **not static**; it must be reviewed periodically as new risks emerge or the external environment changes.
(f) Consistency with Financial Reporting:
a. The determination of materiality must align with principles used in financial reporting under IFRS, ensuring **connectivity and consistency** between financial and sustainability-related disclosures.

Soution 3

IFRS S1 expects entities to implement robust **governance structures** and **internal control systems** to support the accuracy, completeness, and reliability of sustainability-related financial disclosures.

Governance Expectations:

(a) Board Oversight:
- The entity must disclose how the board of directors oversees sustainability-related risks and opportunities, including:
- The frequency and format of updates to the board.
- How the board evaluates the impact of ESG issues on the business strategy.

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- Whether a sub-committee (e.g., ESG or Risk Committee) exists.

(b) **Management's Role:**

- Entities should outline:
- Who in management is responsible for managing sustainability issues.
- How authority is delegated and performance is monitored.
- Integration of sustainability considerations into day-to-day operations and strategic planning.

Internal Control Processes:

a) **Integration with Risk Management Systems:**

i. Sustainability-related risks should be embedded within the entity's **enterprise risk management (ERM)** framework.
ii. Clear policies and control procedures must exist for identifying, measuring, and monitoring ESG-related risks.

b) **Controls over Data Quality and Disclosure:**

Internal processes must be in place to ensure:

i. **Data integrity and accuracy** of reported metrics and targets.
ii. Use of recognised reporting standards (e.g., GRI, SASB).
iii. Regular **internal audits or reviews** of sustainability reports.

c) **Assurance and External Validation:**

Entities are encouraged (though not mandated by IFRS S1) to seek **third-party assurance** to enhance the credibility of sustainability disclosures.

d) **Training and Capacity Building:**

Board members, management, and preparers should receive **regular training** on sustainability issues and reporting standards.

e) **Documentation and Evidence:**

should maintain evidence of governance activities, such as board meeting minutes, risk assessments, ESG policy documents, and ESG-specific performance evaluations.

Example:
A financial institution may implement a Sustainability Steering Committee that reports quarterly to the board. The internal audit team is tasked with verifying emissions data, and sustainability KPIs are linked to executive remuneration. Such practices demonstrate effective internal control under IFRS S1.

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Set 2 Questions
Question 1 – Strategy and Governance

ABC Industries Plc has incorporated sustainability governance by forming a Sustainability and Risk Committee and aligning its strategy with energy efficiency, employee empowerment, and ESG training.

Required:
a) Explain the importance of integrating sustainability into enterprise risk management and governance structures.
b) Assess how linking executive bonuses to sustainability performance could influence corporate behavior.

Question 2 – Materiality and Stakeholder Engagement

In its 2024 Sustainability Report, ABC Industries Plc adopted a **double materiality approach** and engaged over 15 stakeholder groups including employees, investors, and regulators.

Required:
a) Define double materiality and explain its relevance in sustainability reporting.
b) Discuss how stakeholder engagement enhances the credibility and usefulness of sustainability disclosures.

Question 3 – Sustainability Performance and Metrics

The report shows year-on-year improvement in GHG emissions, energy intensity, training hours, and gender diversity.

Required:
a) With reference to the report, evaluate the environmental and social KPIs used by ABC Industries Plc.
b) Suggest two additional metrics the company could include to strengthen its ESG performance monitoring.
c) Briefly discuss the role of independent assurance in verifying sustainability performance data.

Question 4 – Financial Integration and Reporting

ABC Industries Plc integrated sustainability disclosures into its annual report, conducted scenario analysis using climate pathways, and updated its financial statements to reflect ESG-related risks.

Required:
a) Explain how sustainability risks can affect financial statement items such as provisions and impairments.
b) Outline two ways scenario analysis supports strategic decision-making in climate reporting.

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Question 5 – Community Investment and Future Commitments

ABC invested ₦120 million in CSR and aims to achieve net-zero emissions by 2040 and full IFRS S2 compliance by 2026.

Required:
a) Discuss the strategic value of community investment initiatives to a business.
b) Identify two key requirements for IFRS S2 compliance in relation to climate-related disclosures.

Solution to **Question 1 – Strategy and Governance**

a) Importance of integrating sustainability into enterprise risk management and governance structures

i. **Strategic Alignment**: Embedding ESG within ERM ensures sustainability is central to long-term corporate strategy.
ii. **Proactive Risk Identification**: ESG integration helps identify material risks like climate change, regulatory shifts, and reputational issues.
iii. **Board Accountability**: A Sustainability and Risk Committee ensures oversight and accountability for ESG performance.
iv. **Investor Confidence**: Demonstrates maturity in managing non-financial risks, enhancing trust and transparency.
v. **Compliance**: Ensures alignment with ISSB standards (e.g., IFRS S1) and regulatory frameworks like NGX.
vi. **Performance Monitoring**: Embeds ESG indicators into key performance tracking and decision-making.
vii. **Stakeholder Engagement**: Fosters more robust engagement with internal and external stakeholders.

b) Impact of linking executive bonuses to sustainability performance.

i. **Behavioral Incentive**: Motivates executives to prioritize ESG goals.
ii. **Cultural Shift**: Reinforces an ethical and responsible corporate culture.
iii. **Long-Term Value Creation**: Aligns short-term executive actions with long-term sustainability strategy.
iv. **Improved Accountability**: Performance is objectively assessed against set ESG KPIs.
v. **Reputation Management**: Encourages management to avoid ESG risks that could harm brand image.
vi. **Compliance with best practice**: Encourages alignment with stakeholder expectations and global ESG trends.

Solution to Question 2 – Materiality and Stakeholder Engagement

a) Definition and relevance of double materiality

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(a)

- **Definition**: Double materiality considers both:
  i. **Financial Materiality** (impact of ESG risks on the company's financial performance)
  ii. **Environmental/Societal Materiality** (impact of the company's operations on society and the environment).
- **Relevance**: Ensures reporting reflects the full scope of a company's sustainability influence and exposure.
- **Compliance**: Aligns with EU CSRD and global ESG reporting trends.

- **Enhances credibility** by identifying issues that matter to both investors and society.

b) How stakeholder engagement enhances reporting

i. **Informed Materiality**: Helps determine what is relevant to various stakeholders.
ii. **Trust and Transparency**: Builds trust when stakeholders are part of the reporting process.
iii. **Reputational Advantage**: Shows responsiveness to stakeholder concerns.
iv. **Risk Reduction**: Early identification of ESG-related issues.
v. **Improved Decision-Making**: Broadens perspective for board and management decisions.
vi. **Regulatory Compliance**: Aligns with ISSB, GRI, and NGX expectations.

Solution to Question 3 – Sustainability Performance and Metrics

a) Evaluation of KPIs used

Environmental KPIs:

i. GHG Emissions: Clear reductions from 65,000 to 58,000 tonnes CO_2e (Scope 1 & 2).
ii. Energy Intensity: Measurable and decreasing, shows efficiency.
iii. Water Consumption: Reduction aligns with sustainable resource use.

Social KPIs:

i. Employee Training: Growth suggests investment in human capital.
ii. LTIFR: Decrease from 1.5 to 0.9 shows improved safety.
iii. Gender Leadership Diversity: Increasing female representation reflects DEI commitment.

Governance KPIs:

ESG training, anti-corruption updates, and third-party assurance indicate strong control systems.

b) Additional ESG metrics

i. **Carbon Intensity per Revenue Unit** – connects emissions to financial performance.
ii. **Employee Turnover Rate** – indicates staff satisfaction and workplace stability.

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(Other valid examples: ESG audit scores, diversity index, renewable energy use.)

c) Role of external assurance

i. **Credibility**: Independent verification enhances trust in data.
ii. **Compliance**: Required by FRC and international ESG frameworks.
iii. **Risk Management**: Identifies data integrity gaps.
iv. **Investor Confidence**: Increases reliability of ESG-related decisions.

Solution to Question 4 – Financial Integration and Reporting

a) Sustainability risks in financial statements

i. **Provisions**: ESG risks (e.g., carbon pricing, remediation costs) may require financial provisions.
ii. **Asset Impairments**: Stranded assets due to climate change or regulatory bans may reduce asset value.
iii. **Contingent Liabilities**: Legal or compliance risks linked to ESG performance.
iv. **Revenue Recognition Adjustments**: Reputation-related risks may impact demand forecasts.
v. **Scenario Planning Impacts**: Used to test resilience of financial models under different ESG outcomes.

b) Use of scenario analysis

i. **Stress Testing**: Helps evaluate how extreme climate events affect operations.
ii. **Strategic Planning**: Informs long-term investment and adaptation decisions.
iii. **Stakeholder Communication**: Shows preparedness and risk awareness.
iv. **Capital Allocation**: Informs decisions on capex, divestments, and hedging.

Solution to Question 5 – Community Investment and Future Commitments
a) Strategic value of community investment

i. **License to Operate**: Builds local support for operations.
ii. **Social Impact**: Reduces inequality and builds capacity.
iii. **Reputation Building**: Positions company as a responsible corporate citizen.
iv. **Workforce Pipeline**: Initiatives like “Green Jobs” support future talent needs.
v. **Alignment with SDGs**: Supports ESG reporting and global development goals.

b) Two key IFRS S2 climate disclosure requirements

(a) **Disclosure of Climate-related Risks and Opportunities**: Identified over short, medium, and long term.
(b) **Metrics and Targets**: Quantitative KPIs such as emissions, reduction targets, and progress

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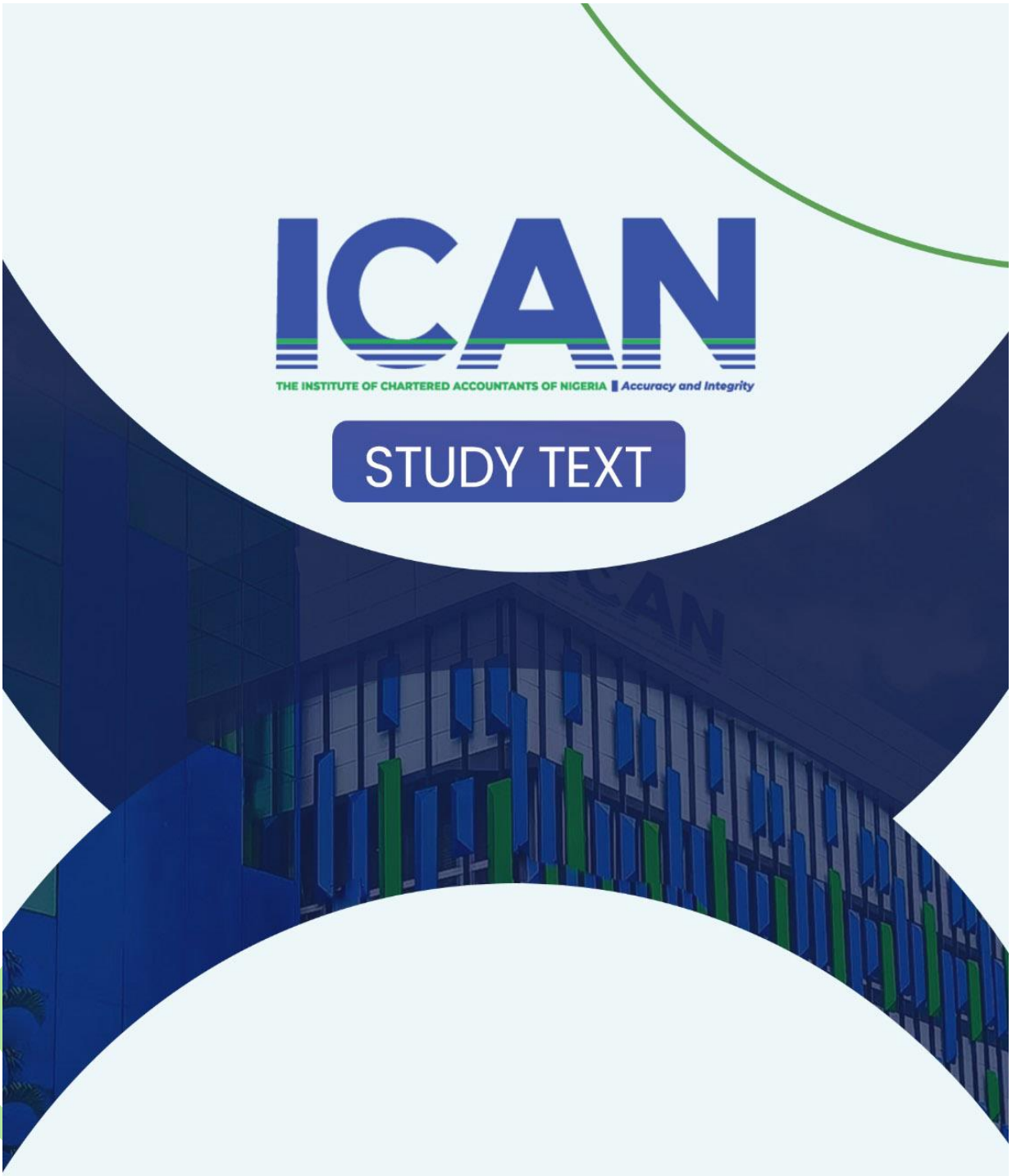
updates.
(Other valid: Scenario analysis, governance structure, transition plan.)

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