STRATEGIC BUSINESS REPORTING (SBR)

STUDY TEXT

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

STRATEGIC BUSINESS REPORTING (SBR)

Published by:
The Institute of Chartered Accountants of Nigeria
PC 16, Idowu Taylor Street
Victoria Island, Lagos, Nigeria
Email: info.ican@ican.org.ng
www.ican-ngr.org

ISBN 978-978-57010-0-5 (A NEW ONE IS REQUIRED)

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August 2025

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FOREWORD

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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).

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

ACKNOWLEDGEMENT

The Institute expresses its heartfelt appreciation to the following Syllabus Review Committee members, writers, reviewers, and editorial board members for their invaluable contributions, expertise, and scholarly dedication that enabled the successful production of these new study texts: They are:

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Professional Level

Strategic Business Reporting

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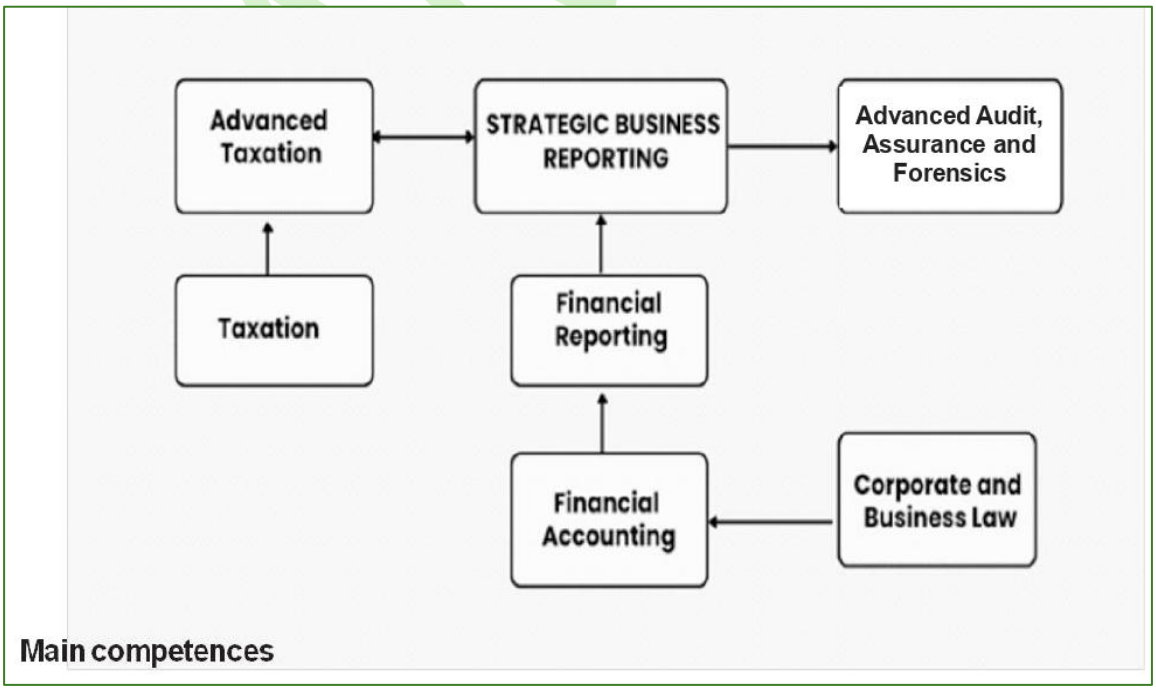
SYLLABUS

Aim

To develop candidates' knowledge of generally accepted accounting principles (GAAP), deepen their understanding and application of accounting standards on financial reporting, sustainability reporting and their ability to apply and evaluate principles and practices in the preparation and interpretation of corporate disclosures and reports in the context of complex groups

Linkage With Other Subjects

This diagram depicts the relationship between this subject and other subjects.



Main Competencies	
On successful completion of this paper, candidates should be able to:	
	Prepare financial statements and notes, and sustainability disclosures on complex single-entity, group (subsidiaries and associates) and all forms of business combinations;
	Evaluate the appropriateness of accounting and other policies used in preparing financial statements and other disclosures and reports;
	Prepare and analyse financial statements to show the position, performance, prospect and risks of a business entity;
	Interpret financial statements, sustainability disclosures, non-financial data and information, and other related disclosures and reports;
	Understand current issues in the reporting framework and Corporate Reporting; and
	Understand current issues in the reporting framework and business reporting; and
	Understand and apply ethical and professional principles to ethical dilemmas and assess and discuss the consequences of creative accounting, window dressing and aggressive earnings management.

Syllabus Overview		
Grid		**Weighting**
A	Ethical issues in and regulatory framework of strategic business reporting	5
B	Reporting of entity's performance to stakeholders	25
C	Group financial statements	30
D	Analysis of financial and other reports to appraise entity's financial performance and position	20
E	Sustainability and integrated reporting	20
F	The impact of changes and potential changes in accounting regulations	5
G	Other current developments in and beyond financial reporting	5
Total		**100**

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Detailed Syllabus				Chapter
A	**ETHICAL ISSUES IN, AND REGULATORY FRAMEWORK OF STRATEGIC BUSINESS REPORTING - 5%**			
	1	**Regulatory Framework of Strategic Business Reporting**		
		a	Discuss the need for convergence in international regulatory frameworks of financial reporting standards.	1
		b	Evaluate the desirability, feasibility and implications of global financial reporting convergence using IFRS accounting standards.	1
		c	Differentiate between rules-based and principles-based accounting standards.	1
		d	Assess the applicable regulations as sources of Nigerian GAAP.	1
		e	Discuss the merits and demerits of international convergence of financial reporting standards.	1
		f	Evaluate disclosures of corporate governance policies and chairman's report as they relate to a company's annual report.	3
		g	Discuss the roles of Financial Reporting Council of Nigeria (FRC) in financial reporting regulations and enforcement, including IFRS accounting standards compliance.	1
	2	**Ethical issues in strategic business reporting**		
		a	Discuss professional accountants' code of ethics as it relates to strategic business reporting.	1
		b	Discuss and evaluate the ethical considerations that may arise in strategic business reporting, including ethical dilemmas.	1
		c	Assess, recommend and justify actions to be taken where ethical issues arise in given strategic business reporting scenarios.	1
B	**REPORTING OF ENTITY'S PERFORMANCE TO STAKEHOLDERS - 25%**			
	1	**Performance Reporting**		
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.	7
		b	Apply accounting standards relating to performance reporting such as IFRS 5; IFRS 8; IFRS 15; IAS 33; and IAS 34 to the preparation of financial statements.	3, 8, 28
		c	Formulate and evaluate entity's accounting policies (including group entities) in accordance with the provisions of IAS 8.	6
		d	Prepare financial statements and sustainability disclosures, in accordance with IFRS accounting standards and or other relevant standards.	Sundry
	2	**Non- Financial Assets**		
		a	Assess the effects of different recognition and measurement methods and timing of recognition of non-financial assets on reported financial position.	7 and 9 to 12

Detailed Syllabus				Chapter
		b	Discuss and appraise accounting treatments of non-current assets, such as: Property, Plant and Equipment – IAS 16; Intangible Assets - IAS 38; Investment Properties - IAS 40; Leases - IFRS 16; Non-current Assets Held for Sale - IFRS 5; Inventories -IAS 2; Agriculture – IAS 41; Accounting for Government Grants and Disclosure of Government Assistance - IAS 20; and Borrowing Costs - IAS 23.	9 to 12 and 19
	3	**Non-Financial Liabilities**		
		a	Evaluate how different methods and timing of recognition and measurement of non-financial liabilities affect reported financial position.	7 and 12 to 15
		b	Appraise accounting treatments of non-financial liabilities, such as: Employees' Benefits – IAS 19; Share-based payment –IFRS 2; Income Tax – IAS 12; Provisions, Contingent Liabilities and Contingent Assets – IAS 37; and Leases - IFRS 16.	12 to 15
		c	Evaluate the effect of related parties' transactions and disclosures on reported performance in line with relevant accounting standards.	3
	4	**Financial Assets and Liabilities**		
		a	Determine and assess how different bases for recognition, measurement and classification of financial assets and financial liabilities impact on reported performance and position.	17 and 18
		b	Discuss the accounting treatment of financial instruments (IFRS 7 and IFRS 9), including impairment and hedge accounting under IFRS 9 for financial assets and liabilities.	17 and 18
	5	**Segment Reporting**		
		a	Determine and assess the nature and extent of reportable segments (IFRS 8).	3
		b	Discuss the nature of segment information to be disclosed and its overall impact on reported performance of the reporting entity.	3
C	**GROUP FINANCIAL STATEMENTS - 30%**			
	1	**Introduction to Consolidating Complex Group Structure**		
		a	Identify and discuss complex group relationships, including the criteria used to identify a subsidiary and an associate.	20, 22
		b	Identify and discuss the circumstances in which a group is required to prepare group financial statements and when an exemption can be granted.	20
		c	Identify and discuss the criteria used to determine how different types of investment are recognised and measured.	20, 22
		d	Discuss and apply the treatment given to a subsidiary acquired exclusively with a view to its subsequent disposal.	20
		e	Discuss why directors may not wish to consolidate a subsidiary and when this will be permitted.	20
		f	Outline and apply the key definitions and accounting methods relating to interests in associates and joint arrangements.	22

Detailed Syllabus				Chapter
	2	**Preparation of Financial Statements of a Complex Group**		
		a	Apply the provisions of relevant standards in determining the cost of acquisition in business combination under different scenarios.	20
		b	Determine and apply appropriate procedures to be used in preparing group financial statements.	20, 21 and 24
		c	Determine, apply and disclose from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of acquisitions achieved one time or in stages involving subsidiaries, associates and joint ventures.	20 to 23 and 25
		d	Calculate, determine and disclose, from financial information and other data in a given scenario, the amounts to be included in group financial statements in respect of full or partial disposals involving subsidiaries, associates and joint ventures.	24
		e	Discuss and appraise how foreign currency transactions of a single entity or group entities are measured and accounted for in the financial statements.	26
		f	Discuss and appraise how the financial statements of overseas entities are translated and consolidated.	26
		g	Calculate, determine and disclose, from financial information or other data in a given scenario, the amounts to be included in group financial statements relating to part of a group which activities have been discontinued, or have been acquired or disposed of in the period.	24
		h	Prepare group financial statements and sustainability disclosures, in accordance with IFRS accounting standards or other relevant standards.	20 to 24
D	**INTERPRET FINANCIAL STATEMENTS, SUSTAINABILITY DISCLOSURES, NON-FINANCIAL DATA AND INFORMATION, AND OTHER RELATED DISCLOSURES AND REPORTS - 20%**			
	1	**Suitability of Accounting Policies and Reported Numbers**		
		a	Evaluate the appropriateness of accounting and other policies used to prepare financial statements and other disclosures and reports.	Sundry
		b	Assess accounting treatments adopted in financial statements and assess their validity, suitability and acceptability.	Sundry
		c	Appraise the nature and validity of information disclosed in annual reports, including sustainability reporting and other voluntary disclosures.	
		d	Appraise the nature and validity of items included in published financial statements.	2
	2	**Analyses, Interpretation and Appraisal of Financial and Other Reports**		
		a	Evaluate relevant indicators of financial and non- financial performance.	5
		b	Analyse and evaluate the performance, including stock market performance, liquidity, efficiency and solvency of an entity using different techniques of analysis, such as: horizontal; vertical; ratios; trends; and	5

Detailed Syllabus				Chapter
			common size.	
		c	Adjust reported earnings of an entity to make it comparable over time, with similar entities and industry average.	
		d	Assess the potential complex economic environment in which an entity operates, and its strategies based on financial and operational information contained within the annual report (such as Chairman and MD/CEO/CFO business and performance reports, management commentary, corporate governance disclosures, financial summaries and highlights).	
		e	Make inferences from the analyses of information taking into account the limitations of the information, the analytical methods used and the business environment in which the entity operates.	
		f	Discuss and evaluate earnings management, window dressing and creative accounting and assess their impact on the usefulness of ratios.	
	3	Limitations of financial analyses		
		a	Appraise the limitations of financial analyses.	
		b	Appraise the significance of inconsistencies and omissions in reported information in evaluating performance.	
E	**SUSTAINABILITY AND INTEGRATED REPORTING - 10%**			
	1	**Discuss the progress from environmental, social and governance (ESG) 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 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.**		
	6	**Discuss the emergence of International Sustainability Standards Board (ISSB)**		
	7	**Discuss the key differences amongst the IFRS Sustainability Disclosure Standards, Global Reporting Initiative (GRI) and United States (US) Sustainability Accounting Standards Board (SASB) frameworks for sustainability reporting.**		
	8	**Discuss the scope, conceptual foundations, objectives and core content of ISSB standards.**		
	9	**Explain the roadmap for adopting IFRS S1 and S2 issued by the Financial Reporting Council (FRC) of Nigeria for the implementation of S1 and S2:**		
		a	Early adopters for accounting period ending on or before December 31, 2023.	4
		b	Voluntary adopters for accounting period ending or before December 31, 2026.	6
		c	Mandatory adopters for accounting period beginning on or after January 1, 2027; and	5
		d	Public sector entities - to be communicated later.	4

Detailed Syllabus				Chapter
	10	**List and explain, including the timeline for submission, documents to be submitted by entities adopting IFRS S1 and S2 to Financial Reporting Council of Nigeria for readiness test assessment, including:**		
		a	To be submitted at least three (3) 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.	29
		b	To be submitted not more than three (3) 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 Framework. (vi) Evidence of Sustainability and ESG-specific training for Board Members, Management, and Preparers by reputable training providers acceptable by the FRC.	29
		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 effects of sustainability-related risks and opportunities on the entity's business model and value chain. (viii) Internal control over sustainability reporting	29
	11	**Evaluate the usefulness of corporate disclosures of climate-related risks and opportunities.**		29
	12	**Discuss, apply and prepare sustainability report in accordance with the international sustainability standards issued by ISSB:**		
		a	IFRS S1 – General requirements for disclosure of sustainability-related financial information.	29
		b	IFRS S2 – Climate - related Disclosures.	29
F	**THE IMPACT OF CHANGES AND POTENTIAL CHANGES IN ACCOUNTING REGULATIONS - 5%**			
	1	**Discuss and apply the accounting implications of the first time adoption of**		

Detailed Syllabus				Chapter
		new accounting standards that are effective six (6) months to the examination date.		
	2	**Identify issues and deficiencies which have led to proposed changes to an accounting standard.**		
	3	**Discuss developments in devising a structure for business reporting that addresses the needs of stakeholders.**		
	4	**Discuss the impact of current issues in business reporting.**		
	5	**Discuss and apply newly issued exposure drafts.**		
G	**OTHER CURRENT DEVELOPMENTS IN AND BEYOND FINANCIAL REPORTING 5%**			
	1	**Global Convergence of Financial Reporting and Nigerian Generally Accepted Accounting Principles (NGAAP)**		
		a	Determine, discuss and apply the accounting treatment of issues arising from the first-time transition to international accounting standards such as IFRS accounting standards from NGAAP.	4
		b	Discuss accounting issues relating to applicable Nigerian accounting standards after IFRS accounting standards adoption.	6
	2	**Technology and Other Employability Skills**		
		a	Discuss the following in relation to business reporting: (ii) Multiple capitals (iii) Integrated thinking (iv) Distributed ledger and related technologies (v) Cloud computing (vi) Reporting in a virtual environment (vii) Artificial intelligence; and (viii) Machine learning.	29

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

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

NOTES:

- Candidates are required to understand interpretations of the relevant standards.
- New standards may be examined six months after dates of issue, even if the effective date is in the future.
- Applicable laws may be examined six months after dates of amendment or enactment.

Standard	Examinable in earlier paper	Examinable at this level?	Chapter
Preface of IFRS	Yes	Yes	1
The Conceptual Framework for Financial Reporting	Yes	Yes	1
The Management Discussions & Commentaries	No	Yes	1
IAS 1: Presentation of Financial Statements	Yes	Yes	3
IAS 2: Inventories	Yes	No	NA
IAS 7: Cash Flow Statements	Yes	Yes	30
IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors	Yes	Yes	6
IAS 10: Events occurring after the reporting period	Yes	No	3
IAS 12: Income Taxes	Yes (in part)	Yes	14
IAS 16: Property, Plant and Equipment	Yes	Yes	9
IAS 19: Employee Benefits	No	Yes	14
IAS 20: Accounting for Government Grants and Disclosure of Government Assistance	Yes	No	na
IAS 21: The Effects of Changes in Foreign Exchange Rates	No	Yes	26
IAS 23: Borrowing Costs	Yes	No	na
IAS 24: Related Party Disclosures	No	Yes	3
IAS 26: Accounting and Reporting by Retirement Benefit Plans	No	Yes	19
IAS 27: Separate Financial Statements	Yes	Yes	25
IAS 28: Accounting for Investments in Associates and Joint ventures	Yes	Yes	22
IAS 32: Financial Instruments: Presentation	Yes	Yes	18
IAS 33: Earnings Per Share	Yes	Yes	28
IAS 34: Interim Financial Reporting	No	Yes	3
IAS 36: Impairment of Assets	Yes	Yes	10
IAS 37: Provisions, Contingent Liabilities and Contingent Assets	Yes	Yes	9
IAS 38: Intangible Assets	Yes	Yes	9
IAS 40: Investment Property	Yes	Yes	9
IAS 41: Agriculture	Yes	Yes	19
IFRS 1: First time adoption of IFRS	No	Yes	30
IFRS 2: Share-based payment	No	Yes	15

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Standard	Examinable in earlier paper	Examinable at this level?	Chapter
IFRS 3: Business combinations	Yes	Yes	20
IFRS 5: Non-current assets held for sale and discontinued operations	Yes	Yes	11
IFRS 6: Exploration for and evaluation of mineral resources	No	Yes	19
IFRS 7: Financial Instruments: Disclosures	Yes	Yes	18
IFRS 8: Operating segments	No	Yes	3
IFRS 9: Financial Instruments	No	Yes	17
IFRS 10: Consolidated financial statements	Yes	Yes	20-25
IFRS 11: Joint arrangements	No	Yes	22
IFRS 12: Disclosure of interests in other entities	No	Yes	25
IFRS 13: Fair value measurement	No	Yes	16
IFRS 14: Regulatory deferral accounts	No	Yes	19
IFRS 15: Revenue from contracts with customers	Yes	Yes	8
IFRS 16: Leases	No	Yes	12
IFRS 17: Insurance contracts	No	No	na
IFRS 18: IFRS 18 Presentation and Disclosure in Financial Statements	No	Yes	1
IFRS 19: Subsidiaries without Public Accountability	No	Yes	20-25
IFRS for SMEs	No	Yes	19
NGAAP-SAS 32- Statement for Not-for-profit	No	Yes	19

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Professional Level
Strategic Business Reporting

CHAPTER 1

ETHICAL ISSUES IN, AND REGULATORY FRAMEWORK OF STRATEGIC BUSINESS REPORTING

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1.1 Learning outcomes

1.2 Regulatory framework of Strategic Business Reporting

1.3 Ethical Issues in Strategic Business Reporting

1.4 Chapter review

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1 Ethical Issues in, and Regulatory Framework Of Strategic Business Reporting

1.0 Learning objective

This chapter develops readers" understanding of the ethical and regulatory frameworks governing Strategic Business Reporting.

1.1 Learning Outcomes

On successful completion of this chapter, readers should be able to:

a. explain the need for convergence in international financial reporting standards;
b. evaluate the desirability, feasibility, and implications of IFRS global convergence;
c. differentiate between rules-based and principles-based accounting standards.
d. assess applicable regulations as sources of Nigerian Generally Accepted Accounting Principles (NGAAP);
e. discuss the merits and demerits of international financial reporting convergence;
f. evaluate corporate governance disclosures, including the chairman's report, within a company's annual report;
g. explain the role of the Financial Reporting Council of Nigeria (FRC) in financial reporting regulation and IFRS compliance enforcement;
h. understanding of the Conceptual Framework for Financial Reporting by the International Accounting Standard Board (IASB);
i. explain the professional accountants' code of ethics as it applies to financial reporting;
j. identify and evaluate ethical dilemmas that may arise in strategic business reporting; and
k. recommend and justify appropriate actions to be taken in response to ethical issues in financial reporting scenarios.

1.2 Regulatory framework of Strategic Business Reporting

1.2.1 International Financial Reporting Standards (IFRSs)

(a) The Need for global financial reporting standards

The journey towards the integration of accounting and financial reporting began when governments of developed nations and multinational corporations faced challenges due to varying national accounting standards. These differences required foreign investors to convert the local financial statements of investee companies to their home country's Generally Accepted Accounting Principles (GAAP) for interpretation and decision-making. This process was costly, time-consuming, and complex, making cross-border investment cumbersome.

With the rise of globalization in the 1970s, there was a significant push to remove barriers to international trade, including the harmonization of business and accounting languages. The necessity to create a globally accepted financial reporting framework led to the development of what we now know as **International Financial Reporting Standards (IFRS)**.

(b) The Evolution from IASC to IFRS Foundation

The IFRS journey started as an effort to harmonize accounting within the European Union (EU), but its global significance soon became evident. Initially, international accounting standards were issued by the **International Accounting Standards Committee (IASC)**, established in **1973**. The IASC was the first international accounting standard-setting

body, and between **1973 and 2001**, it issued **International Accounting Standards (IASs)** to improve global financial reporting comparability.

To strengthen the independence and effectiveness of global standard-setting, the IASC underwent a major reorganization in 2001, leading to the creation of:

(i) The International Accounting Standards Board (IASB) – an independent standard-setting body responsible for developing IFRS.
(ii) The IFRS Foundation, a not-for-profit public interest organization established to oversee the work of the IASB and promote IFRS adoption globally.

As part of the restructuring:

i. The IASB succeeded the IASC and assumed responsibility for setting international accounting standards.
ii. The Standing Interpretations Committee (SIC) was replaced by the International Financial Reporting Interpretations Committee (IFRIC), later renamed the IFRS Interpretations Committee (IFRS IC).

During its first meeting in April 2001, the IASB adopted all IASs and SICs that were in force at that time, continuing the development of new and revised standards, which have since been known as International Financial Reporting Standards (IFRSs).

(c) IFRS as a Global Financial Reporting Framework

Over time, IFRS transitioned from an effort of **harmonization** (reducing differences between standards in different jurisdictions) to **convergence** (developing a unified set of high-quality accounting standards applicable globally). By the 1990s, the goal was to create a **single, globally accepted accounting framework** that major capital markets could adopt.

As of **2013**, IFRS had been adopted in **more than 100 countries, including the European Union**, with many nations either requiring or permitting IFRS in financial reporting. The **IASB**, headquartered in London, currently consists of **15 members from nine countries**, including representatives from major economies such as the United States.

(d) Governance Structure and Role of the IFRS Foundation

The **IFRS Foundation** oversees the standard-setting activities of the **IASB** and is responsible for developing globally accepted financial reporting standards. It is funded through contributions from:

(i) Major accounting firms
(ii) Private financial institutions
(iii) Industrial companies
(iv) Central and development banks
(v) National funding regimes
(vi) International and professional organisations

The **mission of the IFRS Foundation** is to develop IFRS Standards that promote:

(i) **Transparency** – By enhancing international comparability and quality of financial information, IFRS enables investors and market participants to make informed economic decisions.
(ii) **Accountability** – IFRS strengthens trust by bridging the information gap between capital providers and management, ensuring corporate accountability.

(iii) **Economic efficiency** – By providing a common accounting language, IFRS reduces reporting costs for multinational businesses, improves capital allocation, and enhances global investment efficiency.

(e) IFRS as a Comprehensive Financial Reporting Framework

The term **International Financial Reporting Standards (IFRS)** is used broadly to encompass the entire body of globally accepted accounting rules, which includes both the **historical International Accounting Standards (IASs) issued by the IASC** and the **new IFRS standards developed by the IASB**. Additionally, it includes interpretations that clarify financial reporting requirements. The composition of IFRS is structured as follows:

Category	Pre-2001 (IASC Era)	Post-2001 (IASB Era)
Accounting Standards	International Accounting Standards (**IASs**)	International Financial Reporting Standards (**IFRSs**)
Interpretations	Standing Interpretations Committee Pronouncements (**SICs**)	IFRS Interpretations Committee Pronouncements (**IFRICs**)

Since the reorganisation in **2001**, many **IASs and SICs have been revised, replaced, or superseded by IFRSs and IFRIC interpretations** as the IASB continues to refine and enhance global financial reporting standards.

(f) Adoption, regulatory approval, and implementation of IFRS

While IFRS serves as the globally recognised financial reporting framework, **its application is subject to the approval of national regulatory bodies** in each jurisdiction. Every country follows its own formal process for endorsing IFRS before requiring or permitting its use in financial reporting. Some jurisdictions adopt IFRS **in full**, while others implement **local adaptations** to align with national regulatory requirements and economic considerations.

Thus, while IFRS aims to create a **uniform global accounting framework**, its actual application depends on **jurisdictional adoption policies**, ensuring that financial reporting remains both **globally consistent** and **locally relevant**.

While IFRS provides a globally recognised financial reporting framework, its adoption is subject to approval by **national regulators** in individual jurisdictions. Countries follow their **own due process** to assess and implement IFRS, with some opting for full adoption while others adapt IFRS to local regulatory environments.

In summary, the transition from **IASC to the IFRS Foundation and IASB** has been instrumental in **creating a single set of high-quality accounting standards** that enhance financial reporting consistency, support investor confidence, and facilitate global economic growth. IFRS continues to evolve, with ongoing efforts to **align financial reporting standards worldwide and strengthen the reliability of financial information in an increasingly interconnected global economy**.

1.2.2 Convergence of accounting standards

Convergence of accounting standards refers to the process of developing a single set of high-quality global accounting standards that can be applied consistently across all jurisdictions. This approach evolved from **harmonisation**, which focused on reducing differences among national accounting frameworks, to **convergence**, which seeks to create a unified global standard that enhances comparability and transparency in financial reporting.

The need for convergence arose due to the complexities faced by multinational corporations, investors, and regulators in interpreting financial statements prepared under different national GAAPs. A **globally accepted accounting framework** is expected to improve financial reporting quality, enhance market efficiency, and facilitate international investment and capital flows.

Historically, two principal accounting frameworks have competed as the foundation for an international GAAP:

(a) **International Financial Reporting Standards (IFRS)** – Developed by the **International Accounting Standards Board (IASB)** and increasingly adopted by countries worldwide.

(b) **United States Generally Accepted Accounting Principles (US GAAP)** – Developed by the **Financial Accounting Standards Board (FASB)**, widely used in the U.S. and adopted by some multinational companies.

Over time, **IFRS has gained widespread support** as the preferred framework for international financial reporting. Many jurisdictions either **require or permit IFRS** for domestic and foreign companies, particularly in the **European Union, Asia, Africa, and Latin America**.

(a) Advantages of convergence

(i) **Improved comparability for investors** – A single global accounting framework allows investors and analysts to compare financial statements across different countries, enhancing decision-making and reducing uncertainty.

(ii) **Simplified financial reporting for multinational corporations** – International businesses operating in multiple jurisdictions can prepare financial statements using a common set of accounting standards, reducing the need for reconciliations and adjustments.

(iii) **Enhanced Monitoring of Performance** – Management within multinational groups can assess and compare subsidiary performance more effectively when a uniform reporting framework is in place.

(iv) **Facilitation of Cross-Border Trade and Investment** – Businesses can evaluate the financial position of international customers, suppliers, and partners more easily, fostering growth in global trade.

(v) **Easier Access to International Capital Markets** – Companies seeking to raise funds internationally can benefit from a standardized reporting framework that increases transparency and investor confidence.

(vi) **Reduction in the Cost of Capital** – Greater transparency and comparability can lead to lower risk premiums for investors, reducing borrowing costs and enhancing capital allocation efficiency.

(b) Disadvantages of convergence

(i) **Conflict with national legal and tax systems** – Some countries have strict legal and tax-driven accounting frameworks that may not align with IFRS principles, requiring legislative amendments to enable IFRS adoption.

(ii) **Resistance from countries with established accounting standards** – Certain jurisdictions, such as the United States, have historically viewed their national frameworks as superior and have been reluctant to fully converge with IFRS.

(iii) **Cultural and economic differences** – A single set of accounting standards may not fully accommodate the diverse economic conditions, regulatory environments, and business practices across different regions.

While full **global convergence** remains a long-term objective, IFRS has emerged as the dominant international accounting framework, widely accepted across various jurisdictions. The process of convergence continues, with ongoing efforts by the **IASB and national standard-setters** to align financial reporting standards and enhance financial statement comparability across the world.

1.2.3 International adoption of IFRS

The **adoption of International Financial Reporting Standards (IFRS)** has significantly expanded across the world, reflecting the growing need for a **globally unified financial reporting framework**. IFRS promotes **comparability, transparency, and accountability**, enhancing investor confidence and improving the efficiency of capital markets.

The **IFRS Foundation** monitors global IFRS adoption and, as of **February 2025**, provides updated statistics on IFRS use across jurisdictions:

(a) **169 jurisdictions** have been profiled, covering all **G20 countries**.

(b) **161 jurisdictions (95%)** have made a public commitment to IFRS.

(c) **147 jurisdictions (87%)** require IFRS for all or most **publicly accountable entities** (listed companies and financial institutions).

(d) Of the **22 jurisdictions that have not fully adopted IFRS**:

(i) 13 permit IFRS without requiring it.
(ii) 1 requires IFRS only for financial institutions (Iraq).
(iii) 1 (Indonesia) is converging its national standards with IFRS but has not fully adopted it.
(iv) 7 (including the USA, China, India, and Egypt) continue using national or regional accounting standards.

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IFRS Adoption by Region

Region	Total Jurisdictions	Require IFRS for Most Publicly Accountable Entities	% Adoption in Region	Permit IFRS for Some Entities	Neither Require nor Permit IFRS
Europe	44	43	98%	1	0
Africa	40	37	92.5%	2	1
Middle East	13	12	92%	1	0
Asia-Oceania	35	28	80%	2	5
Americas	37	26	70%	9	2
Total	169	147	87%	14 (8.3%)	8 (4.7%)

Source: IFRS Foundation website

IFRS Adoption in Nigeria

Nigeria is **one of the African countries that have fully adopted IFRS**. The **Financial Reporting Council of Nigeria (FRCN)**, established under the **Financial Reporting Council Act, 2011**, is responsible for IFRS adoption and implementation.

Nigeria's IFRS Implementation Phases

Nigeria adopted **IFRS in phases**, as outlined in the **2010 IFRS Roadmap**:

Phase 1 (2012):

- IFRS became **mandatory for public interest entities (PIEs)**, including **listed companies, banks, insurance firms, and significant government-related entities**.
- These entities were required to prepare IFRS-compliant financial statements by **January 1, 2012**.

Phase 2 (2013):

- Other **publicly accountable entities**, such as unlisted companies with significant public interest, were required to adopt IFRS.

Phase 3 (2014):

- **Small and Medium-sized Enterprises (SMEs)** were required to adopt **IFRS for SMEs**, a simplified version of IFRS tailored for non-listed entities.

Impact and challenges of IFRS adoption in Nigeria

The adoption of IFRS in Nigeria has led to:

a. **Improved financial reporting quality**, enhancing investor confidence;
b. **Greater transparency**, aligning Nigeria with global best practices; and
c. **Easier access to international capital markets**, reducing financial statement conversion costs for multinational investors.

However, some challenges persist, including:

a. **High compliance costs** for SMEs and smaller corporations;
b. **Capacity-building issues**, as many local accountants and auditors require additional training in IFRS application; and
c. **Regulatory enforcement concerns**, with variations in compliance levels across industries.

Despite these challenges, IFRS remains the **recognised financial reporting framework in Nigeria**, ensuring consistency with global financial markets.

IFRS Adoption in Other Key Jurisdictions:

United States (US GAAP vs. IFRS)

The **United States has not fully adopted IFRS**, but allows **foreign companies** listed on US stock exchanges to file **IFRS financial statements** without **reconciling them to US GAAP**. The US **Securities and Exchange Commission (SEC)** continues to explore IFRS convergence, but challenges remain:

a. **US GAAP is more rules-based**, while **IFRS is principles-based**;
b. **Regulatory and legal complexities** make transitioning difficult; and
c. **Stakeholders in the US accounting and finance industry** resist full adoption due to potential disruptions.

Nonetheless, **many US multinational corporations and subsidiaries of IFRS-reporting companies apply IFRS in their global operations**, demonstrating its relevance in international markets.

European Union (EU) and IFRS

The **European Union (EU) was among the first regions to mandate IFRS**, requiring all **listed companies** to prepare **consolidated financial statements under IFRS since 2005**.

The **EU endorsement process** ensures that IFRS aligns with European regulatory and economic environments. While **listed entities must comply with IFRS**, individual **member states decide on IFRS application for non-listed companies**. For example:

The **UK initially allowed private companies to choose between IFRS and UK GAAP**, but over time, **UK GAAP incorporated IFRS-aligned standards**.

Scope of IFRS use in global markets

a. 30 EU and EEA member states require IFRS for companies listed in regulated markets.
b. 10 jurisdictions (e.g., Afghanistan, Angola, Belize) do not have stock exchanges but require IFRS for financial institutions.
c. Six countries (e.g., Argentina, Israel, Peru) require IFRS for most listed companies but not for financial institutions.
d. 85 jurisdictions require or permit IFRS for SMEs, with 12 others considering adoption.

The **adoption of IFRS has reshaped global financial reporting**, providing a **common accounting language** that enhances **comparability, transparency, and efficiency**. While **Nigeria and the European Union** have fully embraced IFRS, **countries like the US and China continue to use national standards** with limited convergence efforts.

IFRS adoption continues to evolve, with ongoing efforts by the **IASB and national standard-setters** to strengthen the **global financial reporting landscape**. As more jurisdictions commit to IFRS, the standard will further **reduce financial reporting complexities, foster economic growth, and improve global capital market stability**.

1.2.4 The Relationship between FASB and IASB

The **United States Securities and Exchange Commission (SEC)** is responsible for **protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation in the United States**. As part of its regulatory role, the **SEC has recognised the importance of a single set of global financial reporting standards** to enhance comparability and improve the efficiency of international capital markets.

In the **United States**, the **SEC delegates accounting standard-setting responsibilities** to the **Financial Accounting Standards Board (FASB)**, which develops and maintains **US Generally Accepted Accounting Principles (US GAAP)**. On a global scale, the **International Accounting Standards Board (IASB)** is responsible for developing **International Financial Reporting Standards (IFRS)**, which are widely adopted across jurisdictions.

(a) The Norwalk Agreement (2002)

In an effort to promote **global financial reporting consistency**, the **IASB and FASB held a joint meeting in 2002 in Norwalk, Connecticut, USA**. At this meeting, both boards acknowledged their commitment to developing **high-quality, compatible accounting standards** that could be used for both **domestic and cross-border financial reporting**.

Following the meeting, the **Norwalk Agreement** was signed, outlining a **Memorandum of Understanding (MoU)** between FASB and IASB. The key commitments in this agreement were to:

(i) **Work towards full compatibility** between **US GAAP and IFRS** as soon as practicable.

(ii) **Coordinate future work programs** to ensure that once compatibility is achieved, it is maintained.

To achieve these goals, FASB and IASB agreed to:

(i) Undertake **short-term projects** to **eliminate individual differences** between US GAAP and IFRS.

(ii) Engage in **joint projects** on significant accounting topics, including:

- Business combinations
- Financial instruments
- Leases
- Revenue recognition
- Insurance contracts

The objective was to create **a unified set of high-quality international accounting standards** that would be **suitable for use in all capital markets, including the United States**.

(c) Roadmap for IFRS adoption in the US

As part of its commitment to IFRS convergence, the **SEC announced a roadmap for the adoption of IFRS in the United States**. The roadmap initially projected that:

(i) Large US companies would begin adopting IFRS by 2014.

(ii) Other entities would transition in subsequent phases.

However, despite these initial plans, **full IFRS adoption in the US has not materialised**. Resistance from **US stakeholders, the legal complexity of transitioning from rules-based US GAAP to principles-based IFRS, and**

concerns over regulatory oversight have delayed any full-scale move towards IFRS adoption.

(d) The concept of "condorsement" (2010)

Before 2010, three primary approaches to IFRS adoption were considered:

(i) **Adoption / Conversion** – A direct switch from **US GAAP to IFRS**, with companies applying IFRS as issued by the IASB.

(ii) **Convergence** – Aligning **US GAAP with IFRS** through **gradual standard-by-standard updates**.

(iii) **Endorsement** – A **formal approval process**, where IFRS standards are reviewed before being incorporated into **US financial reporting regulations**.

In 2010, an SEC official introduced the term **"Condorsement"**, describing a hybrid approach combining **convergence and endorsement**. Under this plan:

(i) US GAAP would remain in existence but would be gradually aligned with IFRS through convergence projects.

(ii) The FASB would endorse IFRS in areas where significant differences remain.

The condorsement model reflected a **cautious approach to IFRS adoption**, allowing the **US to retain control over its standard-setting process** while benefiting from **global financial reporting harmonisation**.

(e) Conclusion: Future of IFRS in the US

While IFRS has become the global accounting standard in most parts of the world, the US remains committed to US GAAP. There is little indication that IFRS will be fully adopted in the US in the near future.

Despite this, FASB and IASB continue to work together on convergence efforts, ensuring that US GAAP and IFRS remain as aligned as possible. However, as of today, US GAAP remains distinct from IFRS, and companies operating in the US continue to prepare financial statements under the FASB's regulatory framework.

1.2.5 Principles-based vs. Rules-based financial reporting system

The **Principles-based** and **Rules-based** approaches represent two distinct financial reporting methodologies that influence the preparation and interpretation of financial statements globally.

(a) Principles-Based Financial Reporting (e.g., IFRS)

Principles-based accounting, as exemplified by **International Financial Reporting Standards (IFRS)**, is widely adopted in modern financial reporting. It focuses on **broad accounting principles** rather than prescriptive rules, allowing companies to apply **professional judgment** to ensure financial statements are **understandable, relevant, comparable, and faithfully represent economic transactions**.

(b) Key Features of Principles-Based Accounting:

(i) **Flexibility** – Enables adaptation to different industries and business models.

(ii) **Conceptual framework reliance** – Ensures transactions align with **economic substance rather than form**.

(iii) **Reduces loopholes** – Focuses on core principles to prevent accounting manipulation.

(iv) **Judgment-based approach** – Requires management discretion in financial reporting, which may lead to **inconsistencies** between entities.

However, critics argue that **excessive discretion may lead to reduced transparency**, allowing companies to present financial information in a way that **favours their interests rather than the economic reality**.

(c) Rules-based financial reporting (e.g., US GAAP, former Nigerian SAS)

A **Rules-based** approach, such as **US Generally Accepted Accounting Principles (US GAAP)** and Nigeria's former **Statement of Accounting Standards (SAS)**, prescribes **detailed accounting rules** that companies must follow. This framework seeks to enhance comparability and minimize ambiguity by defining specific **accounting treatments for different scenarios**.

(d) Key features of Rules-based accounting:

(i) **Detailed prescriptions** – Establishes clear, structured guidelines for transactions.

(ii) **Consistency** – Ensures financial statements of different companies are directly comparable.

(iii) **Legal protection** – Reduces litigation risks for accountants by following explicit rules.

(iv) **Reduces judgment reliance** – Minimizes subjective interpretations.

However, **strict adherence to rules may lead to loopholes**, where companies structure transactions to **comply with the letter rather than the spirit of the law**. Additionally, rules-based systems **tend to be complex**, requiring frequent updates to **cover emerging financial instruments and economic events**.

Comparison of Principles-Based vs. Rules-Based Accounting

Aspect	Principles-Based (IFRS)	Rules-Based (US GAAP, Former SAS)
Flexibility	High – allows for professional judgment.	Low – rigid application of rules.
Comparability	Can vary due to judgment-based application.	High due to uniform rules.
Transparency	Promotes faithful representation but may lead to inconsistencies.	Reduces judgment but can be exploited via loopholes.
Adaptability	Can accommodate new and complex transactions.	Requires frequent revisions to address emerging transactions.
Legal Protection	Requires strong corporate governance.	Reduces litigation risk for preparers.
Potential for Manipulation	Higher due to discretion in accounting treatments.	Rules can be manipulated for favourable reporting.

(e) IFRS vs. US GAAP: Ongoing Convergence Efforts

Historically, **IFRS has been more principles-based**, whereas **US GAAP has been more rules-based**. However, **convergence efforts by the IASB and FASB** have led to increased alignment, particularly in areas such as:

(i) Business combinations;
(ii) Revenue recognition (IFRS 15 & ASC 606);
(iii) Financial instruments (IFRS 9 & ASC 815); and
(iv) Leases (IFRS 16 & ASC 842).

Despite these efforts, **differences persist in areas such as lease accounting, impairment testing, and insurance contracts**.

(f) Case Studies Highlighting the Impact of Rules-Based Standards

(i) Enron Scandal (2001) – US GAAP Loophole Exploitation

Enron structured **off-balance-sheet entities** to hide liabilities, exploiting **rules-based loopholes** within **US GAAP**. The company's financial engineering misled investors, leading to **$75 billion in shareholder losses** and **the largest bankruptcy in corporate history** at that time.

(ii) WorldCom Scandal (2002) – Rules-Based Reporting Manipulation

WorldCom's management **capitalized expenses instead of recording them as costs**, inflating profits by **$11 billion**. The **strict rules-based system allowed the firm to misinterpret technical provisions**, delaying detection by auditors and regulators.

These cases highlight how **rules-based accounting frameworks, despite being prescriptive, can still be manipulated** if **entities exploit technical loopholes**.

(g) Regulatory and market implications

As financial markets become increasingly global, **regulators continue to assess the effectiveness of both systems**:

(i) Principles-Based IFRS provides flexibility but requires strong regulatory oversight.

(ii) Rules-Based US GAAP offers clarity but needs frequent updates and refinements.

The **American Institute of Certified Public Accountants (AICPA)** and **SEC** have proposed **gradual convergence** between IFRS and US GAAP, though **full IFRS adoption in the US remains uncertain**.

(h) Conclusion: The future of financial reporting

Both **principles-based** and **rules-based** systems have **merits and drawbacks**.

(i) IFRS, as a principles-based system, is more adaptable to complex financial transactions but relies heavily on professional judgment.

(ii) US GAAP, being rules-based, ensures standardization and consistency but can lead to technical loophole exploitation.

Most modern frameworks integrate both elements, emphasizing principles while incorporating specific guidance where necessary. The global convergence movement, driven by IASB and FASB, continues to narrow the gap between IFRS and US GAAP, ensuring that financial reporting remains transparent, reliable, and relevant in an evolving economic landscape.

1.2.6 Accounting rules In Nigeria

Sources of regulation

Financial reporting in Nigeria is governed by several regulatory frameworks that ensure **transparency, comparability, and accountability** in financial reporting. The main sources of regulation include:

(i) **International Financial Reporting Standards (IFRS):** The globally accepted framework for financial reporting, issued by the **International Accounting Standards Board (IASB)** and adopted in Nigeria.

(ii) **Companies and Allied Matters Act (CAMA) 2020:** The primary corporate law regulating financial reporting, company administration, and compliance obligations.

(iii) **Financial Reporting Council of Nigeria (FRC) Act 2011 (as amended in 2023):**

- Establishes the **Financial Reporting Council of Nigeria (FRCN)** as the regulatory body responsible for **monitoring and enforcing** compliance with financial reporting standards.
- The **FRC (Amendment) Act 2023** strengthens corporate governance, regulatory oversight, and enhances financial reporting quality in Nigeria.

(iv) **Conceptual Framework for Financial Reporting by IASB:** Guides the **recognition, measurement, presentation, and disclosure** of financial information under IFRS.

(v) **IFRS Foundation Constitution:** Outlines the governance structure and operational principles of the **IFRS Foundation and IASB**.

Further Reading:

Candidates should review the provisions and requirements of the following regulations for a deeper understanding of Strategic Business Reporting and Financial Reporting:

a. Financial Reporting Council (FRC) Act, 2011 (as amended in 2023);
b. Companies and Allied Matters Act (CAMA) 2020;
c. Conceptual Framework for Financial Reporting (IASB);
d. IFRS Foundation Constitution; and
e. Other relevant financial reporting and corporate governance regulations.

Evolution of accounting standards in Nigeria

(a) Nigerian Accounting Standards Board (NASB)

The **Nigerian Accounting Standards Board (NASB)** was established in **1982** as an independent body responsible for **developing and issuing Nigerian accounting standards**. These were known as **Statements of Accounting Standards (SAS)**, providing financial reporting guidelines.

The **legal backing** for NASB was provided under **Section 335 of the then Companies and Allied Matters Act (CAMA) 1990**, which stated:

"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."

(b) Establishment of the Financial Reporting Council of Nigeria (FRCN)

The Financial Reporting Council of Nigeria (FRCN) was established under the Financial Reporting Council of Nigeria Act No. 6 of 2011, replacing NASB. The FRCN was created to align Nigeria's financial reporting framework with IFRS and promote high-quality corporate reporting.

Composition of the FRC Board

The FRCN Board consists of:

a. **A Chairman** appointed by the President of Nigeria.
b. **The Executive Secretary/Chief Executive Officer (CEO)** of FRC.
c. **At least one representative each from key regulatory bodies and institutions**, including:
    i. Institute of Chartered Accountants of Nigeria (ICAN) – *2 Representatives*
    ii. Association of National Accountants of Nigeria (ANAN) – *2 Representatives*
    iii. Office of the Accountant General of the Federation
    iv. Office of the Auditor General of the Federation
    v. Central Bank of Nigeria (CBN)
    vi. Federal Ministry of Commerce (now, Federal Ministry of Trade and Investments)
    vii. Federal Ministry of Finance
    viii. Securities and Exchange Commission (SEC)
    ix. Nigerian Stock Exchange (now Nigeria exchange or "NGX")
    x. Federal Inland Revenue Service (FIRS)
    xi. Corporate Affairs Commission (CAC)
    xii. National Insurance Commission (NAICOM)
    xiii. Nigerian Deposit Insurance Corporation (NDIC)
    xiv. Chartered Institute of Stockbrokers (CIS)
    xv. Chartered Institute of Taxation of Nigeria (CITN)
    xvi. Nigeria Accounting Association (NAA)
    xvii. Nigerian Association of Cambers of Commerce, Industries, Mines and Agriculture (NACCIMA)
    xviii. Nigeria Institute of Estate Surveyors and Valuers (NIESV)
    xix. National Pension Commission (PENCOM)
    xx. Executive Secretary of the Council (who also serves as the Chief Executive Officer for the FRC)

Directorates of the FRCN

The FRCN operates through **six directorates**, each responsible for a **specific aspect of financial reporting and governance**:

i. **Directorate of Accounting Standards for Public Sector** – Ensures compliance with IPSAS (International Public Sector Accounting Standards).
ii. **Directorate of Accounting Standards for Private Sector** – Regulates financial reporting for corporate entities and ensures IFRS compliance.
iii. **Directorate of Auditing Practices Standards** – Oversees audit quality, ensuring that external auditors comply with professional and ethical requirements.

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iv. **Directorate of Actuarial Standards** – Supervises financial reporting standards for insurance and pension entities.
v. **Directorate of Corporate Governance** – Implements corporate governance regulations, monitoring compliance with **Nigeria's Corporate Governance Code**.
vi. **Directorate of Inspection & Monitoring** – Conducts financial reporting compliance reviews and enforcement activities.

Responsibilities of the FRCN

The **Financial Reporting Council of Nigeria (FRCN)** has **broad regulatory responsibilities** to ensure **integrity and reliability** in financial reporting. The FRCN is tasked with:

a. **Developing and publishing financial reporting standards** aligned with IFRS and IPSAS;
b. **Ensuring compliance with accounting and auditing standards** by public interest entities;
c. **Overseeing corporate governance practices** and financial disclosures in listed and unlisted companies;
d. **Monitoring the quality of financial reports** and ensuring investor protection.
e. **Regulating the activities of professional accountants, auditors, actuaries, and corporate finance professionals**.
f. **Collaborating with regulatory agencies** (CBN, SEC, NGX, NAICOM, FIRS, CAC) to enforce financial reporting compliance.
g. **Issuing sanctions and penalties** for non-compliance with financial reporting standards.

Responsibilities of companies and key stakeholders

Under the FRC Act, companies and key stakeholders are expected to:

a. Prepare and present financial statements in accordance with IFRS.
b. Ensure corporate governance compliance, including disclosure of financial risks.
c. Appoint qualified accountants and auditors to review financial statements.
d. Submit financial statements to regulatory bodies (SEC, FIRS, CAC, NGX).

IFRS Adoption Roadmap (Under the FRC Act 2011, as Amended in 2023)

The FRCN facilitated Nigeria's transition from **Nigerian GAAP (SAS) to IFRS** through a structured roadmap:

(i) **Phase 1 (2012):** Mandatory IFRS adoption for Public Interest Entities (PIEs), including listed companies, banks, and insurance firms.
(ii) **Phase 2 (2013):** Other significant public entities, including large unlisted companies and regulated financial institutions, were required to comply.
(iii) **Phase 3 (2014):** Small and Medium-sized Entities (SMEs) were mandated to apply IFRS for SMEs.

As per the **FRC Act (as amended in 2023)**, compliance enforcement has been strengthened, ensuring **penalties for non-compliance** and **greater regulatory oversight**.

Industry-specific accounting standards in Nigeria

While IFRS is the primary accounting framework, some industry-specific standards (formerly SAS) still apply where they do not conflict with IFRS:

SAS Standard	Industry/Scope
SAS 14	**Petroleum Industry (Downstream)**
SAS 17	**Petroleum Industry (Upstream)**
SAS 25	**Telecommunications Industry**
SAS 32	**Not-for-Profit Organizations**

Conclusion

Nigeria's financial reporting landscape has **evolved significantly**, transitioning from **NASB and SAS to IFRS under the FRCN**. The **FRC Act of 2011 (as amended in 2023)** further strengthens **regulatory enforcement, corporate governance, and financial transparency**.

Key takeaways for candidates:

a. Understand the FRC of Nigeria's regulatory framework and governance structure.
b. Recognise the role of IFRS and CAMA 2020 in financial reporting compliance.
c. Review the FRC Act 2011 (as amended) to understand corporate responsibilities.
d. Ensure familiarity with industry-specific standards and sectoral reporting requirements.

By adhering to these acts, regulations and standards, Nigeria aims to enhance investor confidence, improve financial transparency, and align with global best practices in corporate reporting.

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International Financial Reporting Standards – A list

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

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

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Standard	Applicable in Nigeria	Examinable at this level?
IFRS 1: First time adoption of IFRS	Yes	Yes
IFRS 2: Share-based payment	Yes	Yes
IFRS 3: Business combinations	Yes	Yes
IFRS 5: Non-current assets held for sale and discontinued operations	Yes	Yes
IFRS 6: Exploration for and evaluation of mineral resources	Yes	Yes
IFRS 7: Financial Instruments: Disclosures	Yes	Yes
IFRS 8: Operating segments	Yes	Yes
IFRS 9: Financial Instruments	Yes	Yes
IFRS 10: Consolidated financial statements	Yes	Yes
IFRS 11: Joint arrangements	Yes	Yes
IFRS 12: Disclosure of interests in other entities	Yes	Yes
IFRS 13: Fair value measurement	Yes	Yes
IFRS 14: Regulatory deferral accounts	Yes	Yes
IFRS 15: Revenue from contracts with customers	Yes	Yes
IFRS 16: Leases	Yes	Yes
IFRS 17: Insurance contracts	Yes	No
IFRS 18: IFRS 18 Presentation and Disclosure in Financial Statements	Yes (*2027)	Yes
IFRS 19: Subsidiaries without Public Accountability	Yes (*2027)	Yes
IFRS for SMEs	Yes	Yes
*NGAAP-SAS 32- Statement for Not-for-profit	Yes	Yes

**This is a local standard adopted in Nigeria for Not-for-profit making organisation that may not have adopted IFRS or IFRS for SMEs.*

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Companies and Allied Matters Act (CAMA) 2020

The Companies and Allied Matters Act (CAMA) 2020 serves as the primary legislation governing corporate regulation and financial reporting in Nigeria. It establishes the legal framework for accounting records, financial statement preparation, audits, and disclosures.

Financial reporting requirements under chapter 14 of CAMA 2020

Chapter 14 of CAMA 2020, titled **"Financial Statements and Audit Accounting Records",** outlines the statutory requirements for financial reporting, auditing, and disclosure obligations of companies. The relevant sections of the Act are detailed below:

Accounting records and compliance:

Companies to keep accounting records (Section 374)

a. Companies must **maintain proper accounting records** that explain all transactions and reflect the company's financial position at any time.
b. Accounting records must comply with **IFRS and FRCN standards**.

Place, duration, and form of records (Section 375)

a. Accounting records must be **kept at the company's registered office** and maintained for at least **six (6) years**.
b. Records may be **electronic or physical**, provided they are **readable and retrievable when required**.

Penalties for Non-Compliance (Section 376)

Failure to maintain proper accounting records attracts **regulatory penalties** under CAMA.

Directors' Responsibilities for Financial Reporting:

Directors' Duty to Prepare Annual Accounts (Section 377)

Directors are responsible for **ensuring that financial statements comply with IFRS and the FRCN's financial reporting framework**.

Form and Content of Financial Statements:

Form and Content of Individual Financial Statements (Section 378)

a. Financial statements must comply with:
   - First Schedule of CAMA 2020
   - IFRS, as adopted by the Financial Reporting Council of Nigeria (FRCN)
b. The financial statements must provide a **true and fair view** of the company's financial performance and position.

The financial statements shall include:

(a) **Balance sheet (statement of financial position)** – Must present an accurate and fair view of the company's assets, liabilities, and equity at the reporting date.
(b) **Statement of profit or loss (statement of comprehensive income)** – Must reflect the company's revenues, expenses, profits, and losses for the reporting period.
(c) **Statement of cash flows** – Must report the cash movements in operating, investing, and financing activities.

(d) **Statement of changes in equity** – Must show changes in the company's share capital, reserves, and retained earnings.
(e) **Notes to the financial statements** – Must include disclosures on **accounting policies, assumptions, and additional information** relevant to the financial statements.
(f) **Statement of the source and application of funds** – Must provide information on the company's fund generation and utilization.
(g) **Value added statement** – Must report how wealth is created and distributed among stakeholders (employees, government, creditors, shareholders, etc.).
(h) **Five-year financial summary** – Must provide a comparative financial summary for a minimum of five years.

If compliance with the prescribed format does not present a true and fair view, the directors must provide additional information or depart from certain requirements, stating the reasons and impact in the notes to the financial statements.

Group Financial Statements of Holding Companies (Section 379 - 381):

a. Holding companies must **prepare consolidated financial statements** incorporating the financial performance of all subsidiaries.
b. **Definitions of a Holding Company and Subsidiary (Section 381):**
   - A **holding company** controls **more than 50% voting rights** in a subsidiary.
   - A **wholly-owned subsidiary** is **100% owned** by the parent company.

Additional Disclosure Requirements (Sections 382 - 384):

Financial statements must disclose:

- Loans granted to directors, officers, and connected persons.
- Details of related-party transactions.

Directors' reports and compliance obligations

Directors' report (Section 385)

The **Directors' report** must include:

- A summary of the company's business performance.
- Corporate governance disclosures.
- The company's risk management and compliance measures.

Financial statements completion and filing (Sections 386 - 392)

- **Signing of financial statements (Section 386):** Must be signed by **at least two directors**.
- **Persons entitled to receive financial statements (Section 387):** Shareholders and other stakeholders entitled to **receive and review** financial statements.
- **Directors' Duty to Deliver Financial Statements (Section 388):** Directors must **submit financial statements to the Corporate Affairs Commission (CAC) and other regulatory agencies** within the required period.
- **Penalties for Non-Compliance (Sections 389 - 391):** Companies delivering **defective or fraudulent** financial statements face **legal penalties, fines, or regulatory sanctions**.
- **Shareholders' Right to Access Financial Statements (Section 392):** Shareholders can **request copies of the company's financial statements** at any time.

Modified Financial Statements

Certain **small companies and holding entities** are permitted to file **modified financial statements**:

Entitlement to Deliver Modified Financial Statements (Sections 393 - 397)

Qualification as a small company (Section 394):

a. Annual turnover **not exceeding ₦120 million**.
b. Total assets **not exceeding ₦60 million**.
c. **No foreign shareholders** or government ownership.
d. Directors must hold **at least 51% of the company's equity**.

Modified Individual and Group Financial Statements (Sections 396 - 397):

Small and parent companies may **present financial information in simplified form** if eligible.

Publication of financial statements

Publication of full and abridged financial statements (Sections 398 - 399)

a. **Companies publishing financial statements in newspapers or electronic media** must ensure they are **accurate and complete**.
b. **Abridged financial statements** must indicate that **full statements are available on request**.

Supplementary Regulations and Amendments

Power to Alter Accounting Requirements (Section 400)

The **Minister of Industry, Trade, and Investment**, in consultation with FRCN and CAC, has the authority to **amend financial reporting requirements** when necessary.

Conclusion

CAMA 2020 **strengthens Nigeria's financial reporting framework**, ensuring compliance with **IFRS and FRCN regulations**. It enhances **corporate governance, transparency, and regulatory oversight**, ensuring **better financial reporting practices**.

Key Takeaways for Candidates:

a. Understand CAMA 2020's financial reporting requirements.
b. Recognise the responsibilities of directors and auditors.
c. Familiarise with modified financial reporting provisions.
d. Ensure compliance with corporate filing and disclosure obligations.

By enforcing **financial reporting discipline**, CAMA 2020 helps Nigerian companies **maintain investor confidence and meet global reporting standards**.

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1.3 Ethical Issues in Strategic Business Reporting

1.3.1 Introduction to ethics in professional accounting

Ethics, though often challenging to define, is fundamentally concerned with **human character and conduct**. It goes beyond mere compliance with **laws, rules, and regulations**—it is about **doing the right thing** even in the absence of explicit directives. In the accounting profession, ethical behaviour is crucial to maintaining **public trust, professional integrity, and accountability**.

Professional accountants often face **ethical dilemmas**, where their responsibilities to **employers, clients, regulators, and the public** may come into conflict. Navigating these situations requires **sound ethical judgment and adherence to established ethical principles**.

1.3.2 Ethical standards in the accounting profession

The **International Federation of Accountants (IFAC)** publishes the **"Handbook of the International Code of Ethics for Professional Accountants"**, which provides a **global ethical framework** for professional accountants. This code:

a. Sets **fundamental principles** that guide accountants in **ethical decision-making**.
b. Helps accountants address situations where **ethical conflicts arise**.
c. Promotes **public interest** by ensuring professional behaviour remains **transparent and credible**.

Most **national accounting bodies** develop their own **code of ethics** in alignment with the IFAC framework, incorporating **local legal, regulatory, and cultural considerations**. In Nigeria, the **Institute of Chartered Accountants of Nigeria (ICAN)** has established its **Code of Professional Conduct and Guide for Members**, which all **members and student members** must follow. This code provides **guidance on ethical decision-making, professional conduct, and regulatory compliance**.

1.3.3 Ethical challenges in accounting

While **most individuals uphold integrity and honesty**, accountants may encounter situations where **ethical decisions are not straightforward**. Ethical dilemmas may arise from:

a. **Pressure from employers or clients** to manipulate financial information;
b. **Conflicts of interest** between personal gain and professional responsibilities; and
c. **Regulatory and legal constraints** that may complicate ethical decision-making.

The **ICAN Code of Conduct** serves as a **practical guide** to help accountants **identify, assess, and respond to ethical challenges**, ensuring they uphold the **highest standards of professionalism**.

1.3.4 Application to accountants in practice and business

Ethical standards apply to **all accountants**, regardless of whether they work in **public practice, corporate environments, regulatory bodies, or academia**.

a. **Accountants in practice** must ensure their work is conducted **objectively, independently, and free from undue influence**.

b. **Accountants in business** must maintain **professional competence, confidentiality, and integrity**, particularly when preparing **financial statements, tax reports, and corporate disclosures**.

This section explores **ethical considerations in financial reporting**, including:

a. **The role of ethical guidelines in financial statement preparation**.
b. **Common ethical dilemmas faced by accountants**.
c. **How to apply ethical principles in professional decision-making**.

By adhering to **ethical principles**, accountants not only **protect the reputation of the profession** but also contribute to **stronger corporate governance, investor confidence, and financial system integrity**.

1.3.5 Fundamental principles of professional ethics

The **Institute of Chartered Accountants of Nigeria (ICAN) Code of Ethics** is structured around **five fundamental principles** that guide members in their professional and business conduct. These principles ensure that **chartered accountants uphold the highest standards of integrity, professionalism, and ethical behaviour**.

(a) Integrity

Chartered accountants must be **honest, straightforward, and fair** in all **professional and business relationships**. Integrity extends beyond honesty to include **fair dealing, truthfulness, and professional transparency**.

A chartered accountant must not be associated with **any report, statement, or financial information** if they believe that it:

(i) Contains materially false or misleading information.
(ii) Includes statements or data presented recklessly.
(iii) Omits or obscures essential information, leading to a misleading impression.

(b) Objectivity

Professional Accountants must exercise **independent judgment** and **not allow bias, conflicts of interest, or undue influence** to compromise their professional decisions.

As professional accountants frequently encounter situations that may **challenge their objectivity**, they must actively:

i. **Avoid relationships** that could unduly influence professional judgment.
ii. **Resist pressures from clients, employers, or other stakeholders** that could impair their impartiality.

(c) Professional competence and due care

Chartered accountants have a duty to **maintain and enhance their professional knowledge and skills** to provide **competent and up-to-date services** to clients and employers.

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This principle requires accountants to:

i. Commit to lifelong learning to stay informed about current accounting practices, legislation, and evolving professional standards;
ii. Exercise diligence and adhere to technical and professional standards in all engagements; and
iii. Participate in continuing professional development (CPD) to maintain their ability to perform effectively within professional environments.

(d) Confidentiality

Professional Accountants must **respect the confidentiality of information** obtained through professional or business relationships. They must not **disclose confidential information to third parties** unless:

i. They have explicit authorization to do so.
ii. There is a legal or professional duty to disclose the information (e.g., in cases of fraud or regulatory compliance).

Additionally, confidential information must **not be used for personal advantage** or to benefit third parties.

(e) Professional Behaviour

Chartered accountants must **comply with all applicable laws and regulations** and refrain from actions that could **bring disrepute to the profession**. They should:

(i) Act with courtesy, professionalism, and respect in all professional interactions.
(ii) Ensure that their conduct upholds public confidence in the accounting profession.
(iii) Avoid actions that could mislead, deceive, or create reputational harm to the profession.

These fundamental principles form the foundation of **ethical professional conduct**, ensuring that accountants consistently **act in the public interest and uphold professional integrity**.

1.3.6 Threats to the fundamental principles of professional ethics

Accountants must adhere to **fundamental ethical principles**, but these principles can be challenged by various **threats** that may impair professional judgment, objectivity, and integrity. These threats often arise from **personal, financial, or professional pressures** and must be **identified, evaluated, and mitigated** to ensure compliance with ethical standards.

The five key **ethical threats** to professional accountants include:

(a) Self-interest threat;
(b) Self-review threat;
(c) Advocacy threat;
(d) Familiarity threat; and
(e) Intimidation threat.

Unless a threat is **clearly insignificant**, accountants must **implement safeguards** to eliminate or **reduce it to an acceptable level** to prevent ethical compromise.

Self-interest threat

A **self-interest threat** arises when an accountant's **personal or financial interests** conflict with their professional responsibilities. This could lead to **biased decision-making**, reluctance to take necessary but unfavorable actions, or compromised professional integrity.

Real-world examples of self-interest threats

Financial interest in a client: A financial controller holds shares in the company whose financial statements they are responsible for preparing. If company performance is poor, the controller may manipulate financial results to maintain stock value.

Loans or guarantees: An external auditor discovers irregularities in the financial statements of a company that has given them a personal loan. The auditor may hesitate to report the findings to avoid jeopardizing their financial relationship.

Incentive compensation: A CFO's bonus is tied to profitability, leading them to overstate revenue or understate liabilities to maximize their compensation.

Personal use of corporate assets: A finance manager uses company funds for personal expenses, such as vacations or luxury purchases, and then adjusts financial records to conceal the misuse.

Employment security concerns: A company's accountant discovers fraud committed by senior management but hesitates to report it due to fear of job loss.

How to mitigate self-interest threats

Avoid financial conflicts by ensuring accountants do not have direct financial stakes in their clients or employers.

Establish independent oversight to review critical financial decisions.

Maintain transparent policies on corporate asset usage.

Encourage whistleblowing mechanisms to protect employees from retaliation for reporting unethical conduct.

Self-review threat

A **self-review threat** occurs when an accountant is required to **evaluate their own previous work** or **judgment**, leading to **biased decision-making** and a failure to critically assess past errors.

Real-world examples of self-review threats

Internal accountants reviewing their own work: A company's accountant is responsible for both bookkeeping and internal auditing. When conducting a financial review, they may overlook errors or misstatements in their previous records to avoid scrutiny.

External auditor reviewing past work: An auditor previously prepared financial statements for a company they are now auditing. They may be reluctant to identify errors that could damage their professional credibility.

Financial analyst evaluating investment performance: An investment officer assesses the performance of an asset portfolio they previously recommended. If the investments perform poorly, they may manipulate performance metrics to justify their decisions.

How to mitigate self-review threats

Separate roles and responsibilities within the organization.

Require independent reviews by a different professional.

Implement strict rotation policies to prevent long-term association with the same tasks.

Advocacy threat

An **advocacy threat** arises when an accountant **actively promotes or defends the interests of a client or employer** in a way that **compromises objectivity and independence**.

Real-world examples of advocacy threats

defending a client during a tax audit: A tax consultant aggressively defends a client's position to tax authorities, ignoring questionable deductions that should have been corrected.

Lobbying for favorable regulations: A company's accountant advocates for changes in industry regulations that could loosen financial reporting standards, benefiting their employer but compromising transparency.

Misleading investors: A CFO presents exaggerated financial forecasts to potential investors to secure funding, knowing the projections are unrealistic.

How to mitigate advocacy threats

Ensure all information presented is accurate and not misleading.

Maintain professional skepticism when advocating on behalf of an organisation.

Disclose potential biases when preparing financial information for external stakeholders.

Familiarity threat

A **familiarity threat** arises when a close relationship with a client, colleague, or employer **impairs professional skepticism** and leads to **biased decision-making**.

Real-world examples of familiarity threats

Long-term relationship with a client: An external auditor has been auditing the same client for over 10 years and has developed a personal relationship with the CFO. This friendship may prevent objective reporting of financial irregularities.

Family members in key positions: A financial controller's spouse works in the procurement department. If the controller notices fraudulent procurement practices, they may hesitate to report them to avoid harming their spouse's career.

Accepting expensive gifts: An accountant receives luxury gifts or vacations from a supplier, creating a sense of obligation that could influence their purchasing decisions.

How to mitigate familiarity threats

Rotate roles regularly to avoid excessive closeness with clients.

Prohibit accountants from working on matters involving close relatives.

Implement strict policies on accepting gifts or preferential treatment.

Intimidation threat

An **intimidation threat** occurs when an accountant is pressured or coerced into **compromising ethical principles** due to fear of consequences.

Real-world examples of intimidation threats

Threat of job loss: A company's CEO pressures the CFO to adjust revenue figures to meet investor expectations, threatening termination if they refuse.

Influence from senior management: A finance manager is instructed to hide liabilities in financial statements by a dominant executive who controls promotions and salary reviews.

Legal or physical threats: A forensic accountant investigating fraud in a government agency receives anonymous threats, warning them to stop their audit.

How to mitigate intimidation threats

Establish clear reporting channels for ethical concerns.

Ensure whistleblower protection policies are in place.

Encourage a culture of ethical leadership within organizations.

Conclusion

Ethical threats are **real-world challenges** that accountants face in their **professional and business environments**. To maintain **integrity, objectivity, and public trust**, accountants must:

(a) **Recognise and evaluate ethical threats** in their professional roles.
(b) **Implement safeguards** to mitigate risks and prevent ethical breaches.
(c) **Follow professional codes of conduct**, such as those set by **ICAN, IFAC, and other regulatory bodies**.

By upholding **strong ethical standards**, accountants **protect financial transparency, corporate governance, and public trust in the profession**.

1.3.7 Professional ethical challenges in business and financial reporting

Accountants in business play a critical role in ensuring **financial transparency, compliance, and ethical decision-making**. However, they often face **ethical dilemmas** where their **professional integrity** is tested by competing pressures from employers, clients, or other stakeholders.

To uphold **the fundamental principles of ethics**, accountants must recognise and address **potential ethical threats** that could impair **objectivity, professional competence, and due care** in financial reporting.

Ethical challenges for accountants in business

(a) Responsibilities of accountants in business

Accountants in business are **directly responsible** for preparing and presenting **financial information**. Their primary obligation is to ensure that all financial reports:

(i) Reflect the true financial position of an entity.
(ii) Are prepared in compliance with IFRS and applicable financial reporting standards.
(iii) Are free from material misstatement or misleading representations.

However, **pressure from management or external stakeholders** may create **conflicts of interest**, making it challenging for accountants to maintain **independence and professional judgment**.

Real-World Ethical Dilemma

A finance manager is pressured by the Chief Financial Officer (CFO) to overstate revenue and understate liabilities to meet investor expectations. If the finance manager refuses, they risk losing their job or facing retaliation.

Ethical conflict: Should they comply and misrepresent financial information, or refuse and potentially face consequences?

Professional duty: Accountants **must not** prepare or approve misleading financial statements, even under pressure.

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(b) Ethical considerations in the preparation and reporting of financial information

Types of financial information at risk: Accountants in business prepare various financial reports, including:

i. **Financial statements** – Statement of financial position, income statement, and cash flow statement.
ii. **Forecasts and budgets** – Projections for financial planning.
iii. **Management discussion and analysis (MD&A)** – A report detailing financial performance.
iv. **Representation letters** – Documents provided to external auditors during audits.

All financial information must be:

- **Accurately prepared and honestly presented**.
- **Consistent with professional standards and regulatory requirements**.
- **Not influenced by pressure to manipulate data**.

(c) Common ethical threats in financial reporting

i. **Self-Interest threat** – When personal or financial incentives influence decision-making. ***Example:*** *A CFO inflates revenue to receive a performance-based bonus.*
ii. **Intimidation threat** – When an accountant is pressured by senior management to act unethically. ***Example:*** *A finance manager is told they will be fired if they refuse to manipulate financial data.*
iii. **Familiarity threat** – When close relationships lead to **biased decision-making**. ***Example:*** *An accountant avoids reporting a fraud case because it involves a long-time colleague.*
iv. **Advocacy threat** – When an accountant **promotes** an employer's financial position **without objectivity**. ***Example:*** *A finance executive misleads investors about financial health to secure funding.*

(d) Ethical response and safeguards

Accountants **must not ignore or accept** unethical behavior. When faced with pressure to manipulate financial information, safeguards include:

i. Consulting with superiors (audit committees, boards, or professional bodies);
ii. Refusing to participate in misleading financial reporting;
iii. Seeking independent legal or professional advice; and
iv. Resigning if ethical concerns remain unresolved.

Example – Self-interest threat in financial reporting

Scenario:

i. Olawale, a chartered accountant, is preparing financial statements for a company.
ii. His contract renewal depends on the Finance Director (Adeyemi), who is not a chartered accountant.
iii. Olawale discovers that lease obligations have been incorrectly classified as operating leases instead of finance leases.
iv. Correcting the classification would increase liabilities, which Adeyemi wants to avoid.
v. Adeyemi instructs Olawale to ignore the error, warning that it could affect the company's financial ratios.

Ethical analysis:

i. Olawale faces a self-interest threat because his job security depends on Adeyemi's approval.
ii. The current accounting treatment is incorrect and violates IFRS lease accounting rules.
iii. Olawale's professional duty:
    - Explain to Adeyemi that he cannot support misleading financial information.
    - If Adeyemi refuses to make corrections, report the issue to senior management or the audit committee.
    - If necessary, resign and report the matter to relevant authorities.

(d) Potential conflicts in professional responsibilities

Conflicts between employer expectations and professional ethics

At times, an accountant's responsibility to their employer may **conflict with their professional duty to comply with ethical principles**.

Situations that may create conflicts

a. **Pressure to act unlawfully or against regulations.** Example: A company asks an accountant to **evade tax liabilities** by falsifying records.
b. **Pressure to violate professional accounting standards.** Example: A finance manager is instructed to **inflate profits** to meet investor expectations.
c. **Pressure to mislead stakeholders.** Example: An accountant is told to **conceal losses from external auditors**.
d. **Pressure to produce misleading financial reports.** Example: An accountant is pressured to **manipulate tax compliance reports**.

Ethical decision-making in conflict situations

To address conflicts, accountants should:

i. Seek guidance from professional bodies (e.g., ICAN);
ii. Follow internal dispute resolution processes within the company;
iii. Seek independent legal advice if necessary; and
iv. Consider resignation if ethical violations persist.

Example – Intimidation threat in financial reporting

Scenario:

i. Efe, a chartered accountant, works for Oshogbo Holdings under the Finance Director, Kunle.
ii. Oshogbo Holdings revalues commercial properties annually in accordance with IAS 16.
iii. Last year's valuation showed a slight decrease in property values, but no downward adjustment was made.
iv. This year, the property values have dropped by 5%, with some properties losing as much as 15%.
v. Efe submits a report recognizing the fair value reduction.
vi. Kunle, a dominant personality, dismisses Efe's concerns, instructing him to ignore the valuation adjustments.
vii. Kunle sends an email stating: "Stop bothering me with this rubbish. Restate the numbers immediately."

Ethical analysis:

i. Efe faces an intimidation threat, as Kunle's authority may pressure him into unethical financial reporting.
ii. IAS 16 requires individual property revaluations, meaning Kunle's approach violates accounting standards.
iii. Efe's Professional Duty:
    - Meet with Kunle to clarify IAS 16 compliance requirements.
    - Remind Kunle that as a senior accountant, he must uphold ethical principles.
    - If Kunle refuses, escalate the matter to the audit committee or the board.
    - If the issue remains unresolved, resign and consider reporting to regulators.

Conclusion

Accountants in business **must remain vigilant against ethical threats** that could impair **objectivity, professional competence, and integrity**. Ethical dilemmas often arise from **financial pressure, senior management influence, or conflicts of interest**.

1.3.8 Key takeaways for professional accountants

a. Identify ethical threats early and assess their significance.
b. Implement safeguards to mitigate risks and uphold professional integrity.
c. Refuse to be associated with misleading financial reports.
d. Consult professional bodies or seek legal advice when ethical concerns persist.
e. If necessary, resign and escalate unresolved ethical violations.

By maintaining **ethical standards**, accountants **protect the credibility of financial reporting, uphold public trust, and contribute to sound corporate governance**.

1. 4 Chapter review

Before proceeding to the next chapter, ensure that you can:

a. explain the Role of the IASB in Convergence of Accounting Standards
b. discuss the extent of convergence in international financial reporting
c. discuss the sources of accounting regulation in Nigeria
d. discuss ethical issues in financial reporting
e. Discuss common ethical threats in financial reporting

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1.5 End of chapter questions and suggested solutions

1.5.1 End of chapter questions

Question 1: Ethics and financial reporting integrity

Scenario:
Ayo, a newly appointed financial controller, is responsible for preparing the financial statements of Oakfield Ltd. During the review process, Ayo discovers that the company has **overstated its revenue by 15% to attract new investors**. When he raises the issue with the Chief Financial Officer (CFO), he is told:

"Adjust the figures as instructed, or your future at this company might be short-lived."

Required:

(a) Identify and explain the **ethical threats** Ayo faces in this situation. *(5 marks)*
(b) Recommend the appropriate **professional actions** Ayo should take, in line with the **ICAN Code of Ethics**.

Question 2: IFRS Convergence and International Financial Reporting

Scenario:
Lush Fashion Ltd, a multinational clothing company headquartered in Nigeria, is expanding into Europe and the United States. The company's Nigerian financial statements **comply with IFRS**, but its new US subsidiary must **prepare financial statements under US GAAP**. The CEO is concerned about the **differences between IFRS and US GAAP**, particularly in lease accounting, revenue recognition, and financial instruments.

Required:

(a) Explain the concept of **IFRS convergence** and discuss its benefits and challenges for multinational corporations like Lush Fashion Ltd. *(8 marks)*
(b) Identify and discuss two key **differences between IFRS and US GAAP** that may affect Lush Fashion Ltd's financial reporting.

Question 3: Corporate Governance and Regulatory Compliance in Nigeria

Scenario:
Crystal Bank Plc, a publicly traded financial institution in Nigeria, has **failed to submit its audited financial statements to the Corporate Affairs Commission (CAC) within the stipulated timeframe** as required under **CAMA 2020**. Additionally, the Financial Reporting Council of Nigeria (FRCN) has flagged the bank for **non-disclosure of related-party transactions** in its annual report.

Required:

(a) Discuss the **financial reporting obligations** of Nigerian companies under **CAMA 2020 and the Financial Reporting Council Act**. *(7 marks)*
(b) Identify and explain the **potential regulatory penalties** Crystal Bank Plc could face for non-compliance.

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1.5.2 Suggested solutions

Question 1: Ethics and Financial Reporting Integrity

(a) Ethical Threats Ayo Faces

Ayo, as a financial controller, is facing multiple **ethical threats** under the **ICAN Code of Ethics**:

a. **Self-interest threat:** If Ayo complies with the CFO's instructions, he might **secure job stability**, but at the **expense of professional integrity**.
b. **Intimidation threat:** The CFO's threat of job loss creates undue pressure, making Ayo hesitant to report the issue truthfully.
c. **Advocacy threat:** If Ayo falsely inflates revenue figures, he is **misleading investors**, breaching the principle of **professional behaviour**.
d. **Objectivity threat:** The pressure from senior management may **bias Ayo's judgment**, preventing him from presenting financial information fairly.

(b) Recommended Professional Actions

Ayo must follow professional ethical principles and **take appropriate action**:

a. **refuse to alter the revenue figures**: Ayo should inform the CFO that **manipulating revenue violates IFRS, professional ethics, and regulatory requirements**.
b. c**Document the conversation**: Ayo should **keep written records** of all discussions to protect himself from potential retaliation.
c. **Escalate the issue internally**: If the CFO refuses to comply, Ayo should **report the matter to the company's audit committee, board of directors, or compliance officer**.
d. **seek external guidance**: If internal resolution fails, Ayo should consult **ICAN or another professional accounting body** for guidance.
e. **Consider whistleblowing and legal action**: If fraudulent reporting continues, Ayo should **resign and consider reporting the misconduct to regulators** (e.g., the FRCN, SEC, or CAC).

Final thought:

Ayo must **prioritize ethical responsibilities over job security**, as involvement in fraudulent financial reporting could lead to **professional sanctions, legal consequences, and reputational damage**.

Solution 2: IFRS convergence and international financial Reporting

(a) Explanation of IFRS convergence and its benefits/challenges *(8 marks)*

What is IFRS convergence?

IFRS **convergence** refers to the **process of aligning national accounting standards (e.g., US GAAP) with IFRS** to create a **single set of high-quality, globally accepted financial reporting standards**.

Benefits of IFRS Convergence for Lush Fashion Ltd:

(i) **Improved comparability for investors**: Financial statements will be **uniform across multiple jurisdictions**, making it **easier for investors to compare financial performance**.

(ii) **Reduced financial statement adjustments**: Lush Fashion Ltd will spend **less time reconciling** financial reports across different countries.

(iii) **Easier access to global capital markets**: IFRS-compliant companies are **more attractive to international investors and lenders**.

(iv) **Cost savings**: Eliminating the need to **prepare multiple sets of financial statements** under different standards reduces accounting costs.

Challenges of IFRS Convergence:

a. **Differences Between IFRS and US GAAP**: **Key differences in lease accounting, revenue recognition, and financial instruments** could create difficulties for Lush Fashion Ltd's US operations.

b. **Regulatory Resistance in Some Countries**: The **United States has not fully adopted IFRS**, requiring Lush Fashion Ltd to **continue using US GAAP for its US subsidiary**.

(b) Two Key Differences Between IFRS and US GAAP *(7 marks)*

(i) **Lease Accounting (IFRS 16 vs. ASC 842)**

- **IFRS 16** requires **all leases (except short-term leases) to be recognised on the balance sheet** as right-of-use assets and lease liabilities.
- **US GAAP (ASC 842)** allows **operating leases to remain off-balance sheet**, creating differences in financial reporting for leasing transactions.

(ii) **Revenue Recognition (IFRS 15 vs. ASC 606)**

Both IFRS 15 and ASC 606 follow a **five-step revenue recognition model**, but **US GAAP provides more industry-specific guidance**, while **IFRS relies more on principles-based judgment**.

Solution 3: Corporate governance and regulatory compliance in Nigeria

(a) Financial Reporting Obligations Under CAMA 2020 and the FRC Act *(7 marks)*

Under **CAMA 2020 and the FRCN Act**, Nigerian companies must:

(i) **Maintain proper accounting records (Section 374, CAMA 2020)**: Companies must **keep proper financial records for at least six (6) years**.

(ii) **Prepare annual financial statements (Section 377, CAMA 2020)**: Financial statements must **comply with IFRS and provide a true and fair view**.

(iii) **Submit Financial Statements to Regulators (Sections 388-392, CAMA 2020)**: Public Interest Entities (PIEs) must **file audited financial statements with the CAC, FRCN, and SEC**.

(iv) **Ensure Corporate Governance Compliance**: Listed companies must **disclose related-party transactions and governance policies**.

(b) Potential regulatory penalties for Crystal Bank Plc *(8 marks)*

If Crystal Bank Plc **fails to comply** with its financial reporting obligations, it may face:

(i) **Regulatory Fines and Sanctions**: The **FRCN and CAC can impose fines for late filing or misleading disclosures**.

(ii) **Legal Consequences (Sections 389-391, CAMA 2020): Failure to submit financial statements** can lead to **court action and penalties for directors**.

(iii) **Investor Confidence Damage**: Non-compliance may **harm investor trust** and **reduce stock value**.

(iv) **Possible Delisting from the Nigerian Stock Exchange (NGX)**: If the company is listed, continued **non-compliance with disclosure requirements** could result in **suspension or delisting**.

(v) **Loss of Banking License (For Financial Institutions)**: If the issue persists, **the Central Bank of Nigeria (CBN) may take regulatory action**, affecting the bank's ability to operate.

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CHAPTER 2

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

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2 Conceptual Framework for Financial Reporting

2.0 Learning objective

This chapter explores **the Conceptual Framework for Financial Reporting** issued by the **International Accounting Standards Board (IASB)** and how these principles shape financial statements in compliance with **International Financial Reporting Standards (IFRS)**.

2.1 Learning Outcomes

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

a. explain the **purpose and significance of general-purpose financial statements**.
b. identify the **components of the Conceptual Framework for Financial Reporting**.
c. analyze and apply **fundamental and enhancing qualitative characteristics** of financial information.
d. define and explain the **elements of financial statements**, including assets, liabilities, equity, income, and expenses.
e. understand the **recognition and derecognition** criteria for financial statement elements.
f. discuss and apply **measurement bases** such as historical cost, fair value, and present value in financial reporting.

2.2 The IASB Conceptual Framework for Financial Reporting

The **Conceptual Framework for Financial Reporting**, last updated in **March 2018**, provides **principles and guidelines** that underpin the preparation and presentation of financial statements. It consists of the following chapters:

Chapter 1 — The Objective of General-Purpose Financial Reporting
Chapter 2 — Qualitative Characteristics of Useful Financial Information
Chapter 3 — Financial Statements and the Reporting Entity
Chapter 4 — The Elements of Financial Statements
Chapter 5 — Recognition and De-Recognition
Chapter 6 — Measurement
Chapter 7 — Presentation and Disclosure
Chapter 8 — Concepts of Capital and Capital Maintenance

These principles ensure that financial statements are **useful, comparable, and transparent** for decision-makers, including **investors, regulators, lenders, and stakeholders**.

2.3 Chapter 1: Objective of General-Purpose Financial Reporting

2.3.1 Purpose of General-Purpose Financial Statements

The primary purpose of financial statements is to provide **relevant and reliable financial information** about an entity's financial position, performance, and cash flows. This helps users make informed decisions, such as:

(a) **Investors deciding whether to buy or sell shares** in a Nigerian publicly listed company.
(b) **Banks determining creditworthiness** before granting a ₦50 million loan to a manufacturing business.
(c) **Regulators evaluating compliance** with Nigerian accounting and tax laws.

2.3.2 Key users of financial statements

Financial statements are primarily used by:

(a) **Investors**: To assess profitability and future growth potential.
(b) **Lenders and Creditors**: To evaluate the entity's ability to repay debt obligations.
(c) **Government Agencies (FIRS, SEC, CBN, FRCN)**:To monitor compliance with tax and regulatory frameworks.
(d) **Employees**: To determine job security and salary increment prospects.
(e) **General Public**: To analyse a company's corporate social responsibility efforts.

2.3.3 Economic resources and claims

Financial statements provide information about an entity's:

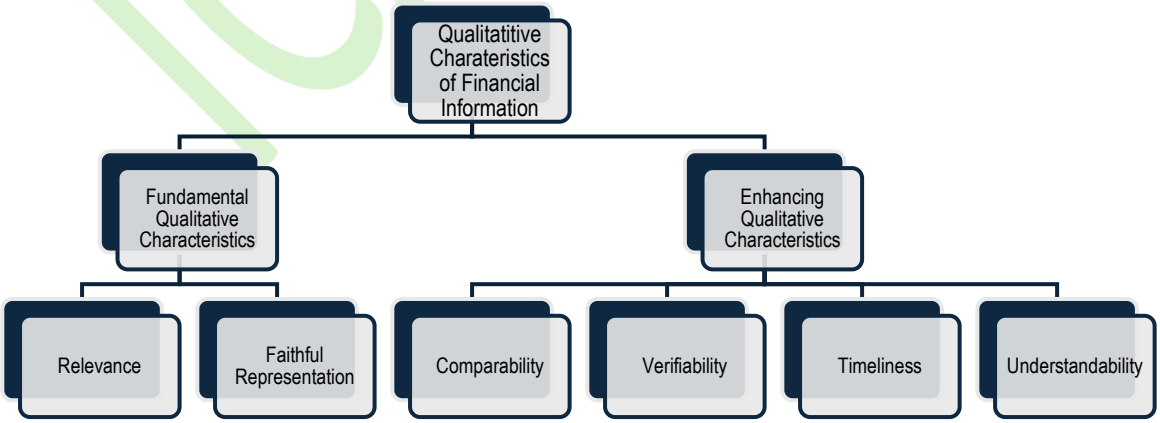
a. **Economic resources** (e.g., buildings, cash, machinery, inventory);
b. **Claims against those resources** (e.g., loans, supplier payables, tax obligations); and
c. **Efficiency of resource utilisation** by management.

Illustration (Nigerian Context): Imagine **Dangote Cement Plc** reports ₦2 trillion in total assets and ₦1.2 trillion in liabilities. Investors and analysts can determine the company's financial strength by assessing whether it can comfortably pay off its debts while maintaining profitability.

2.4 Chapter 2: Qualitative Characteristics of Useful Financial Information

The qualitative characteristics of useful financial information apply to financial information provided in financial statements, as well as to financial information provided in other ways. Cost, which is a pervasive constraint on the reporting entity's ability to provide useful financial information, applies similarly.

However, the considerations in applying the qualitative characteristics and the cost constraint may be different for different types of information. For example, applying them to forward-looking information may be different from applying them to information about existing economic resources and claims and to changes in those resources and claims.



2.4.1 Fundamental qualitative characteristics

a. **Relevance** – Information must be capable of influencing user decisions.
Example: A Nigerian investor deciding whether to buy GTBank shares based on earnings forecasts.

b. **Faithful representation** – Information must be complete, neutral, and free from error.
Example: If an oil company, Seplat, claims ₦500 billion in annual revenue, the figure must be accurate and verifiable.

2.4.2 Enhancing qualitative characteristics

a. **Comparability**: Allows financial data to be compared across periods and with other companies.
b. **Verifiability**: Information should be supported by independent evidence.
c. **Timeliness**: Reports must be available when needed (e.g., annual financial statements published by March 31st as per SEC requirements).
d. **Understandability**: Financial reports should be structured clearly so that users can interpret them without excessive complexity.

2.5 Chapter 3: Financial Statements and the Reporting Entity

2.5.1 The role of financial statements

Financial statements provide information about:

a. **Assets, liabilities, and equity** of a company.
b. **Revenues and expenses** incurred within a financial period.
c. **Cash flows from operating, investing, and financing activities**.

2.5.2 The going concern assumption

Financial statements assume that an entity will continue operating in the foreseeable future unless there is evidence to the contrary (e.g., severe financial distress leading to potential liquidation).

2.5.3 Defining the reporting entity

A reporting entity is any entity that **prepares financial statements**. It can be:

a. A **single entity** (e.g., PZ Cussons Nigeria Plc).
b. A **group of companies** (e.g., Access Holdings Plc, including its subsidiaries).
c. A **government organisation, or government business enterprise (GBE)** (e.g., Nigerian National Petroleum Corporation, NNPC Ltd).

2.6 Chapter 4: Elements of Financial Statements

2.6.1 Key Financial Statement Elements

(a) **Assets**: Present economic resources controlled by an entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
For example, a Nigerian bank's loan portfolio, office buildings, and cash reserves.

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An economic resource is a set of rights – the right to use, sell, or pledge the object, as well as other undefined rights. In principle, each right could be a separate asset. However, related rights will most commonly be viewed collectively as a single asset that forms a single unit of account.

Control links a right to an entity and is the present ability to direct how a resource is used so as to obtain the economic benefits from that resource (power and benefits). An economic resource can be controlled by only one party at any point in time.

(b) **Liabilities**: A present obligation of the entity to transfer an economic resource as a result of past events, for example, Dangote Group's outstanding loans from commercial banks.

- Example

  An entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. The going-concern basis implies that an entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade. If new legislation is enacted, a present obligation arises only when an entity obtains economic benefits, or takes an action, within the scope of that legislation. The enactment of legislation is not in itself sufficient to give an entity a present obligation. (*Deloitte document - IFRS in your pocket – 2024*).

The focus is on the existence of an asset or liability. It does not need to be certain, or even likely that the asset will produce (or the obligation will require an entity to transfer) economic benefits. It is only necessary that in at least one circumstance it would produce (or require an entity to transfer) economic benefits, however remote that occurrence might be.

(c) **Equity** – The residual interest in the assets of the entity after deducting all its liabilities. In a simple term, Equity by the mathematical equation is Assets minus Liabilities.
Example: The total share capital and retained earnings of a Nigerian publicly listed company.

Equity = Assets – Liabilities … (Fundamental/Basic Accounting Equation)

Then, Where:

i. ***Equity is POSITIVE (+):*** It implies Assets is sufficiently more than enough to settle all the liabilities; thereby resulting in a NET [of] ASSETS (or popularly called "Net Assets").

ii. ***Equity is NEGATIVE (-):*** It implies Assets is less sufficient to settle all the liabilities; thereby resulting in a NET [of] LIABILITIES (or popularly called "Net Liabilities"). At this juncture, this might evident a "Going Concern" problem for such an entity, but not necessary.

Equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities. In other words, they are claims against the entity that do not meet the definition of a liability. Such claims may be established by contract, legislation or similar means, and include, to the extent that they do not meet the definition of a liability:

i. Shares of various types, issued by the entity; and
ii. Some obligations of the entity to issue another equity claim.

Different classes of equity claims, such as ordinary shares and preference shares, may confer on their holders' different rights, for example, the right to receive some or all of the following from the entity:

i. Dividends, if the entity decides to pay dividends to eligible holders;
ii. The proceeds from satisfying the equity claims, either in full on liquidation, or in part at other times; or
iii. Other equity claims.

Equity can basically be grouped into two basic components, namely:

(a) Share Capital: This is statutory capital required of an entity from the legal status of its registration or incorporation in line with the relevant company's law of a country. Like in Nigeria, the requirement to establish a minimum amount of share capital is as contained in the Companies and Allied Matters Act (CAMA 2004, as amended), and such amount is registered with the Corporate Affairs Commission) via the relevant forms CO2 and the MEMART (Memorandum and Articles of Association) of a company.

(b) Reserves: In financial reporting, "reserve" always has a credit balance and can refer to a part of shareholders' equity. In this regards, reserves can be summarized as all other components of equity other than the Statutory (or Share) Capital of an entity. This implies the make-up of Equity other than Share Capital. This makeup can include the following:

i. Statutory/Capital reserve: which may include Share Premium and other regulatory required reserves an entity is expected by the [company's] law to maintain as part of Regulatory Capital.
ii. Retained Earnings: This is otherwise known as either of 'retained profits/losses' or 'accumulated profits or losses': This is the portion of a company's profit that is held or retained and saved for future use, or an unfavourable situation, the accumulated losses suffered by a company over time. Retained earnings could be used for funding an expansion or paying dividends to shareholders at a later date.
iii. Other Components of Equity ("OCE"): These are other reserves created away from retained earnings as may be required by different standards (IFRS) in line with their subsequent measurement principles, and these may include:
    - Revaluation reserve (for items of property, plant and equity, including intangible assets measured at 'Revalued Amount') - *Refer to discussion on IAS 16 (Property, Plant and Equipment) & IAS 38 (Intangible Assets).*
    - Fair value reserves (for financial instruments measured at 'Fair Value through Other Comprehensive Income – FVOCI') - *Refer to discussion on IFRS 9 (Financial Instruments).*
    - Actuarial reserve: This is a reserve created from gains/losses in the re-measurement of Defined Benefit Obligations and Plan Assets in an Employee Benefits Scheme - *Refer to discussion on IAS 19 (Employee Benefits).*
    - Cumulative transaction adjustments ("CTAs"): This is a reserve created from gains/losses in the translation of 'non-monetary assets and liabilities' in foreign currency and also on the gains/losses recognised in the translation of 'Foreign

Operations' - *Refer to discussion on IAS 21 (The Effects of Changes in Exchange Rate).*

- Cash flow Hedge Reserve: This is a reserve created from the 'Effective Portion of a Cash flow Hedge ' when hedge accounting is applied with respect to financial instruments - *Refer to discussion on IFRS 9 (Financial Instruments).*

(c) **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.
Example: Profits from telecommunications services by Airtel Nigeria.

Invariably, income can be considered as 'Gross Inflows' of economic resources (or economic benefits), which tends to increase the amount of equity, without given consideration (or after excluding any increase in the amount of equity attributed) to 'additional contributions from equity participants or shareholders' in a given period.

It follows from this definition of income that contributions from holders of equity claims are not income, rather they are considered 'Transaction within Equity', or "***Transactions with Equity Participants***'. Income comprises of:

i. Revenue: These are incomes from the principal source (or normal course) of business.

ii. Other Gains (or Other Income): These constitute other sources of income that cannot be attributed to normal trade or business, such as profit on disposal of assets, realized gains from foreign currencies, etc. Income is derived in summary when these directions occur, other than from "*additional contributions from owners of equity in an entity*".

(d) **Expenses** – Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.
Example: Cost of raw materials used in manufacturing Indomie Noodles.

Invariably, the expense can be considered as 'gross outflows' of economic resources (or economic benefits), which tends to decrease the amount of equity, without given consideration (or before deducting any decrease in the amount of equity attributed) to distributions to holders of equity claims or shareholders' in a given period.

It follows from this definition of the expense that distributions (such as cash dividends, stock dividends or bonus issues, etc.) to holders of equity claims are not an expense, rather they are considered 'transaction within equity', or "transactions with equity participants'. Income comprises of:

i. Direct costs and operating Expenses: These are expenses incurred in the course of normal trade or business (i.e. in the course of carrying out the activities of the business), which include 'cost of sales', distribution costs', 'administrative expenses', 'finance costs', and 'income taxes'.

ii. Other losses: These constitute decreases in economic benefits. As such they are no different in nature from other expenses. An example includes loss on disposal of assets, realised losses from foreign currencies, etc. Expense is derived in summary when these directions occur, other than those resulting from "distributions to owners of equity in an entity".

2.7 Chapter 5: Recognition and Derecognition

2.7.1 Recognition

Recognition is the **process of including an element** (asset, liability, equity, income, or expense) in the financial statements. For an item to be recognised, it must meet **both** the definition of an element and specific recognition criteria.

(a) Recognition criteria

An item is recognised in the financial statements if:

i. It meets the **definition** of an asset, liability, equity, income, or expense.
ii. It provides **useful information** that is relevant and faithfully represented.
iii. The item's value can be **measured reliably**.

Under the **previous framework**, an element was recognised when:

i. **It was probable** that future economic benefits would flow into or out of the entity.
ii. The item had a **cost or value that could be measured reliably**.
iii. It arose from a **past transaction or event**.

The process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element must satisfy the following criteria for recognition:

i. It is probable that any future economic benefit associated with the item will flow to or from the entity; and
ii. The item has a monetary value that can be measured with reliability.

Recognition links the elements, the statement of financial position and the statement(s) of financial performance as follows:

(i) in the statement of financial position at the beginning and end of the reporting period, total assets minus total liabilities equal total equity; and

(ii) recognised changes in equity during the reporting period comprise:

- income minus expenses recognised in the statement(s) of financial performance; plus
- contributions from holders of equity claims, minus distributions to holders of equity claims.

(b) IASB's updated view on recognition

The IASB has revised its approach, considering **probability as a measurement attribute rather than a recognition criterion**. This change strengthens the conceptual foundation for recognition without significantly altering practical applications.

2.7.2 Derecognition

Derecognition is the **removal of a previously recognised asset or liability** from the statement of financial position. This occurs when:

- An entity **loses control** of an asset; and
- An obligation (liability) is **settled, canceled, or no longer exists**.

The derecognition principles aim to represent faithfully any assets and liabilities retained, and any changes in the entity's assets and liabilities, as a result of that transaction. Sometimes an entity will 'dispose of' only part of an asset or a liability, or retain some exposure. The Conceptual Framework sets out the factors that an entity should consider 'when assessing whether full derecognition is achieved; when derecognition supported by disclosure is necessary and when it might be necessary for an entity to continue to recognise the transferred component'.

Derecognition normally occurs or is required only when an asset or a liability no longer meets the definition in line with the initial recognition criteria; for example:

(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.

Example (Nigerian context): A Nigerian manufacturing company purchases a delivery truck for ₦30 million and recognises it as an asset. If the company later sells the truck for ₦20 million, it **derecognises** the truck and records a profit or loss based on the difference between the carrying amount and the sale price.

2.8 Chapter 6: Measurement of Elements in Financial Statements

Conceptual Framework allows for several measurement bases, depending on the nature of the financial statement element and its relevance to users.

2.8.1 Measurement Bases

The conceptual framework describes the two ultimate measurement bases for the elements of financial position because they both provide *predictive and confirmatory value* to users of financial reports, but one basis might provide more useful information than the other under different circumstances. These two bases are as follows:

a) Historical cost; and
b) Current value

Historical cost:
Historical cost measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other events that gave rise to them. Unlike current value, the historical cost does not reflect changes in values, except to the extent that those changes relate to impairment of an asset or a liability becoming onerous.

Current value:

A current value measurement reflects conditions at the measurement date. Current value includes:

a) Fair value;
b) Value in use (for assets) and fulfilment value (for liabilities); and
c) Current Cost

Current value measures provide monetary information about assets, liabilities and related income and expenses, using the updated information 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. Unlike historical cost, 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.

Application of measurement bases

- **Historical cost** is widely used for tangible assets such as property, plant, and equipment. For an asset, historical cost, including transaction costs, to the extent unconsumed (or uncollected) and recoverable. It includes interest accrued on any financing component. Whilst for a liability, historical consideration as yet owing in respect of goods and services received (net of transaction costs), increased by any onerous provision. It includes interest accrued on any financing component.

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- **Fair value** (a form of current value) is used for investment properties, financial instruments, and biological assets. IFRS 13 defines it 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. It excludes any potential transaction costs on sale or transfer.
- **Present value** is applied in valuing long-term receivables, loans, and pension obligations. For an asset, it is the present value of future cash flows from the continuing use of the asset and from its disposal, net of transaction costs on disposal. For a liability, it is the present value of future cash flows that will arise in fulfilling the liability, including future transaction costs.
- **Current cost** depicts the consideration that would be given to acquiring an equivalent asset at measurement date plus transaction costs. It reflects the current age and condition of the asset. For a liability, consideration that would be received to incur an equivalent liability at measurement date minus transaction costs.

Example (Nigerian context): A real estate company in Lagos purchases a plot of land for ₦500 million in 2020. If land values rise and IFRS requires revaluation, the company may record the asset at **current fair value (e.g., ₦750 million)** instead of historical cost.

2.9 Chapter 7: Presentation and disclosure

Financial reporting has been considered a tool for communication vis-à-vis accepting International Financial Reporting Standards (IFRS) as a business language that facilitates ease of communication of financial information to users of financial reports to aid their individual and collective decision makings. Hence, a reporting entity communicates information about its assets, liabilities, equity, income and expenses by presenting and disclosing information in its financial statements.

Presentation and disclosure requirements ensure that financial statements **communicate information clearly and effectively** to stakeholders.

2.9.1 Key presentation principles

(a) **Classification** – Items must be grouped appropriately (e.g., current vs. non-current assets/liabilities).
(b) **Aggregation** – Similar items are combined, but material items are disclosed separately.
(c) **Offsetting** – Generally prohibited unless explicitly required by a standard (e.g., IFRS allows offsetting deferred tax assets and liabilities).

2.9.2 Disclosure requirements

Financial statements must include:
(a) Statement of financial position (balance sheet).
(b) Statement of profit or loss and other comprehensive income.
(c) Statement of changes in equity.
(d) Statement of cash flows.
(e) Notes to financial statements.

Example: A publicly listed company on the Nigerian Exchange Group (NGX) must provide detailed disclosures in its **annual financial statements**, including director remuneration, tax liabilities, and foreign currency risks.

2.10 Chapter 8: Capital maintenance concepts

Capital can be referred to as the sum of monies initially invested in starting a business and subsequently it can be referred to as the whole amount (including additional equity investment injected into the business) which can be referred to as Statutory Capital or Share Capital (including capital reserves such as share premium) in a company. And, as time goes, the capital in principle can be considered from the 'Equity' perspective, which is synonymous to the 'Net Assets'. Hence, capital may be referred to as the buffer for business continuity even amidst business turbulence and shocks. In mechanical terms, Capital might be likened to a 'Shock Absorber'. This implies that the role capital plays in business for its continuity and invariably its substantiality cannot be overemphasised, therefore there exist the need not only to preserve capital but also maintain capital both in 'nominal' and 'real' terms.

There are two concepts or approaches to which capital maintenance can be viewed and applied in the modern-day business environment and for financial reporting purposes, namely:

(a) Financial concept of capital; and
(b) Physical concept of capital

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that is required to maintain the capital at the beginning of the period is profit.

How is '***Profit***' determined, *under each concept*?

(a) Financial concept of capital maintenance

Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

Profit is recognised only when the financial value of **equity at the end of a period exceeds its value at the beginning** (after adjusting for new equity contributions and distributions).

- **Example:** A company starts with ₦100 million in equity and ends the year with ₦150 million after adjusting for dividend payments. The **realized profit** is ₦50 million.

(b) Physical concept of capital maintenance

Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The selection of the measurement bases and the concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas; management must seek a balance between relevance and reliability. This Conceptual Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the Board to prescribe a particular model other than in exceptional circumstances, such as for those entities reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of global developments.

Profitis earned only if the entity's **operating capability (productive assets) increases** during the period.

Example: A logistics company measures its capital by the number of trucks it owns. If it starts the year with 20 trucks and ends with 25, it has **maintained and increased its physical capital**.

Key differences between financial and physical capital maintenance

Aspect	Financial Capital Maintenance	Physical Capital Maintenance
Basis of Measurement	Monetary terms (equity)	Physical productive capacity
Profit Definition	Increase in financial net assets	Increase in operational capability
Example	₦100m equity → ₦150m = ₦50m profit	20 trucks → 25 trucks = capital maintained

Application in Nigeria:

a. **Financial Capital Maintenance** is commonly used in corporate financial statements (e.g., Dangote Cement Plc).
b. **Physical Capital Maintenance** is relevant in asset-heavy industries such as oil and gas or manufacturing.

Capital maintenance adjustments

The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance.

Conclusion

The **conceptual framework for financial reporting** provides a structured approach for recognition, measurement, presentation, and capital maintenance in financial statements. Understanding these principles ensures accountants produce **transparent, comparable, and decision-useful financial statements** in compliance with **IFRS and regulatory standards in Nigeria**.

In subsequent chapters, **specific IFRS standards and their practical applications in corporate financial reporting** will be examined.

2.11 Accounting concepts

2.11.1 Consistency of presentation

Consistency in financial reporting is crucial for **comparability** across reporting periods. **IAS 1 (Presentation of Financial Statements)** requires that **presentation and classification** of financial statement items remain consistent from one year to the next. Any changes in classification should only occur if:

a. Required by an **accounting standard** or **IFRS interpretation**.
b. The change provides **more relevant and reliable information** to users.

For instance, if a Nigerian company changes how it classifies its financial liabilities from **current to non-current** due to a change in financial policy, **adequate disclosures** must be made to ensure stakeholders understand the impact.

2.11.2 Aggregation

IAS 1 also mandates that **items of a dissimilar nature** should **not** be aggregated in the financial statements unless their individual values are **immaterial**.

a. Material items should be disclosed separately to avoid **distorting financial information**.
b. Aggregating **unrelated items** can lead to misleading financial statements.

For example, **a bank's loan portfolio** should be separately classified into **performing loans, non-performing loans, and write-offs** rather than being aggregated into a single total.

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2.11.3 Offsetting

IAS 1 establishes **clear rules** regarding the offsetting of financial statements items:

a. **Assets and liabilities** should not be **netted off** against each other; and
b. **Income and expenses** should be reported **separately** rather than combined.

However, **offsetting is permitted** in cases where:

(a) It is **required or allowed** by an **accounting standard** (e.g., IFRS 9 for certain financial instruments).
(b) The **economic substance of a transaction** justifies it.

Example:
If a company sells a **non-current asset** for **₦20 million**, with a **carrying amount of ₦15 million** and **selling expenses of ₦1 million**, the profit on disposal would be:

₦20 million (sale price) - ₦15 million (carrying value) - ₦1 million (expenses) = ₦4 million (profit).

In this case, **offsetting is appropriate**, as per IAS 1, because it reflects the economic reality of the transaction.

2.11.4 Fair presentation or a true and fair view?

IAS 1 requires that financial statements provide a **fair presentation** of the entity's **financial position, performance, and cash flows**. This means:

a. **IFRS compliance** is presumed to result in fair presentation;
b. **Additional disclosures** should be provided where necessary to ensure transparency; and
c. **Entities must not claim IFRS compliance** unless they fully adhere to **all applicable standards**.

Exception - Rare circumstances:

IAS 1 acknowledges that in **extremely rare cases**, compliance with IFRS may lead to financial statements that are **so misleading** that they fail to provide useful information. In such cases, **management may depart from IFRS requirements** to ensure that financial statements still present a **fair and true view**.

Example:
If a Nigerian oil & gas company follows **IFRS 6 (Exploration for and Evaluation of Mineral Resources)** but strict compliance leads to a **misrepresentation of financial risk**, management may be allowed to **adjust the reporting approach** while fully disclosing the reasons for departure from IFRS in the **notes to financial statements**.

This principle ensures **financial transparency, integrity, and usefulness of financial reporting to stakeholders**.

2.12 Chapter review

Before moving to the next chapter, ensure that you can:

a. discuss the conceptual framework for financial reporting;
b. discuss the fundamental qualitative characteristics of useful financial information;
c. discuss the enhancing qualitative characteristics of useful financial information;
d. discuss the elements of financial statements;
e. discuss recognition and derecognition of assets an liabilities;
f. discuss measurement of elements of financial statements, using historical cost, current cost, fair value, and present value bases;
g. discuss presentation and disclosure of financial statements; and
h. discuss the concept of capital maintenance.

2.13 End of chapter questions and suggested solutions

2.13.1 End of chapter questions

Question 1: Recognition and derecognition of financial statement elements

Scenario:

Supreme Logistics Ltd., a Nigerian-based transportation company, acquired a fleet of trucks on 1 January 2023 for ₦200 million. In December 2023, due to restructuring, the company sold half of the trucks for ₦90 million and leased back the remaining under a five-year finance lease agreement.

Required:

(a) Explain the recognition criteria for assets under the IASB Conceptual Framework.
(b) Determine whether the sale of the trucks meets the derecognition criteria.
(c) Discuss the impact of the finance lease on the recognition of assets in the company's financial statements.

Question 2: Application of Measurement Bases

Scenario:

Zenith Realty Ltd. acquired land in 2010 for ₦500 million. The company revalues the land every five years, and as of 2023, its fair value has increased to ₦1.2 billion. However, for accounting purposes, the management prefers to continue reporting the land at historical cost.

Required:

(a) Identify and explain the different measurement bases that Zenith Realty Ltd. could apply to the land.
(b) Discuss the advantages and disadvantages of using historical cost versus fair value measurement.
(c) Advise on the appropriate measurement base under IFRS and justify your recommendation.

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Question 3: Capital maintenance concepts in profit calculassions

Scenario:
Olumide Ventures operates in Nigeria's manufacturing sector. The company started in 2023 with an opening capital of ₦5 billion. Due to inflation, the general price level increased by 12%. During the year, the company generated a profit of ₦1.5 billion based on historical cost, but an analysis shows that the replacement cost of major assets has increased significantly.

Required:

(a) Explain the difference between financial capital maintenance and physical capital maintenance.
(b) Calculate the adjusted profit based on constant purchasing power accounting (CPPA), assuming that ₦5 billion must be adjusted for inflation.
(c) Discuss which capital maintenance concept provides a better reflection of the company's financial performance and sustainability.

Question 4: FARASIMI's business transactions and capital maintenance concepts

Scenario:
FARASIMI Limited starts a business on **1 January 2018**, with a **₦1 million capital contribution** from its sole shareholder. The business purchased **one inventory item for ₦1 million** and later sold it for **₦1.4 million** in cash. As of **31 December 2018**, the **replacement cost** of the same inventory item was **₦1.1 million**, reflecting a **10% specific inflation rate**. The **general inflation rate** for the year was **7%**.

Required:
Calculate profit for the year and prepare a **summary statement of financial position** as at **December 31, 2018** under the following **capital maintenance concepts**:
(a) Physical capital maintenance
(b) Financial capital maintenance

i. Historical cost accounting (HCA)
ii. Constant/current purchasing power accounting (CPPA)

2.13.2 Suggested solutions

Solution 1

(a) Recognition criteria: An asset is recognised when it meets the definition of an economic resource, is controlled by the entity, and has measurable economic benefits.
(b) Derecognition criteria: Derecognition of an asset occurs when the entity loses control of it. In this case, Supreme Logistics Ltd. loses control over the sold trucks and must derecognise them.
(c) Finance lease recognition: Under IFRS 16, a finance lease results in the recognition of a right-of-use asset and a lease liability. The company will continue to report leased trucks as assets, but under a different accounting treatment.

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Solution 2

(a) Measurement bases:

i. **Historical cost**: The land remains recorded at the original purchase price.
ii. **Fair value**: The land is revalued based on current market value.

(b) Advantages and Disadvantages:

i. **Historical cost** is stable but may not reflect true economic value.
ii. **Fair value** reflects market conditions but may introduce volatility.

(c) Recommendation: IFRS 13 supports fair value measurement for investment properties. If the land is for operational purposes, historical cost may be appropriate. However, if used for resale, fair value should be considered.

Solution to question 3

(a) Capital maintenance concepts:

i. **Financial capital maintenance** considers profit when financial net assets increase.
ii. **Physical capital maintenance** ensures that profit is earned only after maintaining productive capacity.

(b) Adjusted Profit under CPPA:

i. **Inflation adjustment** = ₦5 billion × 12% = ₦600 million
ii. **Adjusted profit** = ₦1.5 billion - ₦600 million = **₦900 million**

(c) Best concept for financial performance: CPPA provides a clearer picture of real purchasing power, making it more useful in an inflationary economy like Nigeria.

Solution 4

FARASIMI Limited

Capital Maintenance Concepts - Statement of profit or loss for the year ended 31 December 2018

Statement of Profit or Loss for the Year Ended 31 December 2018	Physical Capital Maintenance	Financial Capital Maintenance	Financial Capital Maintenance
	Current Cost Accounting (CCA)	Historical Cost Accounting (HCA)	Constant Purchasing Power Accounting (CPPA)
Sales	₦1,400	₦1,400	₦1,400
Cost of sales	(₦1,000)	(₦1,000)	(₦1,000)
Inflation Adjustment:			
- Specific Inflation (₦1,100 - ₦1,000)	(₦100)		
- General Inflation (₦1,000 × 7%)			(₦70)
Profit	₦300	₦400	₦330

Explanation of capital maintenance concepts

i. **Physical capital maintenance:** Focuses on preserving the productive capacity of the business. The profit of **₦300,000** ensures that the business can replace the sold inventory item with an identical one at the new price of **₦1.1 million**.

ii. **Financial capital maintenance (Historical Cost Accounting - HCA):** Ignores inflation effects and recognises profit as the excess of sales proceeds over the historical purchase price. The reported profit is **₦400,000**.

iii. **Financial capital maintenance (constant purchasing power accounting - CPPA):** Adjusts profit for general inflation, ensuring that the original capital maintains its general purchasing power. The profit is **₦330,000**, leaving a total capital of **₦1,070,000** in real terms.

FARASIMI Limited
Statement of financial position as at 31 December 2018

Statement of Financial Position as at 31 December 2018	Physical Capital Maintenance	Financial Capital Maintenance	Financial Capital Maintenance
	Current Cost Accounting (CCA)	Historical Cost Accounting (HCA)	Constant Purchasing Power Accounting (CPPA)
Assets:			
Cash and Cash Equivalents	₦1,400	₦1,400	₦1,400
Equity:			
Share Capital	₦1,100*	₦1,000	₦1,070*
Retained Earnings	₦300	₦400	₦330
Total Equity	₦1,400	₦1,400	₦1,400

Interpretation of financial capital maintenance concepts (CPPA)

i. The **inflation adjustments** ensure that profit is measured only after preserving the **purchasing power** of the initial capital.

ii. The profit of **₦330,000** leaves the final capital at **₦1,070,000**, which maintains the business's general purchasing power.

This analysis demonstrates how different capital maintenance concepts affect **profit calculation and financial position** presentation, providing **valuable insights for financial reporting and decision-making**.

CHAPTER 3

PRESENTATION OF FINANCIALSTATEMENTS

Contents

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3 Presentation of Financial Statements

3.0 Learning objective

This chapter helps readers to understand and apply the principles governing the **presentation and disclosure** of financial information in accordance with international accounting standards. It equips candidates with the ability to interpret, analyses, and apply the requirements of **IAS 1**, **IFRS 18**, **IAS 34**, **IAS 24**, and **IFRS 8** in a clear, structured, and principles-based manner, consistent with the information needs of users of financial statements.

3.1 Learning outcomes

On successful completion of this chapter, candidates should be able to:

a. Explain the overall purpose and structure of general-purpose financial statements;
b. Interpret and apply the presentation requirements of **IAS 1** including fair presentation, compliance with IFRSs, and the components of a complete set of financial statements;
c. Understand the key changes and new disclosure principles introduced by **IFRS 18**, which replaces IAS 1 effective from 1 January 2027;
d. Evaluate the impact of IFRS 18 on the presentation and disaggregation of financial performance and position;
e. Describe the scope and objective of interim financial reporting under **IAS 34**;
f. Apply the recognition, measurement, and disclosure requirements for interim financial statements;
g. Assess how interim reporting provides timely and relevant financial information to stakeholders;
h. Explain the importance of transparency in related party relationships and transactions;
i. Define and identify related parties and describe the principles guiding disclosure under **IAS 24**;
j. Prepare and evaluate related party disclosures using practical scenarios and case-based analysis;
k. Understand the implications of non-disclosure or inadequate disclosure on financial reporting credibility;
l. Define what constitutes an operating segment under **IFRS 8**;
m. Apply the management approach to identify reportable segments;
n. Explain the nature and usefulness of segment information in assessing the entity's performance and resource allocation; and
o. Prepare disclosures in line with IFRS 8 and evaluate their relevance to users of financial statements.

3.2 IAS 1: Presentation of Financial Statements

3.2.1 Form and content of financial statements

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

A complete set of financial statements consists of:

a. a statement of financial position as at the end of the period;
b. a statement of 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;comparative information in respect of the previous period (as specified); and

f. a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or retrospectively restates or reclassifies items (as specified).

3.2.2 Statement of Financial Position

Current and non-current assets and liabilities

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

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

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

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

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

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

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

(i) 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

(ii) in notes to the financial statements.

3.2.3 Statement of Profit or Loss and Other Comprehensive Income

A single statement or two statements

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

(a) 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.

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

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

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

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

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.

Information to be presented in the other comprehensive income section

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

a) will not be reclassified subsequently to profit or loss:
    i. gain on revaluation of property, plant and equipment (IAS 16);
    ii. gain on revaluation of intangible assets (IAS 38);
    iii. remeasurements of defined benefit pension schemes (IAS 19); and
b) will be reclassified subsequently to profit or loss when specific conditions are met, including:
    i. gains and losses on re-translation of foreign operations (IAS 21); and
    ii. gains and losses recognised on the effective portion of cash flow hedges (IFRS 9)
    iii. fair value gain/loss on financial assets measured through other comprehensive income (FVOCI)

Illustrative example – Reclassification adjustments (exchange differences on disposal of a foreign subsidiary)

Scenario:

A company acquires a foreign subsidiary at the beginning of **Year 1**.

Year 1: Recognition of exchange loss in OCI

At the end of Year 1, the financial statements of the foreign subsidiary are retranslated in line with the requirements of IAS 21, resulting in a foreign exchange **loss of ₦100,000**.

This loss is initially **recognised in other comprehensive income (OCI)** and accumulated in a separate component of equity.

Journal entry (Year 1):

Account	Debit	Credit
Other Comprehensive Income	₦100,000	
Net Assets of Subsidiary		₦100,000

This debit to OCI is transferred to a separate foreign currency translation reserve in equity.

Year 2: Reclassification upon disposal of subsidiary
At the beginning of **Year 2**, the company disposes of the foreign subsidiary. In line with IFRS requirements, the previously recognised exchange loss in OCI must now be **reclassified to profit or loss**.

Journal entry (Year 2):

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

The credit to OCI is also transferred from the foreign currency translation reserve in equity, effectively **reversing the original OCI entry** and bringing the reserve balance back to zero.

Key point:
This example illustrates the **principle of reclassification adjustment**, whereby items previously recognised in OCI are subsequently **recycled to profit or loss** when the underlying transaction or asset is derecognised — in this case, the disposal of a foreign operation.

3.2.4 Statement of changes in equity (SOCE)

A SOCE shows the amount at the beginning of the period, changes during the period, and the amount at the end of the period for each component of equity.
For each component of equity, the SOCE should show changes resulting from:

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

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

3.2.5 Statement of cash flows

As part of a complete set of financial statements under IAS 1, the Statement of Cash Flows is a fundamental component that enhances the understanding of an entity's financial health. It provides insight into the entity's ability to generate cash, meet obligations, and finance operations and investments. This statement presents information about cash inflows and outflows from operating, investing, and financing activities over a reporting period, offering users a clearer view of the entity's liquidity and cash management practices.

While this chapter briefly highlights the inclusion of the Statement of Cash Flows within the presentation framework required by IAS 1 (and by extension IFRS 18), a comprehensive and practical discussion—including classification, format, and interpretation of cash flow information—will be covered extensively in Chapter 27 of this text.

Candidates are encouraged to understand its contextual importance in financial statement presentation while preparing for more detailed application and analysis in the later chapter.

3.2.6 Notes to the financialstatements

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

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

Disclosure of accounting policies

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

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.
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. when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities;
    ii. whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and
    iii. whether the contractual terms of financial assets give rise on specified dates to cash flows that are solely payments of principle and interest.

Which policies?

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

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

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

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

Key measurement assumptions

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

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

(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:

(a) the nature of the assumption or other measurement uncertainty;
(b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
(c) 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
(d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

Capital disclosures

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

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An entity must disclose the following:

a) qualitative information including:
   i. a description of what it manages as capital;
   ii. the nature of any externally imposed capital requirements and how they are incorporated into the management of capital;
   iii. how it meets its objectives for managing capital;
b) summary quantitative data about what it manages as capital; and
c) whether any externally imposed capital requirements have been complied with and if not the consequences of such non-compliance.
   These disclosures must be based on information provided internally to key management personnel.

3.3 IFRS 18: New Perspectives to the Presentation of Financial Statements

A Strategic Business Reporting (SBR) perspective for ICAN candidates

The publication of **IFRS 18 – Presentation and Disclosure in Financial Statements**, which replaces **IAS 1** effective **1 January 2027**, marks a significant evolution in the presentation of general-purpose financial statements. This new standard reflects global calls for better clarity, consistency, and comparability in financial reporting, enabling users to better understand an entity's financial performance, position, and structure. For ICAN SBR candidates, it is essential to appreciate IFRS 18 not just as a technical compliance requirement, but as a **principles-based framework that enhances communication through financial reporting**.
The following structured narrative offers a comprehensive overview of IFRS 18, aligned with examinable expectations and professional application.

3.3.1 Form and content of financial statements

IFRS 18 prescribes the *minimum content* and *overall structure* of financial statements. It ensures that entities present information in a clear, cohesive, and comparable form. Financial statements must reflect fair presentation, faithfully represent the entity's transactions and events, and comply with the conceptual framework principles of relevance and faithful representation.

3.3.2 Components of financial statements

Under IFRS 18, a complete set of financial statements includes:

a. Statement of financial position;
b. Statement of profit or loss;
c. Statement presenting comprehensive income;
d. Statement of changes in equity;
e. Statement of cash flows; and
f. Notes, including significant accounting policies and other explanatory information

3.3.3 Roles of primary financial statements and notes

The **primary financial statements** provide structured summaries of the entity's financial performance and position. The **notes** play a critical supporting role by:

a. Disaggregating and explaining line items;
b. Providing contextual, policy, and forward-looking information; and

c. Highlighting key assumptions, judgements, and measurement bases.

3.3.4 Identification of financial statements

Each financial statement must be clearly identified and labelled appropriately. It must also include:

a. The name of the entity
b. The reporting period
c. The presentation currency
d. The level of rounding used

3.3.5 Frequency of reporting

An entity is required to present a complete set of financial statements **at least annually**. Where there is a change in the reporting period, disclosures must explain the reason for the change and the implications for comparability.

3.3.6 Consistency of presentation, disclosure and classification

IFRS 18 emphasises the need for **consistent presentation and classification** across periods unless a significant change in operations or financial structure necessitates an adjustment, or a new presentation improves relevance and reliability.

3.3.7 Comparative information

Entities must present **comparative figures** for all amounts reported in the current period's financial statements. Where relevant, comparative narrative and descriptive information should also be included.

3.3.8 Aggregation and disaggregation: Principles and requirements

IFRS 18 introduces **enhanced principles for aggregation and disaggregation**, ensuring line items are neither overly summarised nor excessively detailed. Entities must group similar items and disaggregate material or distinctive items separately.

Disaggregation must:

a. Be based on nature, function, or measurement basis;
b. Be consistent across the primary statements and the notes; and
c. Enhance the understandability and comparability of information.

3.3.9 Offsetting

Assets and liabilities, or income and expenses, must **not be offset** unless specifically permitted by an IFRS. IFRS 18 reinforces the principle of separate presentation to ensure transparency.

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3.3.10 Statement of profit or loss and comprehensive income

a) Statement of profit or loss and categories

IFRS 18 introduces a new structure with clearly defined **categories**:

(i) Operating
(ii) Investing
(iii) Financing
(iv) Income taxes
(v) Discontinued operations

These categories ensure more consistent and comparable presentation of profit-related figures across industries and jurisdictions.

b) Subtotals, line items and disclosures

Prescribed subtotals include:

(i) Operating profit
(ii) Profit before financing and income tax
(iii) Profit for the period

Entities must present specific line items (e.g. revenue, cost of sales, impairment losses) either in the statement or within the notes, depending on materiality and relevance. Disclosures must clarify the nature and function of the items.

3.3.11 Statement presenting comprehensive income and OCI

Comprehensive income includes:

a. **Profit or loss** from the statement of profit or loss
b. **Other comprehensive income (OCI)** such as revaluation gains, foreign exchange differences, and actuarial gains/losses

OCI items are grouped into those that **will** or **will not** be reclassified to profit or loss.

3.3.12 Statement of financial position

a) Structure, classification, and disclosure

IFRS 18 retains the classification of assets and liabilities into **current** and **non-current**. Required line items include inventories, trade receivables, deferred tax assets, and financial liabilities.

Additional disclosures, either directly in the statement or in the notes, provide further breakdowns, such as:

(i) Nature and maturity of liabilities
(ii) Measurement bases used
(iii) Judgements in classification

b) Statement of changes in equity

Equity presentation and note disclosures

Entities must present:

i. Total comprehensive income for the period
ii. Effects of restatements and retrospective application
iii. Reconciliations of opening and closing balances of each equity component

Disclosures in the notes must elaborate on:

- Nature of reserves
- Dividends
- Changes in ownership interests

3.3.13 Structure, capital, performance measures and other disclosures

IFRS 18 prescribes a logical and systematic order for notes:

a. Basis of preparation;
b. Accounting policies;
c. Supporting information for line items; and
d. Other disclosures, including:

    i. **Management-defined performance measures (MPMs)**: MPMs must be transparently defined, reconciled to IFRS measures, and consistently presented;
    ii. **Capital disclosures**: Nature, objectives, and policies for managing capital; and
    iii. **Judgements and estimates**: Significant judgements and key estimation uncertainties must be explained.

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3.3.14 Notes to the financial statements

Typical IFRS 18-compliant financial statements
FinPolNomics Green Finance Group
Statement of Profit or Loss
For the year ended 31 December 2028
(in thousands of Naira)

	2028	2027
	₦ '000	**₦ '000**
Revenue	367,000	353,100
Cost of Sales	(241,600)	(224,100)
Gross Profit	**125,400**	**129,000**
Other Operating Income	12,200	4,100
Selling Expenses	(28,900)	(27,400)
Research and Development Expenses	(25,100)	(25,900)
General and Administrative Expenses	(20,900)	(22,400)
Goodwill Impairment Loss	(4,500)	—
Other Operating Expenses	(1,200)	(5,600)
Operating Profit	**57,000**	**51,800**
Share of Profit and Gains on Disposal of Associates and Joint Ventures	5,300	7,300
Profit Before Financing and Income Taxes	**62,300**	**59,100**
Interest Expenses on Borrowings and Lease Liabilities	(13,000)	(13,200)
Interest Expenses on Pension Liabilities and Provisions	(6,500)	(6,000)
Profit Before Income Taxes	**42,800**	**39,900**
Income Tax Expense	(10,700)	(9,975)
Profit from Continuing Operations	**32,100**	**29,925**
Loss from Discontinued Operations	—	(5,500)
PROFIT	**32,100**	**24,425**

Profit Attributable To:	2028	2027
	₦ '000	**₦ '000**
Owners of the Parent	25,680	19,540
Non-controlling Interests	6,420	4,885
Total Profit	**32,100**	**24,425**

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Earnings per share from continuing operations:	**2025**	**2024**
Basic and Diluted EPS (*Naira:Kobo*)	0.67	0.66
Earnings per share:		
Basic and Diluted EPS (*Naira:Kobo*)	0.67	0.54

FinPolNomics Green Finance Group
Statement Presenting Comprehensive Income
For the year ended 31 December 2025
(in thousands of Naira)

	20X2	**20X1**
Profit for the Year	32,100	24,425
Other Comprehensive Income:		
Income and Expenses That Will Not Be Reclassified to Profit or Loss:		
Gains/(Losses) on Remeasurements of Defined Benefit Plans	6,700	(4,600)
Share of OCI of Associates and Joint Ventures	(2,200)	3,300
Income Tax on Above Items	(1,675)	1,150
Total income and expenses that will not be reclassified to profit or loss	**2,825**	**(150)**
Income and expenses that will be reclassified to profit or loss when specific conditions are met:		
Exchange Differences on Translating Foreign Operations	(5,600)	10,000
Losses on Cash Flow Hedges	(1,200)	(4,000)
Income Tax on Above Items	1,700	(1,500)
Total income and expenses that will be reclassified to profit or loss when specific conditions are met	**(5,100)**	**4,500**
Other comprehensive income, net of tax	**(2,275)**	**4,350**
Total comprehensive income	**29,825**	**28,775**
Total comprehensive income attributable to:		
Owners of the parent	23,420	23,680
Non-controlling interests	6,405	5,095
	29,825	**28,775**

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FinPolNomics Green Finance Group
Statement of Financial Position
As at 31 December 2028
(in thousands of Naira)

ASSETS

	2028	2027
Non-Current Assets	**₦ '000**	**₦ '000**
Property, plant and equipment	312,000	295,600
Goodwill	160,000	164,500
Other intangible assets	158,400	146,500
Investments in associates and joint ventures	20,200	17,400
Total Non-Current Assets	**650,600**	**624,000**
Current Assets		
Inventories	55,500	52,500
Trade receivables	34,000	32,000
Cash and cash equivalents	23,400	22,800
Other current assets	4,600	8,575
Total Current Assets	**117,500**	**115,875**
Total assets	**768,100**	**739,875**
Equity and liabilities		
Equity Attributable to Owners of the Parent		
Share capital	110,000	100,000
Retained earnings	139,720	123,040
Other components of equity	2,480	4,740
Total Equity Attributable to Owners of the Parent	**252,200**	**227,780**
Non-controlling interests	41,400	34,995
Total Equity	**293,600**	**262,775**

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Non-Current Liabilities		
Borrowings	158,700	147,200
Lease liabilities	85,400	97,500
Pension liabilities	112,000	108,000
Provisions	38,000	32,000
Deferred tax liabilities	4,800	8,600
Total Non-Current Liabilities	**398,900**	**393,300**
Current Liabilities		
Borrowings	25,000	28,000
Lease liabilities	14,000	18,000
Payables for goods or services and other payables	21,800	22,400
Provisions	9,700	10,600
Income taxes payable	5,100	4,800
Total Current Liabilities	**75,600**	**83,800**
Total Liabilities	**474,500**	**477,100**
TOTAL EQUITY AND LIABILITIES	**768,100**	**739,875**

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FinPolNomics Green Finance Group
Statement of Changes in Equity
For the year ended 31 December 2028
(in thousands of Naira)

	Share Capital	Retained Earnings	Translation of Foreign Operations	Defined Benefit Plans	Share of OCI of Associates & Joint Ventures	Cash Flow Hedges	Total Equity Attributable to Owners	Non-controlling Interests	Total Equity
	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000
Balance at 1 January 2027	100,000	108,100	(2,500)	2,600	(1,500)	2,000	208,700	29,800	238,500
Change in Accounting Policy	—	400	—	—	—	—	400	100	500
Adjusted Balance	**100,000**	**108,500**	**(2,500)**	**2,600**	**(1,500)**	**2,000**	**209,100**	**29,900**	**239,000**
Profit or loss		19.540					19,540	4,885	24,425
Other comprehensive income			6,000	(2,760)	3,300	(2,400)	4,140	210	4,350
Total Comprehensive Income	**—**	**19,540**	**6,000**	**(2,760)**	**3,300**	**(2,400)**	**23,680**	**5,095**	**28,775**
Transactions within Equity:									
Dividend paid		(5,000)							
Additional paid-in capital	—								
Balance at 31 December 2027	**100,000**	**123,040**	**3,500**	**(160)**	**1,800**	**(400)**	**227,780**	**34,995**	**262,775**

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FinPolNomics Green Finance Group
Statement of Changes in Equity
For the year ended 31 December 2028
(in thousands of Naira)

	Share Capital	Retained Earnings	Translation of Foreign Operations	Defined Benefit Plans	Share of OCI of Associates & Joint Ventures	Cash Flow Hedges	Total Equity Attributable to Owners	Non-controlling Interests	Total Equity
Balance at 1 January 2028	100,000	123,040	3,500	(160)	1,800	(400)	227,780	34,995	262,775
Change in Accounting Policy	—	—	—	—	—	—	—	—	—
Adjusted Balance	**100,000**	**123,040**	**3,500**	**(160)**	**1,800**	**(400)**	**227,780**	**34.995**	**262,775**
Profit or loss		25,680					25,680	6,420	32,100
Other comprehensive income			(3,360)	4,020	(2,200)	(720)	(2,260)	(15)	(2,275)
Total Comprehensive Income	**—**	**25,680**	**(3,360)**	**4,020**	**(2,200)**	**(720)**	**23,420**	**5,095**	**28,775**
Transactions within Equity:									
Dividend paid		(9,000)							
Additional paid-in capital	10,000								
Balance at 31 December 2028	**110,000**	**139,720**	**140**	**3,860**	**(400)**	**(1,120)**	**252,200**	**41,400**	**293,600**

Note 1 – Specified Expenses by Nature

(in thousands of Naira)

	2028	2027
Depreciation:	**₦ '000**	**₦ '000**
Cost of Sales	23,710	21,990
Research & Development	2,515	2,590
General & Administrative	4,975	4,750
Total Depreciation	**31,200**	**29,330**
Amortisation:		
Research & Development	13,840	12,690
Total Amortisation	**13,840**	**12,690**
Employee Benefits:		
Cost of Sales	61,640	57,175
Selling Expenses	7,515	7,110
Research & Development	6,545	6,750
General & Administrative	8,920	5,825
Total Employee Benefits	**84,620**	**76,860**
Impairment Losses:		
Research & Development	1,600	1,500
Goodwill Impairment	4,500	—
Total Impairment Losses	**6,100**	**1,500**
Write-down of Inventories(a):		
Cost of Sales	2,775	2,625
Total Write-down	**2,775**	**2,625**

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(a) The amounts disclosed represent the total of impairment losses and reversals of impairment losses and the total of write-down of inventories and reversals of write-down of inventories. The amounts disclosed are those the entity recognised as expenses in the statement of profit or loss for the year, except for depreciation and employee benefits.

The amounts disclosed for depreciation are the charge for the year, calculated in accordance with IAS 16 - Property, Plant and Equipment. The amounts include amounts that have been capitalised by including them in the carrying amount of inventory at the end of the reporting period.

The amounts disclosed for employee benefits are the costs incurred for the year, including pension costs, for employee services, calculated in accordance with IAS 19 Employee Benefits. The amounts include amounts that have been capitalised by including them in the carrying amount of inventory at the end of the reporting period.

Note 2 – Management-defined performance measures

This section presents FinPolNomics Green Finance Group's disclosures for its management-defined performance measures in accordance with IFRS 18.

Key Disclosures by FinPolNomics Green Finance Group:

(a) The Group stated that:
Adjusted operating profit and *adjusted profit from continuing operations* reflect management's view of performance. These metrics may not be comparable with similarly labelled measures used by other entities (IFRS 18, para. 122).

(b) Each measure was **clearly labelled and described**, explaining that:
Adjustments are made for non-recurring income/expenses not expected to arise in the foreseeable future (IFRS 18, paras. 123 and B134–B135).

(c) Each performance measure included a **description of the aspect of financial performance it communicates**, emphasising that:
These adjusted figures help users understand trends in underlying profitability (IFRS 18, paras. 123(a), B137(b), B138–B139).

(d) The calculation method was explained:
Adjusted operating profit and profit from continuing operations were derived by specifying and linking each adjusting item to relevant financial statements. This includes restructuring costs and their classification (IFRS 18, paras. 123(b), B137(b), B138–B139).

(e) A **reconciliation** between operating profit and adjusted profit, and between profit from continuing operations and adjusted profit, was provided. These reconciliations were linked to the most directly comparable IFRS-compliant subtotals (IFRS 18, para. 123(c)).

(f) For each adjusting item, XYZ disclosed:

i. The **tax effect**;
ii. The **impact on non-controlling interests**; and
iii. Related amounts in the financial statements (IFRS 18, paras. 123(d), B141).

(g) A description of **how the income tax effects were determined** was included (IFRS 18, para. 123(e)).

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FinPolNomics Green Finance Group's defined performance measures

The Group's management-defined measures include:

- **Adjusted operating profit; and**
- **Adjusted profit from continuing operations.**

These measures are **used in public communications** but are *not specified by IFRS Accounting Standards*.

Purpose and basis of adjustment

The objective is to enhance understanding of **underlying financial trends** by excluding:

i. Non-recurring items of income or expense; and
ii. Events not expected to recur in the near term.

Common Adjusting Items Include:

i. Impairment losses (or reversals) on **property, plant, equipment**, and **intangible assets**
ii. **Restructuring costs**
iii. **Non-recurring litigation costs** (e.g., IP disputes, regulatory fines, employment claims)
iv. Gains or losses on disposal of **non-current assets**
v. Gains or losses on disposal of **subsidiaries, associates, and joint ventures**

Note: FinPolNomics Green Finance Group treats litigation expenses as non-recurring based on **case-by-case assessment**, reinforcing its internal control framework to mitigate future occurrences.

3.4 IAS 34: Interim financial reporting

3.4.1 Scope of IAS 34

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

IAS 34 - **Interim Financial Reporting** does not specify the frequency of interim reporting: this is a matter for national regulations, which may vary between countries. IAS 34 focuses on providing guidance on the form and content of these interim accounts.
It encourages publicly-traded companies to prepare interim accounts and to file them with the national authority no later than 60 days after the end of the interim period.

3.4.2 Form and content of interim financial statements

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

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

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

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

The interim statements are designed to provide an update on the performance and position of the entity. It should focus on new activities, events, and circumstances that have occurred since the previous annual financial statements were issued. They should not duplicate information that has already been reported in the past.

3.4.3 Periods for which interim financial statements must be presented

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

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

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Illustrative Example – Required periods for interim financial statements

Scenario:
X Plc prepares **quarterly interim financial reports**. The entity's financial year ends on **31 December** (calendar year-end). The interim financial statements for the quarter ending **30 June 2024** must include comparative information for prior periods in accordance with **IAS 34 – Interim Financial Reporting**.

Periods to be Presented in the Interim Report as at 30 June 2024

Financial Statements	30 June 2023 (Comparative)	31 December 2023 (Annual)	30 June 2024 (Current)
Statement of Financial Position	–	✓	✓
Statement of Profit or Loss and Other Comprehensive Income	6 months ending ✓ 3 months ending ✓	–	6 months ending ✓ 3 months ending ✓
Statement of Cash Flows	6 months ending ✓ 3 months ending –	–	6 months ending ✓ 3 months ending –
Statement of Changes in Equity	6 months ending ✓ 3 months ending –	–	6 months ending ✓ 3 months ending –

Explanation and Application:

a. The **Statement of Financial Position** is presented for the **end of the current interim period (30 June 2024)** and the **end of the immediately preceding financial year (31 December 2023)**. No comparative statement is required for 30 June 2023.
b. The **Statements of Profit or Loss and Other Comprehensive Income**, **Cash Flows**, and **Changes in Equity** must present information for:
   i. The **6-month period** ending 30 June 2024 (current);
   ii. The **corresponding 6-month period** ending 30 June 2023 (comparative); and
   iii. Additionally, the **3-month period** for profit or loss (Q2) is shown for both the current and comparative periods.

Note:
IAS 34 allows for flexibility in format and encourages consistency with the entity's annual financial statements. However, minimum comparative information requirements must be satisfied to ensure meaningful interim reporting.

3.4.4 Recognition and measurement

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

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

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

Intangible assets

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

Tax

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

3..4.5 Use of estimates in interim financial statements

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

Pensions

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

Provisions

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

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Inventories

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

3.4.6 Interim reporting in Nigeria

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

Securities and Exchange Commission (SEC)

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

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

Quarterly report

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

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

The quarterly report must contain the following by way of notes

a) accounting policy changes;
b) seasonality or cyclicality of operations;
c) Changes in estimates;
d) issuance, repurchase and repayment of debts and equity securities;
e) dividends;
f) items of segment information;
g) significant events after the end of the interim period;
h) business combinations;
i) long term investments;
j) restructuring and reversals of restructuring provisions;
k) discontinuing operations;
l) correction of prior errors;
m) write down of inventory to net realisable value;
n) the impairment loss of property, plant and equipment intangible or other assets and reversal of such impairment loss;
o) the litigation settlements;
p) any debt defaults or any breach of a debt that has not been corrected

subsequently;

q) related party transactions;
r) acquisitions and disposals of property, plant and equipment;
s) commitments to purchase property, plant and equipment;

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

Half yearly returns

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

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

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

3.5 IAS 24: Related party disclosures

3.5.1 Impact on the financialstatements

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'.

3.5.2 The objective of IAS24

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.

3.5.3 Definitions

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

Related Party

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

a) The party controls the entity, or is controlled by it: (e.g. parent and subsidiaries' relationship);
b) It has significant influence over the entity: (e.g. investor and associate relationship);
c) It has joint control over the entity: (e.g. joint venturers' relationship);
d) The parties are under common control. (e.g. fellow subsidiaries' relationship);
e) The party is a member of the key management personnel of the entity or its parent; and
f) 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 at the **substance** of the arrangement, and not merely its legal form. Although two entities that have the same individual on their board of directors would not meet any of the above conditions for a related party, a related party relationship would nevertheless exist if influence can be shown.

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

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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;
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.)

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

Illustrative Example – Related Party Transactions (IAS 24)

In the examples below, identify the related party relationships between all parties involved, and highlight any additional factors to be considered in reaching a conclusion:

Scenario A:

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

Analysis and conclusion:

W Plc is related to **X Ltd** and **Y Ltd** as both are its subsidiaries.

X Ltd and **Y Ltd** are related to each other as they are **under common control** of W Plc.

Z Ltd is related to **X Ltd** as its **subsidiary**.

Z Ltd is also related to **W Plc**, as it is **indirectly controlled** through W Plc's interest in X Ltd.

All entities are within the same group and are therefore related parties for disclosure purposes under IAS 24.

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Scenario B:

Mr Z owns **75% of the voting capital** of **A Ltd** and **40% of the voting capital** of **B Ltd**.

Analysis and conclusion:

Mr Z is related to **A Ltd** due to his **majority shareholding and control**.

B Ltd may be considered an **associate** of Mr Z but is **not related** to A Ltd under IAS 24.

There is **no common control** between A Ltd and B Ltd because Mr Z does not exercise control or significant influence over both simultaneously (only 40% in B Ltd).

Accordingly, **A Ltd and B Ltd are not related parties** to each other.

Scenario C:

H and W, a married couple, are the **directors and majority shareholders** of **Q Ltd**. Q Ltd makes purchases from **P Ltd**, which is **jointly controlled** by W and their daughter, **D**. D is also a **director of P Ltd** but holds **no shares in Q Ltd**.

Analysis and conclusion:

- **H and W** are related to **Q Ltd** as they are **key management personnel** and **major shareholders**.
- **D**, the daughter, could be regarded as **close family member**, making her potentially a related party. However, this is dependent on whether she is **influenced** by H and W in her business decisions. The standard requires **judgement** to determine this, and the information given is **insufficient** to confirm the influence.
- **P Ltd** is related to **Q Ltd** because it is **jointly controlled** by **a close family member (W)** of key management personnel. Any **transactions** between Q Ltd and P Ltd must be **disclosed** in line with IAS 24.

Summary guidance:

Under **IAS 24**, related party disclosures are necessary when:

- There is **control**, **joint control**, or **significant influence** between entities.
- Parties are **key management personnel**, **close family members**, or entities under common control.

Disclosure enhances transparency and accountability, and candidates must apply **judgement based on control, influence, and relationships** outlined in the standard.

3.5.4 Disclosure requirements

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

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, or price charged is at arm's length, 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;
    iii. any guarantees given or received;
    iv. any provision for doubtful/irrecoverable debts.

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;
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.

Illustration – Disclosure note for related party transactions

Below is an example of a related party disclosure note that may be included in the financial statements of a **large publicly listed (quoted) company**, in accordance with **IAS 24 – Related Party Disclosures**.

(a) Trading Transactions with Related Parties

Related Party Category	Sales to Related Parties (₦m)	Purchases from Related Parties (₦m)	Amounts Owed by Related Parties (₦m)	Amounts Owed to Related Parties (₦m)
Associates	–	48	14	17
Joint Ventures	57	14	12	–

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(b) Non-Trading Transactions with Related Parties

Related Party Category	Loans to Related Parties (₦m)	Loans from Related Parties (₦m)
Associates	–	11
Joint Ventures	33	–

Note to candidates:

a. Related party disclosures must be **comprehensive and clearly categorised** into trading and non-trading activities.
b. All amounts presented should be based on **arm's length terms**, and the **nature of relationships** with associates and joint ventures should be disclosed.
c. Material balances and transactions should be supported by **additional narrative explanations** where relevant (e.g. terms of loans, settlement timelines, pricing policies).

3.6 IFRS 8: Operatingsegments

3.6.1 Scope of IFRS 8

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

Objective of IFRS 8

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

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

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

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3.6.2 Operating segments

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

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

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

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

(a) Aggrgation of segments

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

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

(b) Quantitative thresholds

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

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

(c) Reportable segments

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

(i) has been identified in accordance with the definition of an operating segment shown above, or
(ii) is aggregated with another segment, or
(iii) exceeds the quantitative thresholds.

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

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

Oakwood – Segmental Data (₦ million)

Division	Wood Sales	Furniture Sales	Veneer Sales	Waste Sales	Other Sales	Total
Revenue from External Customers	220	256	62	55	57	650
Inter-Segment Revenue	38	2	–	5	3	48
Reported Profit	54	45	12	9	10	130
Total Assets	4,900	4,100	200	400	600	10,200

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

Suggested Solutions – Reportable segments assessment under IFRS 8

IFRS 8: Quantitative thresholds for reportable segments:

A segment qualifies as reportable if it meets *any* of the following criteria:

a. Revenue test
Its internal and external revenue is at least **10%** of the total internal and external revenue of all segments.

b. Profit or loss test
Its reported profit (or loss) is at least **10%** of the greater of:
i. The combined reported profit of all profitable segments, or
ii. The combined reported loss of all segments that reported a loss.

c. Assets test
Its assets are at least **10%** of the combined assets of all operating segments.

Initial assessment:

From the provided data:

(a) Only **Wood Sales** and **Furniture Sales** meet the **10% threshold** in **all three categories** — revenue, profit, and assets.

(b) The remaining segments — **Veneer**, **Waste**, and **Other Sales** — do **not** meet any of the thresholds and thus **do not independently qualify** as reportable segments under IFRS 8.

IFRS 8: 75% Test – Additional segment identification:

IFRS 8 also requires that reportable segments together must account for at least **75% of the entity's total external revenue**. If this is not met, additional segments must be identified - even if they don't meet the 10% thresholds - until the 75% requirement is satisfied.

a) External revenue from Wood + Furniture = **₦220m + ₦256m = ₦476m**

b) Total external revenue = **₦650m**

c) Percentage Covered = **₦476m/₦650m × 100 = 73%**

Since 73% < 75%, we must include **at least one more segment** to satisfy the 75% rule.

Inclusion of additional segment:

Adding **Veneer sales (₦62m)** raises covered external revenue to:

- ₦476m + ₦62m = **₦538m**
- ₦538m/₦650m = **83%**

Thus, including **Veneer sales** satisfies the **75% coverage requirement**, even though it doesn't meet the individual 10% thresholds.

Final reportable segments:

(a) **Wood sales**

(b) **Furniture sales**

(c) **Veneer sales** *(included to meet the 75% total revenue rule)*

These segments should be included in the segmental disclosures in accordance with IFRS 8.

Technical Note: Further Guidance for ICAN Professional Candidates

IFRS 8 Reportable segment criteria:

A segment is reportable if it meets any of the following **quantitative thresholds**:

a. Revenue (external + inter-segment) is **≥ 10%** of the combined revenue of all segments.

b. Reported profit or loss is **≥ 10%** of the greater of:

i. The combined reported profit of all profitable segments, or

ii. The combined reported loss of all loss-making segments.

c. Assets are **≥ 10%** of the combined assets of all segments.

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Calculations:

a. Total figures:

(i) Total revenue (external + inter-segment) = 650 + 48 = **₦698m**
(ii) Total profit = **₦**130m (No segment made a loss)
(iii) Total assets = **₦**10,200m

b. 10% thresholds:

(i) Revenue threshold = 10% of **₦**698m = **₦69.8m**
(ii) Profit threshold = 10% of **₦**130m = **₦13m**
(iii) Asset threshold = 10% of **₦**10,200m = **₦1,020m**

Segment assessment:

Segment	Revenue (Ext. + Int.)	Meets Revenue ≥ ₦69.8m?	Profit	Meets Profit ≥ ₦13m?	Assets	Meets Assets ≥ ₦1,020m?
Wood Sales	220 + 38 = 258	✅ Yes	54	✅ Yes	4,900	✅ Yes
Furniture Sales	256 + 2 = 258	✅ Yes	45	✅ Yes	4,100	✅ Yes
Veneer Sales	62	❌ No	12	❌ No	200	❌ No
Waste Sales	55 + 5 = 60	❌ No	9	❌ No	400	❌ No
Other Sales	57 + 3 = 60	❌ No	10	❌ No	600	❌ No

Reportable segments under IFRS 8:

(a) **Wood sales**
(b) **Furniture sales**

These segments meet **all three criteria** and are therefore *reportable* under IFRS 8.

(a) Disclosure

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

The information that is to be disclosed is:

(i) A measure of profit or loss for each reportable segment.
(ii) A measure of total assets liabilities for each reportable segment if such an amount is reported regularly to the chief operating decision maker.
(iii) Information about the following items if they are specified and included in the measure of segment profit that is reported to the chief operating decision maker:

- revenues from external customers
- revenues from transactions with other operating segments of the same entity
- interest revenue
- interest expense

- depreciation and amortization
- material items of income and expense in accordance with IAS 1 the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method
- income tax expense or income
- material non-cash items other than depreciation and amortisation.

(iv) the amount of investment in associates and joint ventures accounted for by the equity method and the amounts of additions to non-current assets (excluding financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts), providing these amounts are included in segment assets.

Additionally, the following reconciliations are required:

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

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

(b) Measurement

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

The minimum amount the entity must disclose is:

(i) The basis of accounting for any transactions between reportable segments

(ii) The nature of any differences between the measurement of the reportable segments' profit or loss before tax and the entity's profit or loss, for example, the allocation of centrally incurred costs.

(iii) The nature of any differences between the measurement of the reportable segments' assets and the assets of the entity.

(iv) The nature of any differences between the measurement of the reportable segments' liabilities and the liabilities of the entity.

(v) The nature of any changes from prior periods in measurement methods used to determine segment profit or loss and the effect on profit or loss from those changes.

(vi) The nature of asymmetrical allocations to reportable segments. For example, a reportable segment may be charged the depreciation expense for a particular asset but the depreciable asset might not have been allocated to the segment.

(c) Entity wide disclosures

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

(i) Revenue from external customers for each product and service or each group of similar products and services.

(ii) Revenue from external customers attributed to the entity's country of domicile and attributed to all foreign countries in total where revenue is made.

(iii) Non-current assets located in the country of domicile and located in all foreign countries in total where the entity holds assets.

(iv) If revenue from any customer is more than 10% of total revenue, then it must be disclosed along with the total of revenues from these customers and the identity of the segment reporting the revenue.

3.7 Chapter review

Before moving to the next chapter, ensure that you can:

a. discuss the **form and content** of a complete set of financial statements, including the statement of financial position, profit or loss and OCI, changes in equity, cash flows, and accompanying notes;
b. explain the principles of **fair presentation, comparability, consistency, materiality, and aggregation/disaggregation**;
c. evaluate the **transition from IAS 1 to IFRS 18**, including:
   i. introduction of structured categories: operating, investing, and financing;
   ii. emphasis on disaggregation and management-defined performance measures (MPMs); and
   iii. clearer subtotals and note-linkages that enhance transparency and user understanding;
d. identify the **scope, objective**, and **minimum content** of interim financial statements;
e. apply the principles of **recognition, measurement, and estimation** in interim periods;
f. appreciate the importance of **timeliness and relevance** of interim reporting to capital markets, particularly within the Nigerian SEC regulatory context;
g. present **comparative information** and explain how interim reports supplement annual financial statements;
h. define a **related party** and identify **related party transactions**, including control, joint control, significant influence, and close family relationships;
i. discuss the **importance of transparency** in disclosing transactions not conducted at arm's length;
j. prepare appropriate **disclosure notes** showing the nature of the relationship, transaction amounts, balances, and terms;
k. explain the **implications of non-disclosure**, including reduced financial credibility and audit risks;
l. define an **operating segment** and apply the **management approach** to identify reportable segments;
m. apply the **quantitative thresholds** (10% of revenue, profit/loss, or assets) and the **75% revenue coverage rule** for determining reportable segments;

n. prepare **disclosure notes** that include segment revenues, profits, assets, and reconciliations to the entity's financial results; and
o. evaluate the **usefulness of segment information** for decision-making, performance appraisal, and resource allocation by users of financial statements.

3.8 End of chapter questions and suggested solutions

Question 1: Case Study: Farayola Plc – Year Ended 31 December 2018

Background information

Farayola Plc is a trading company that commenced operations on **2 January 2016** and prepares its accounts up to **31 December** annually.

In the current financial year, Farayola Plc:

i. Issued an additional **50 million shares** on **April 1, 2018** at ₦4.20 per share (fully paid).
ii. The shares have been recorded at the issue price, but the **market price** at **December 31, 2018** stood at ₦4.35 per share.

The company operates under a **preceding year basis (PYB)** tax regime, with a **tax rate of 40%** applicable on taxable profits.

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Extract of trial balance as at December 31, 2018

General Ledger Lines	Debit (₦'000)	Credit (₦'000)
Ordinary share capital (50 kobo)		100,000
Share premium		400,000
Motor vehicles	50,000	
Property	120,000	
Plant and equipment	100,000	
Software cost	20,000	
Accumulated depreciation – Motor vehicles		20,000
Accumulated depreciation – Plant and equipment		24,500
Accumulated amortisation – Software		4,000
Inventory (Opening)	800,000	
Purchases	12,100,000	
Trade discount received		100,000
Cash discount allowed	50,000	
Rent and rates	829,900	
Repairs and maintenance	367,257	
Personnel costs	5,326,352	
Printing and stationeries	62,482	
Other operational costs	625,822	
Distribution and trucking expenses	1,372,863	
Telephone expenses	625,822	
Financial assets	3,000,000	
Bank	1,965,691	
Petty cash	1,627	
Trade receivables	9,353,229	
Trade payables		11,155,060
Deferred tax liability		127,386
Current tax payable		138,948
Bank overdraft		529,309
Dividend paid (30 May 2018)	800,000	
Retained earnings (Opening)		740,950
Interest on bank overdraft	41,097	
Insurance	16,853	
TOTAL BALANCES	**37,839,653**	**37,839,653**

Additional relevant information

a. Inventory valuation

i. Inventory valuation based on **selling price less cost to sell**: ₦846,242,000
ii. Physical count (Tally/bin card) value: ₦874,087,000
iii. Tax authority permits inventory write-off/write-back as necessary.

b. Depreciation policies (useful lives)

Asset Category	Useful Life
Property	40 years
Motor Vehicles	5 years
Plant & Equipment	10 years
Software	5 years

- Property consists of **land (₦70 million)** (non-depreciable) and **building** (depreciable over 40 years).
- No depreciation charged for the current year yet.

c. Taxation information

- Current tax provision for 2017 overstated by ₦95,727,000.
- Other operational costs include fines and penalties of ₦10 million (non-tax deductible).
- Trucking expenses of ₦125,389,000 accrued but unpaid (not allowable for tax in cash basis accounting).
- Tax allowable capital allowances granted based on:
  - Motor vehicles: 25% per annum for first 4 years
  - Plant & equipment: 20% per annum for 5 years
  - Software: 40% and 30% declining balance method for year 1 and years 2–3 respectively
  - Property: 10% per annum for first 10 years
- The corporate tax rate remains stable at 40%.

d. Financial assets

- **Equity investment portfolio "A"**: ₦2.2 billion (classified as FVTPL – fair value ₦2.42 billion at year-end)
- **Equity investment portfolio "B"**: ₦780 million (classified as FVTOCI – fair value ₦780 million)
- Equity investments are **exempt from tax**.

e. Trade receivables – ECL model (IFRS 9)

Company applies **expected credit loss (ECL) model** from 1 January 2018 using the **provision matrix method**.

Past Due Category	Amount (₦'000)	Loss Rate (%)
Current	7,372,615	1.6%
1–30 days	1,063,351	2.2%
31–60 days	354,384	8.5%
61–90 days	453,034	14.7%
Above 90 days	109,845	32.8%

Opening impairment provision as at 1 January 2018: **₦249,999,000**, which was erroneously omitted from previous closing balances.

f. Cash and cash equivalents at 31 December 2018

i. Trade receivables: ₦8,948,263,000
ii. Net cash equivalents: ₦1,583,982,000
iii. Trade payables: ₦9,265,742,000
iv. Current tax payable: ₦1,553,948,000

Required

a) Prepare the **statement of profit or loss and other comprehensive income** for the year ended 31 December 2018.
b) Prepare the **statement of financial position** as at 31 December 2018.\
c) Prepare the **statement of changes in equity** for the year ended 31 December 2018.
d) Prepare an **abridged statement of cash flows** showing cash flows from **Operating activities** using the **indirect method**.
e) Compute the **basic and diluted earnings per share (EPS)** for the year ended 31 December 2018.

Note: *All calculations must be rounded to the nearest thousand (₦'000).*

Question 2: Scenario-Based Question: IAS 24 – Related Party Disclosures

Scenario:

ZOE Plc is a public listed company engaged in the manufacturing of industrial chemicals. The following relationships and transactions are identified during the preparation of its financial statements for the year ended 31 December 2024:

a. **Mr. Tunde Ogunleye**, the Chairman and major shareholder (holding 40% of shares) of ZOE Plc, also holds a 30% equity interest in **Beta Chemicals Ltd**.
b. **Beta Chemicals Ltd** supplied raw materials worth ₦150 million to ZOE Plc during the year.
c. **Mrs. Adesuwa Ogunleye**, the spouse of Mr. Tunde, is the Chief Financial Officer (CFO) of **Sigma Solutions Ltd**, a logistics company that provides transportation services to ZOE Plc. ZOE Plc paid Sigma Solutions Ltd ₦25 million during the year.
d. One of ZOE Plc's directors, **Mr. Idris Bello**, resigned during the year but was paid a severance compensation of ₦15 million.

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e. ZOE Plc granted an unsecured loan of ₦10 million to a key management personnel, **Mr. Paul Okafor**, during the year at an interest rate below market rate.
f. ZOE Plc purchased land from **ZOE Real Estates Ltd**, a wholly owned subsidiary, for ₦200 million.

The Board of Directors is unsure about which of these transactions and relationships need to be disclosed in accordance with **IAS 24 – Related Party Disclosures**.

Required:

Advise ZOE Plc on:

(a) The parties that are considered *related parties* under IAS 24.
(b) Which transactions must be disclosed as related party transactions.
(c) The nature of information that should be disclosed in the financial statements for these related party transactions.

QUESTION 3:

Scenario-Based Question: IFRS 8 – Operating Segments

Scenario:

GlobalConnect Plc is a large multinational company operating across three major industries:
(a) Telecommunications
(b) Satellite Services
(c) Financial Technology (FinTech)

Each division is headed by a divisional Chief Executive Officer (CEO), who reports directly to the Global Group Chief Executive Officer (Group CEO). The internal management reports reviewed monthly by the Group CEO focus separately on the performance of each of the three divisions, with separate revenue, expenses, and profit or loss measures.

Further details include:
(i) The **Telecommunications Division** generates 65% of the Group's total revenue.
(ii) The **Satellite Services Division** contributes 20% of the Group's revenue and holds key strategic contracts.
(iii) The **FinTech Division** is relatively new, contributing 10% of the Group's revenue but showing fast growth.

Additionally:
- **Central Administrative Services**, which includes head office HR, Finance, and Legal, are not revenue-generating but incur expenses allocated internally across the three divisions.
- There is a separately identifiable **Investments Unit** that manages surplus cash and short-term investments, but it is not included in internal reports reviewed by the Group CEO.

Global Connect Plc prepares general-purpose financial statements for public use in accordance with IFRS.

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Required:

Advise GlobalConnect Plc on:

(a) How IFRS 8 determines operating segments for reporting purposes.

(b) Which segments must be disclosed separately in GlobalConnect Plc's financial statements.

(c) What specific disclosures must be made for each reportable segment under IFRS 8.

QUESTION 4: Scenario-Based Question: IAS 34 – Interim Financial Reporting

Scenario:

Bolarinwa Plc is a public limited company listed on the Nigerian Exchange (NGX). The company prepares annual financial statements in accordance with IFRS and also publishes **quarterly interim financial reports** as at:

(a) 31 March
(b) 30 June
(c) 30 September
(d) 31 December

The company's financial year-end is **31 December**.

In preparing its interim financial statements for the quarter ended **30 June 2025**, Bolarinwa Plc identified the following events and issues:

(i) The company paid an annual insurance premium of ₦12 million on **1 January 2025**, covering the entire 2025 financial year.

(ii) A significant customer filed a legal claim against Bolarinwa Plc in May 2025. Management believes the claim will likely result in a loss of ₦8 million, but the case is still pending at 30 June 2025.

(iii) Dividend of ₦20 million was proposed by the Board on **15 July 2025**, based on profits for the six months ended 30 June 2025.

(iv) Inventory at 30 June 2025 was measured at net realisable value, which was lower than cost, resulting in a write-down of ₦3 million.

(v) Depreciation is charged annually in the financial statements, but management is unsure how to account for it in the interim report.

(vi) There was a change in the estimated useful lives of certain property, plant, and equipment effective from 1 April 2025, resulting in lower annual depreciation charges.

Management has approached you, as the Financial Reporting Consultant, to clarify how these issues should be treated in accordance with **IAS 34 – Interim Financial Reporting**.

Required:

Advise Bolarinwa Plc on:

(a) The general principles governing the preparation of interim financial reports under IAS 34.

(b) The appropriate accounting treatments for each of the issues (1 to 6) listed above.

(c) The minimum content requirements for an interim financial report under IAS 34.

Suggested solutions

Solution 1

Farayola Plc
Statement of profit or loss and other comprehensive income
for the year ended 31 December 2018

	Note	₦'000
Revenue		24,500,000
Cost of sales	1	(11,953,758)
Gross profit		**12,546,242**
Operating expenses:		
- Administrative expenses	2	(8,120,375)
- Distribution costs		(1,372,863)
Total operating expenses		(9,493,238)
Operating profit		**3,053,004**
Investment and other income	3	40,000
Profit before interest and taxes		**3,093,004**
Finance cost		(41,097)
Profit before taxation		**3,051,907**
Income taxes	18	(898,050)
Profit for the year		**2,153,857**
Other comprehensive income (OCI):		
Items that may not be reclassified through profit or loss		
- Fair value (loss) on financial assets measured at FVOCI	9	(20,000)
Total comprehensive income for the year		**2,133,857**
Earnings per share (EPS):		
- Basic EPS (Naira: kobo)	23	11.49
- Diluted EPS (Naira: kobo)	23	11.49

Important notes:

a. **Profit for the year** reflects the bottomline, result after deducting all expenses and taxes.
b. **Other comprehensive income (OCI)** relates to fair value changes in financial assets designated through **other comprehensive income (FVOCI)**, which are **not recycled** through profit or loss.
c. **Total comprehensive income** summarises both the **profit for the year** and the **OCI** effects.
d. EPS is a critical measure for investors and must be presented separately for **basic** and **diluted** shares.

Farayola Plc
Statement of financial position
as at 31 December 2018

ASSETS	*Note*	₦'000
Non-current assets:		
Property, plant and equipment	*7*	208,750
Intangible asset – Software cost	*8*	8,000
Financial assets	*10*	3,020,000
Deferred tax asset	*19*	119,647
Total non-current assets		**3,356,397**
Current assets:		
Inventory	*1*	846,242
Trade receivables	*11*	9,123,251
Cash and cash equivalents	*12*	1,967,318
Total current assets		**11,936,811**
Total assets		**15,293,208**

Equity and liabilities	*Note*	₦'000
Equity:		
Share capital (Ordinary shares @ 50 kobo each)	*SOCE*	100,000
Share premium	*SOCE*	400,000
Retained earnings	*SOCE*	1,844,808
Other component of equity (Fair Value Reserve)	*SOCE*	(20,000)
Total equity		**2,324,808**
Non-current liabilities:		
Deferred tax liability	*19*	-
Current liabilities:		
Bank overdraft		529,309
Trade payables		11,155,060
Current tax payable	*20*	1,284,031
Total current liabilities		**12,968,400**
Total equity and liabilities		**15,293,208**

Important Notes:

a. **Non-current assets** are measured net of accumulated depreciation/amortisation.
b. **Financial assets** are classified into portfolios based on the entity's business model (FVTPL and FVOCI).

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c. The **fair value reserve** relates to changes in equity investments measured at **FVOCI**, which are not reclassified through profit or loss.
d. **Deferred tax asset** has been recognised based on deductible temporary differences.
e. No deferred tax liability is recognised due to the position at the reporting date.
f. **Current liabilities** reflect both operating and financing obligations at year-end.

Farayola Plc
Statement of changes in equity
for the year ended December 31, 2018

	Notte	re Capital (₦'000)	Share Premium (₦'000)	Retained Earnings (₦'000)	Fair Value Reserve (₦'000)	Total Equity (₦'000)
As at December 31, 2017		75,000	215,000	740,950		1,030,950
Prior-year adjustment	*14*			(249,999)		(249,999)
Restated Balance as at January 1, 2018		**75,000**	**215,000**	**490,951**		**780,951**
Profit for the year				2,153,857		2,153,857
Other comprehensive income:						
- Fair value (loss) on financial assets at FVOCI	*9*				(20,000)	(20,000)
Total Comprehensive Income				**2,153,857**	**(20,000)**	**2,133,857**
Transactions within equity:						
- Additional paid-in capital	*13*	25,000	185,000			210,000
- Dividend paid				(800,000)		(800,000)
Total transactions within equity				**(800,000)**		**(590,000)**
As at December 31, 2018		**100,000**	**400,000**	**1,844,808**	**(20,000)**	**2,324,808**

Important explanatory notes for ICAN candidates:

a. **Prior-year adjustments** arose from the correction of errors related to omitted impairment provisions on trade receivables under the ECL model.
b. **Restatement** of opening balances ensures comparability and compliance with IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors).
c. **Fair value losses** on financial assets measured at FVOCI are recognised directly in equity and do not pass through the statement of profit or loss.
d. **Dividend payments** reduce retained earnings.
e. **New shares issued** increase both share capital and share premium accordingly.

Farayola Plc

Abridged statement of cash flows

for the year ended December 31, 2018

(*Operating Activities Only – Indirect Method*)

	₦'000
Profit before taxes	**3,051,907**
Adjustments for non-cash items:	
- Depreciation of property, plant, and equipment	21,250
- Amortisation of software cost	4,000
- Accrued trucking expenses	125,389
- Interest paid on bank overdraft	41,097
- Impairment gain on trade receivables	(20,021)
Total adjustments	**171,715**
Cash flows from operations before changes in working capital	**3,223,622**
Changes in working capital:	
- Increase in inventory	(46,242)
- Increase in trade receivables	(166,768)
- Increase in trade payables	2,014,707
Net changes in working capital	**1,801,697**
Cash flows from operations after changes in working capital	**5,025,319**
Less:	
- Tax paid	(315,000)
- Interest paid on bank overdraft	(41,097)
Net Cash Generated from Operating Activities	**4,669,222**

Key Points for ICAN Candidates:

a. The **indirect method** starts with **profit before taxes**, adjusted for non-cash transactions and working capital changes.
b. **Interest paid** is shown as a reconciling item in operating activities (per IAS 7 allowance).
c. **Tax paid** is disclosed separately as a cash outflow.
d. Positive **working capital changes** (like an increase in trade payables) boost cash flows, while increases in receivables or inventory reduce cash flows.

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Working notes:

Note 1: Cost of sales

	₦'000
Opening inventory	**800,000**
Add: Net purchases	
Purchases	12,100,000
Less: Trade discount received	(100,000)
Net purchases	**12,000,000**
Cost of goods available for sale (COGAS)	**12,800,000**
Less: Closing Inventory (lower of cost and NRV)*	(846,242)
Cost of goods sold (COGS)	**11,953,758**

Technical note:

Closing inventory is measured at the lower of **cost (₦874,087,000)** and **net realisable value (₦846,242,000)**, in accordance with **IAS 2 – Inventories**.

Note 2: Administrative expenses

	₦'000
Cash discount allowed	50,000
Rent and rates	829,900
Repairs and maintenance	367,257
Personnel costs	5,326,352
Printing and stationeries	62,482
Other operational costs	836,534
Telephone expenses	625,822
Insurance	16,853
Impairment gain on trade receivables (Note 4)	(20,021)
Depreciation of property, plant and equipment (Note 5)	21,250
Amortisation of software cost (Note 6)	4,000
Total administrative expenses	**8,120,375**

Note 3: Investment and other income

	₦'000
Fair value at July 1, 2018 (Financial asset measured at FVTPL)	2,200,000
Fair value at December 31, 2018	2,240,000
Fair value gain recognised in profit or loss	**40,000**

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Technical Note:
Fair value gains or losses on financial assets measured at **fair value through profit or loss (FVTPL)** must be recognised directly in **profit or loss** as required under **IFRS 9 – Financial Instruments**.

Note 4: Allowance for credit losses on trade receivables

Category	₦'000
Current (1.6% of ₦7,372,615)	73,726
1–30 Days (2.2% of ₦1,063,351)	23,934
31–60 Days (8.5% of ₦354,384)	30,123
61–90 Days (14.7% of ₦453,034)	66,593
Above 90 Days (32.8% of ₦109,845)	36,139
Closing Allowance as at 31 December 2018	**229,978**
Opening Allowance as at 1 January 2018	**249,999**
Decrease in Allowance (Impairment Gain)	**20,021**

Technical note:

The expected credit loss (ECL) allowance was measured using the **provision matrix approach** under the **simplified model** of **IFRS 9**.

The result was a **reversal of impairment**, leading to a **reduction in administrative expenses**.

Note 5: Depreciation of property, plant and equipment

Asset	*Useful Life (Years)*	Annual Depreciation (₦'000)
Motor Vehicle (₦50m/5 years)	*5*	10,000
Property – Building (₦50m/40 years)	*40*	1,250
Plant and Equipment (₦100m/10 years)	*10*	10,000
Total Depreciation		21,250

Technical note:

Land portion (₦70 million) is **non-depreciable** in line with IAS 16.

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Note 6: Amortisation of software cost

Asset	Useful Life (Years)	Annual Amortisation (₦'000)
Software (₦20m/5 years)	5	4,000

Note 7: Carrying amount of property, plant and equipment

Asset	Cost (₦'000)	Accumulated Depreciation (₦'000)	Carrying Amount (₦'000)
Motor Vehicles	50,000	(30,000)	20,000
Property (Land and Building)	120,000	(1,250)	118,750
Plant and Equipment	100,000	(30,000)	70,000
Total	**270,000**	**(61,250)**	**208,750**

Note 8: Carrying amount of software cost

Asset	Cost (₦'000)	Accumulated Amortisation (₦'000)	Carrying Amount (₦'000)
Software	20,000	(12,000)	8,000

Note 9: Fair value (loss) on financial assets measured at FVOCI

	₦'000
Fair value as at 10 September 2018	800,000
Fair value as at 31 December 2018	780,000
Fair value loss (to be recognised in Other Comprehensive Income)	**(20,000)**

Note 10: Financial Assets

Asset	Fair Value at Start (₦'000)	Fair Value Gain/(Loss) (₦'000)	Carrying Amount (₦'000)
Equity Investment at FVTPL	2,200,000	40,000	2,240,000
Equity Investment at FVOCI	800,000	(20,000)	780,000
Total	**3,000,000**	**20,000**	**3,020,000**

Note 11: Trade Receivables – Carrying amount

	₦'000
Trade Receivables (as per Trial Balance)	9,353,229
Less: Opening allowance for credit losses (Note 14)	(249,999)
	9,103,230
Add: Impairment gain recognised during the year	20,021
Carrying amount of trade receivables	9,123,251

Note 12: Cash and cash equivalents

	₦'000
Bank Balances	1,965,691
Petty Cash	1,627
Total Cash and Cash Equivalents	1,967,318

Note 13: Additional paid-in capital on 1 April 2018

Detail:		
Number of shares issued	50,000,000 shares	
Issue price per share	₦4.20	
Nominal value per share	₦0.50	
Share premium per share	₦3.70	
Particulars	**Share Capital (₦'000)**	**Share Premium (₦'000)**
Additional paid-in capital	25,000	185,000

Thus, the increase in capital and premium reflects the full proceeds received.

Note 14: Prior-period adjustments

In line with **IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors**, Farayola Plc corrected an error related to the omission of an allowance for expected credit losses (ECL) on trade receivables.

Account	Debit (₦'000)	Credit (₦'000)
Retained Earnings (Opening)	249,999	–
Allowance for Credit Losses (Trade Receivables)	–	249,999
Total Adjustment	249,999	249,999

Professional Note:
This adjustment was made directly against opening retained earnings as at 1 January 2018 to comply with IAS 8.

Note 15: Current Tax Assessments for 2018

	₦'000
Profit before taxes (accounting profit) [A]	3,051,907
Tax adjustments:	
Add back: Depreciation of property, plant, and equipment	21,250
Add back: Amortisation of software cost	4,000
Add back: Fines and penalties (non-deductible)	10,000
Add back: Accrued trucking expenses (cash basis not paid)	125,389
Deduct: Impairment gain on trade receivables	(20,021)
Deduct: Fair value gain on financial assets at FVTPL	(40,000)
Total tax adjustments [B]	100,618
Adjusted/Assessable profit [C = A +/- B]	3,152,525
Capital allowances:	
Balance brought forward	–
Additions for the year (Note 16)	50,500
Less: Absorbed for the year [D]	(50,500)
Balance carried forward	–
Taxable Profit [E = C – D]	3,102,025
Current Taxes for 2018 (40% of ₦3,102,025) [F = E x Tax Rate]	1,240,810
Less: Overprovision for 2017	(95,727)
Net Current Tax Provision for 2018	1,145,083

Note 16: Computation of capital allowances (2016–2018)

Asset	Year 1 (2016)	Year 2 (2017)	Year 3 (2018)
Motor Vehicles	12,500	12,500	12,500
Property – Building	1,250	1,250	1,250
Plant and Equipment	20,000	20,000	20,000
Software Cost	6,750	4,500	16,750
Total Capital Allowances	**40,500**	**38,500**	**50,500**

Note 17: Determination of Tax Base as at 31 December 2018

Asset	Tax Base Calculation ₦'000
Property, Plant and Equipment	
Cost	270,000
Less: Cumulative capital allowances	(109,500)
Tax written down value	**160,500**
Intangible Asset – Software	
Cost	20,000
Less: Cumulative capital allowances	(20,000)
Tax written down value	**-**
Trade receivables	**₦'000**
Net trade receivables	9,123,251
Add: Allowance for expected credit losses	229,978
Gross trade receivables	**9,353,229**
Trade payables	**₦'000**
Trade payables (gross)	11,155,060
Less: Disallowed accrued trucking cost	(125,389)
Net Trade Payables	**11,029,671**

Note 18: Income Taxes for 2018

	₦'000
Current Tax Charge (Note 15)	1,145,083
Deferred Tax Credit (Note 19)	(247,033)
Total income tax charge	**898,050**

Note 19: Deferred tax credit for 2018

	₦'000
Deferred tax liability as at January 2018	127,386
Deferred tax asset as at December 31, 2018 (Note 21)	(119,647)
Net deferred tax movement (Credit)	**247,033**

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Note 20: Current tax payable as at December 31, 2018 ₦'000

Balance at 1 January 2018	453,948
Less: Cash paid during the year	(315,000)
Add: Current tax charge for 2018	1,145,083
Balance at 31 December 2018	**1,284,031**

Note 21: Deferred Tax Computations

Assets & Liabilities FS Lines	Carrying Amount (₦'000)	Tax Base (₦'000)	Temporary Difference (₦'000)	Tax Rate	Deferred Tax (₦'000)	DT Type
Property, Plant and Equipment	208,750	160,500	48,250	40%	19,300	Deferred Tax Liability
Intangible asset – Software	8,000	–	8,000	40%	3,200	Deferred Tax Liability
Financial assets	3,020,000	3,020,000	–	40%	–	–
Inventory	846,242	846,242	–	40%	–	–
Trade receivables	9,123,251	9,353,229	(229,978)	40%	(91,991)	Deferred Tax Asset
Bank Overdraft	529,309	529,309	–	40%	–	–
Trade Payables	11,155,060	11,029,671	125,389	40%	(50,156)	Deferred Tax Asset
Total	**26,857,930**	**26,906,269**	**(299,117)**		**(119,647)**	**Net Deferred Tax Asset**

Note 22: Movement/Changes in Working Capital

A) Inventory

	₦'000
Opening Inventory	800,000
Closing Inventory	846,242
Increase in Inventory	**46,242**

B) Trade receivables

	₦'000
Opening trade receivables (Gross)	8,936,462
Add: Opening allowance for credit losses	249,999
Adjusted opening gross receivables [A]	**9,186,461**
Closing trade receivables (Gross)	9,123,251
Add: Closing allowance for credit losses	229,978
Adjusted closing gross receivables [B]	**9,353,229**
Increase in trade receivables [C = B – A]	**166,768**

C) Trade payables

	₦'000
Opening trade payables [A]	**9,265,742**
Closing trade payables	11,155,060
Add: Accrued Trucking Expenses Adjustment	125,389
Adjusted closing trade payables [B]	**11,280,449**
Increase in trade payables [C = B – A]	**2,014,707**

Note 23: Computation of basic and diluted earnings per share (EPS)

Class of Shares	Period	Units	Time Fraction	Weighted Average (WA) Shares
Existing Shares	1 Jan – 31 Mar 2018	150,000	0.25 ~ ***(3/12)***	37,500
Existing + New Shares	1 Apr – 31 Dec 2018	200,000	0.75 ~ ***(9/12)***	150,000
Total WA Shares			1.00 ~ ***(12/12)***	187,500

Basic EPS Formula:

$$Basic\ EPS = \frac{\text{Earnings attributable to ordinary shareholders}}{Weighted\ Average\ number\ of\ Ordinary\ Shares}$$

Basic EPS= $\frac{₦2,153,857}{187,500\ Ordinary\ Shares}$

= **₦11.49 kobo**

Share movement schedule (*alternative methodology*)

Class of Shares	Date	Period (months)	Units of Shares ('000)	Time Fraction	Weighted Average (WA) Shares ('000)
Existing Shares	1 Jan – 31 Dec 2018	12	150,000	1.00 ~ ***(12/12)***	150,000
New Shares	1 Apr – 31 Dec 2018	9	50,000	0.75 ~ ***(9/12)***	37,500
Total WA Shares					**187,500**

Diluted EPS Formula:

Diluted EPS= Earnings (as per EPS) + Increase in Earnings (attributable to Potential Shares)

Ordinary Shares (as per EPS) + WA Potential Ordinary Shares

Basic EPS= ₦2,153,857 + ₦0

(187,500 + 0) Ordinary Shares = **₦11.49 kobo**

Diluted EPS Formula:

Since there are no potential ordinary shares outstanding, **Basic EPS = Diluted EPS**.

Technical note:
No adjustment for dilution is necessary because no potential ordinary shares (e.g., share options, warrants, convertible instruments) existed as at the reporting date.

Suggested Solution 2

(a) Identification of Related Parties

Under IAS 24, the following are related parties to ZOE Plc:

i. **Mr. Tunde Ogunleye**: Major shareholder with significant influence (40% shareholding).
ii. **Beta Chemicals Ltd**: Entity over which Mr. Tunde exercises significant influence (30% ownership).
iii. **Mrs. Adesuwa Ogunleye**: Spouse of a major shareholder; close family member is considered a related party.
iv. **Sigma Solutions Ltd**: Entity controlled or significantly influenced by a close family member of key management personnel.
v. **Mr. Idris Bello**: Former key management personnel of ZOE Plc (relationship continues until the reporting date of resignation).
vi. **Mr. Paul Okafor**: Current key management personnel.
vii. **ZOE Real Estates Ltd**: Subsidiary of ZOE Plc.

(b) Transactions Requiring Disclosure

The following transactions must be disclosed as related party transactions:

Related Party	Nature of Transaction	Amount (₦)
Beta Chemicals Ltd	Purchase of raw materials	150 million
Sigma Solutions Ltd	Logistics services rendered	25 million
Mr. Idris Bello	Severance compensation paid	15 million
Mr. Paul Okafor	Loan granted at concessional rate	10 million
ZOE Real Estates Ltd	Purchase of land	200 million

(c) Nature of disclosure required

IAS 24 requires ZOE Plc to disclose, at a minimum:

a. **Relationship and identity of related parties**: Names or description of the related parties (e.g., Beta Chemicals Ltd, Sigma Solutions Ltd).
b. **Description of the transactions**: Nature of the transactions (e.g., purchases, services rendered, loan granted).
c. **Amounts of transactions**: The monetary amounts involved during the period.
d. **Outstanding balances**: Any receivables, payables, or loans outstanding at year-end, including terms and conditions, and any provision for doubtful debts.

e. **Terms and conditions**: Pricing policies (e.g., if transactions were conducted on normal commercial terms, at arm's length, or concessional terms).
f. **Key Management compensation**: Aggregate compensation (e.g., salaries, severance payments, benefits) must be disclosed under categories such as short-term benefits, post-employment benefits, other long-term benefits, termination benefits, and share-based payments.
g. **Materiality and aggregation**: Transactions must be disclosed separately or aggregated where appropriate, but sufficient detail must be provided to enable users of the financial statements to understand the impact on the entity.

Notes:

a. **Disclosure is mandatory**, even if no transactions occur but relationships exist.
b. **Close family members** include spouse, children, dependents, and possibly others depending on influence.
c. **Significant influence** usually arises when an individual holds 20% or more of voting rights or is in a position of significant operational control.
d. **Key management personnel** disclosure covers directors and those with authority over planning, directing, and controlling activities of the entity.
e. **Terms not at arm's length** must be clearly highlighted.

Conclusion:

Full and transparent disclosure of related party relationships and transactions under IAS 24 is essential to ensure that users of financial statements are not misled by undisclosed conflicts of interest or undisclosed favourable arrangements.

Suggested Solutions 3:

(a) Determination of operating segments under IFRS 8

According to IFRS 8 – Operating Segments, an operating segment is a component of an entity:

i. That engages in business activities from which it earns revenues and incurs expenses (including inter-segment revenues and expenses),
ii. Whose operating results are regularly reviewed by the entity's **chief operating decision maker (CODM)** to make decisions about resource allocation and performance assessment,
iii. And for which discrete financial information is available.

In GlobalConnect Plc's case:

i. Each of the **Telecommunications**, **Satellite Services**, and **FinTech** divisions are operating segments because they:
   - Earn revenues and incur expenses;
   - Have separate financial information; and
   - Are regularly reviewed by the Group CEO (the CODM).

ii. **Central Administrative Services** is **not an operating segment**, as it does not earn revenue and merely provides support services.

iii. The **Investments Unit** is **not an operating segment**, as its results are not separately reviewed by the Group CEO in internal reporting.

(b) Identification of Reportable Segments

Under IFRS 8, operating segments must be separately reported if they meet any of the following **quantitative thresholds**:

(i) **Revenue threshold**: Segment revenue (external and inter-segment) is **10% or more** of the combined revenue of all operating segments.

(ii) **Profit or loss threshold**: Segment profit or loss is **10% or more** of the combined reported profit or loss (absolute amount).

(iii) **Asset threshold**: Segment assets are **10% or more** of the combined assets of all segments.

Application to GlobalConnect Plc:

Segment	Contribution to Revenue	Meets 10% Test?
Telecommunications	65%	Yes
Satellite Services	20%	Yes
FinTech	10%	Yes

Thus:

All three divisions (**Telecommunications**, **Satellite Services**, and **FinTech**) meet the 10% thresholds and must be separately disclosed as **reportable segments**.

(c) Required Disclosures for Each Reportable Segment

For each reportable segment, GlobalConnect Plc must disclose the following in accordance with IFRS 8:

Disclosure Requirement	Description
General Information	Factors used to identify segments and types of products/services provided by each segment.
Segment Profit or Loss, Assets, and Liabilities	Measures reported internally to CODM for resource allocation and performance review.
Specific Revenue and Expense Items	Disclosure of certain revenues and expenses if reviewed by CODM, e.g., depreciation, interest income, interest expense.
Reconciliations	Reconciliation of segment revenues, segment profit or loss, segment assets, and segment liabilities to the entity's totals.
Measurement Basis	Explanation of measurement of segment profit or loss, segment assets and segment liabilities, including accounting policies if different from the main financial statements.
Entity-Wide Disclosures (regardless of segment reporting)	- Information about products and services,

i. Geographical information (revenues and non-current assets),
ii. Information about major customers (if 10% or more of entity revenue is from a single customer). |

Notes:

i. IFRS 8 adopts a **"management approach"**, meaning segment reporting is based on the internal information provided to management.
ii. **Central functions** like head office operations that do not independently generate revenues are **not reported as segments**.
iii. Entities must **disclose operating segments even if there are losses**, as long as the quantitative thresholds are met.
iv. **Consistency** must be maintained between the internal management reporting framework and the IFRS 8 segment disclosures.
v. **Aggregation of segments** is allowed under specific conditions but must be disclosed transparently with justification.

Conclusion:

GlobalConnect Plc must disclose its three operating divisions — Telecommunications, Satellite Services, and FinTech — separately in accordance with IFRS 8, ensuring users of the financial statements can assess the nature, financial effects, and performance of the business activities across its major operating components.

Solutions 4:

(a) General Principles of IAS 34

IAS 34 requires that interim financial reports should:

- Include financial information that is **timely and reliable**, even if less detailed than annual reports.
- Use the **same accounting policies** as the annual financial statements, unless a change is made after the most recent annual financial statements.
- Recognise **revenues and expenses** on a **year-to-date basis** (i.e., cumulative from 1 January to the reporting date).
- Ensure that measurements for interim reports are made **on a year-to-date basis**, not just for the three-month or six-month period alone.
- Reflect the **materiality** of transactions and balances within the interim period individually.

IAS 34 encourages consistency, comparability, and faithful representation of financial performance for interim periods.

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(b) Treatment of the specific issues

Issue	Treatment under IAS 34
1. Prepaid Insurance Premium	The insurance premium must be **allocated systematically** over the twelve-month period. Thus, for six months ended 30 June 2025, ₦6 million should be recognised as an expense, and ₦6 million remains prepaid.
2. Legal Claim	A **provision** for the ₦8 million should be recognised in the interim financial report, as the loss is probable and can be reliably estimated, even though the court case is pending.
3. Dividend Proposed after Reporting Date	Dividends proposed or declared after the interim period (30 June 2025) **must not** be recognised as a liability at the interim reporting date. It should be disclosed in the **notes** to the interim financial statements.
4. Inventory Write-Down	The inventory write-down to net realisable value should be **recognised immediately** in the interim financial statements, following IAS 2 – Inventories.
5. Depreciation Charges	Depreciation must be **allocated on a systematic basis** over the useful lives of assets. Interim reports must recognise **depreciation proportionately** for the year-to-date period (i.e., for six months).
6. Change in Useful Lives	Changes in accounting estimates, such as useful lives, must be **accounted for prospectively** from the effective date (1 April 2025) in accordance with IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors. Adjusted depreciation should be applied from 1 April onwards.

(c) Minimum content of an interim financial report under IAS 34

IAS 34 requires at a minimum:

a. Condensed set of financial statements:

(i) Condensed statement of financial position,
(ii) Condensed statement of profit or loss and other comprehensive income,
(iii) Condensed statement of changes in equity,
(iv) Condensed statement of cash flows.

b. Selected explanatory notes:

(i) Explanation of events and transactions that are significant to understanding changes since the last annual reporting date,
(ii) Accounting policy updates,
(iii) Changes in estimates,
(iv) Dividends paid,
(v) Significant events after the reporting period.

c. Comparative information:

(i) Comparative figures for the corresponding interim period and the immediately preceding annual reporting period must be provided.

d. Basis of Preparation:

(i) Statement that the interim financial information is prepared in accordance with IAS 34.

Notes:

a. **Interim reports focus on updating** the last annual report, not duplicating it.
b. **Materiality assessments** should be made in relation to the interim period alone, not the annual period.
c. **Full disclosure is not required** — only material changes and significant events.
d. **Estimates may be more frequent** and require updates in interim reporting compared to annual reporting.
e. **Dividends declared after the reporting period** are only disclosed, not recognised.

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Professional Level

Strategic Business Reporting

CHAPTER 4

OTHER INFORMATION IN THE ANNUAL REPORT

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4 Other Information in the Annual Report

4.0 Learning objective

This chapter discusses evaluation and interpretation of additional information commonly included in a company's annual report beyond the primary financial statements.

4.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. **identify** the different types of supplementary information typically included in a company's annual report, beyond the statutory financial statements.
b. **describe** the structure, principles, and minimum content requirements for governance reports, including the chairman's statement, board composition, directors' reports, and audit committee reports.
c. **explain** the purpose, structure, and critical elements of a well-prepared management commentary, aligning financial and non-financial performance with strategy and future prospects.
d. **analyse** the role, purpose, and content of risk management disclosures, including the communication of principal risks, uncertainties, and the organisation's risk mitigation strategies.
e. **evaluate** the relevance and usefulness of other financial and non-financial disclosures that may accompany the statutory financial statements, such as sustainability reports, key performance indicators (KPIs), corporate social responsibility (CSR) narratives, and market outlook analyses.
f. **apply** ethical considerations and regulatory requirements to the preparation, presentation, and assessment of the additional reports and disclosures within the corporate reporting framework.
g. **exercise professional scepticism** in identifying potential areas where narrative information may conflict with or enhance the understanding of the financial statements.

4.2 Annual Reports

4.2.1 Introduction

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

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

4.2.2 Content of Annual Reports

In addition to the audited financial statements, annual reports contain extra information. These information include::

(i) numerical and/or narrative; and
(ii) financial and non-financial

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

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

Mandatory and voluntary disclosures

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

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

(a) Some disclosures are required by law. For example, companies are required to prepare an annual report and accounts, and present these to the shareholders. Company law specifies what the directors' report and the accounts must contain, and in addition other regulations about content apply such as the requirements of Financial Reporting standards.

(b) Some disclosures are required by stock market rules or Financial Reporting Council (FRC) of Nigeria. For example, the SEC/FRC rules require listed companies to provide information relating to corporate governance and a chairman's report in their annual report and accounts. There are also stock market rules about other announcements by the company, such as profit warnings and announcements of proposed takeovers.

4.2.3**Voluntary disclosures**

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

Typically, these include

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

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

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

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

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

4.3 Governance reports

4.3.1 Requirements for disclosures about corporate governance

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

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

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

4.3.2 Requirements in Nigeria

Nigeria has a modern and comprehensive corporate governance code. The Financial Reporting Council of Nigeria has unified the various sectoral corporate governance codes into one, the Nigerian Code of Corporate Governance 2018.

The Securities and Exchange Commission (SEC) requires that the annual reports of all quoted companies should include a corporate governance statement.

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

(a) General requirements

The report should include the following:

(i) details of the composition of board of directors stating the names of chairmen, CEO and non-executive directors;
(ii) the roles and responsibilities of the board setting out matters which are reserved for the board and those delegated to management;
(iii) details of the process for making board appointments and the induction and training of board members;
(iv) details of the evaluation process for the board as a whole, its committees and each individual director with a summary of evaluation results;
(v) details of directors standing for re-election and their biographical details;
(vi) the composition of board committees including names of chairmen and members of each committee;
(vii) a description of the roles and responsibilities of the board committees and how the committees have discharged those responsibilities;
(viii) the number of meetings of the board and the committees held during the year and details of attendance;
(ix) disclosure of the code of business conduct and ethics, if any, for directors and employees;
(x) human resource policies, internal management structure, relations with employees,

employee share ownership schemes and other work place development initiatives; and

(xi) companies sustainability policies and programmes covering issues such as corruption, community service, environmental protection, HIV/AIDs and general corporate social responsibility issues.

(b) Statement of compliance

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

In particular, it should provide:

(i) assurances that effective internal audit function exists and that risk management control and compliance systems are operating efficiently and effectively in all respects;

(ii) justification where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an existing external auditor; explaining the recommendation and the reason for the board decision;

(iii) statement on sustainability initiatives;

(iv) related party transactions; and

(v) the nature of the related party relationships and transactions as well as information about the transactions necessary to understand the potential effect of the relationship on the financial statements

(c) Accounting and risk management issues

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

In particular, the following matters must be disclosed:

(i) the statement of the directors' responsibilities in connection with the preparation of financial statements;

(ii) details of accounting policies utilised and reasons for changes in accounting policies;

(iii) where the accounting policies applied do not conform to standard practice, the external auditor should express an opinion on whether they agreed with the departure and the reasons for such departure;

(iv) a statement from the directors that the business is a going concern;

(v) executive directors' remuneration and share options;

(vi) non-executive directors' fees and allowances and share options if any; and

(vii) risk management indicating the board's responsibility for the total process as well as its opinion on the effectiveness of the risk management procedures.

(d) Chairman's report

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

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

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

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

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

(i) comments on the results;
(ii) an overview of trading and the business including management, succession planning, diversity and values;
(iii) a governance overview including the impact of governance and risk management processes;
(iv) comments on corporate responsibility, sustainability and communities;
(v) commentary on markets and the environment; and
(vi) an outlook statement.

4.3.3 Requirements in the European Union

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

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

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

4.4 Management commentary

4.4.1 Definition and purpose of management commentary

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

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

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

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

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

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

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

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

4.4.2 IFRS Practice statement: management commentary

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

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

The Practice Statement (PS) defines management commentary as a narrative report accompanying financial statements prepared in accordance with IFRSs that provides users with historical and prospective commentary on the entity's financial position, financial performance and cash flows, and a basis for understanding management's objectives and its strategies for achieving those objectives. The PS prescribes a framework for the preparation and presentation of management commentary to assist management in preparing decision-useful management commentary to accompany financial statements prepared in accordance with IFRS.

Management commentary may help users to understand:

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

Management commentary should:

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

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

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

4.5 Risk reporting

4.5.1 Risk management

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

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

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

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

ICGN Corporate Risk Oversight Guidelines

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

Key features are as follows:

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

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

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

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

Illustration: BP's Principal Risks (2024)

(a) Climate Change and Energy Transition
BP acknowledges the risks associated with climate change and the global transition to a lower-carbon energy system. This includes potential impacts from evolving regulations, shifts in market demand, and the physical effects of climate change on operations. The company is actively managing these risks through its net-zero ambition and related strategies.

(b) Geopolitical Risks
BP's operations span multiple countries, exposing it to geopolitical risks such as political instability, sanctions, and changes in international relations. These factors can affect supply chains, operational continuity, and market access.

(c) Competitive Environment
The energy sector is highly competitive, with challenges arising from fluctuating commodity prices, technological advancements, and evolving customer preferences. BP must continuously adapt to maintain and grow its market share.

(d) Reserves Replacement
BP faces the risk of not replenishing its oil and gas reserves at a rate that matches production. A lower reserves replacement ratio can impact long-term production capacity and financial performance. The company is investing in exploration and development projects to address this risk.

(e) Major Project Delivery

The successful execution of large-scale projects is critical for BP's growth. Delays, cost overruns, or operational failures in these projects can have significant financial and reputational consequences. BP employs rigorous project management and oversight to mitigate these risks.

(f) Digital Infrastructure and Cybersecurity
BP's reliance on digital systems exposes it to cybersecurity threats, including data breaches and system disruptions. The company invests in robust cybersecurity measures and infrastructure resilience to protect its operations and data.

4.5.2 Situation in Nigeria

SEC rules require the following:

(i) the board of every public company must establish a risk management committee to assist it in its oversight of risk;

(ii) every public company must include risk management as part of its accounting policies;

(iii) public companies must disclose, by way of notes:

- any material effect of unmitigated risk on corporate profitability; and
- strategies for preventing risks the company is exposed to.

4.5.3 Components of effective risk reporting

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

(i) risk agenda;

(ii) risk assessment;

(iii) risk response;

(iv) risk communication; and

(v) risk governance.

(a) Risk agenda

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

Good risk reports would include the following:

(i) a clear statement of the drivers for the company when planning and undertaking risk management activities;

(ii) a description of the benefits from the risk management processes established; and

(iii) information on resources allocated to risk management activities.

(b) Risk assessment

Good risk reports would include the following:

(i) a clear description of the procedures in place and information used to identify risks;

(ii) an explanation of how risk is evaluated; and

(iii) a list of significant risk.

(c) Risk response

Good risk reports would include the following:

(i) description of appropriate responses for each risk;

(ii) information on how the efficiency and effectiveness of existing controls is assessed; and

(iii) description of disaster response and business continuity plans.

(d) Risk communication

Good risk reports would include the following:

(i) a description of how risk management processes and responsibilities are communicated throughout the company; and

(ii) information on risk management recordkeeping and on risk reporting and

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whistleblowing arrangements in the company.

(e) Risk governance

Good risk reports would include the following:

(i) a description of risk governance arrangements; and

(ii) a description of how emerging risks are being managed.

4.5.4 Situation in the United Kingdom (UK)

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

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

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

4.6 Other financial information

4.6.1 Financial summaries

Financial statements contain a great deal of detail.

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

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

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

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Illustration: Financial summaries

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

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Illustration: Financial summaries

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

4.6.2 Financial highlights

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

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

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

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

4.6.3 Key performance indicators

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

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

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

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

4.6.4 Trends

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

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

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

4.7 Chapter review

Before moving to the next chapter, ensure that you can:

a. explain the structure and key contents of annual reports, including both mandatory and voluntary disclosures;
b. discuss the strategic importance of narrative information in complementing financial statements;
c. explain the requirements for corporate governance disclosures under nigerian regulations and international best practices;
d. evaluate the contents of chairman's reports and corporate governance statements, including board composition, director responsibilities, and sustainability practices;
e. discuss management commentary as a narrative provided by management, presenting the entity's performance, risks, resources, and future prospects;
f. link IFRS Practice Statement guidance to the preparation of effective, decision-useful management commentary;
g. analyse the importance of risk disclosures in building investor confidence;
h. apply best practice frameworks for reporting on risk agenda, assessment, response, communication, and governance;
i. assess Nigerian and UK risk reporting frameworks and compliance expectations;
j. discuss the role of financial summaries, highlights, trends, and key performance indicators (KPIs) in enhancing stakeholder understanding; and
k. critically evaluate the use of non-financial data and narrative commentary in presenting a balanced picture of the organisation's performance.

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4.8 End of chapter questions and suggested solutions

4.8.1 End of chapter questions

Question 1: Governance report disclosures

Scenario:

URI MegaTech Plc, a company listed on the Nigerian Exchange, has just finalised its annual report. However, the governance report omitted the disclosure of board committee compositions, number of board meetings held, and directors' attendance records.

Required:
Identify the shortcomings in **URI MegaTech Plc's** governance report and explain the implications.

Question 2: Management commentary and risk disclosure

Scenario:

NIA Energy Ltd included a management commentary in its annual report. The commentary discusses the company's achievements but omits discussion of significant operational risks, including exposure to volatile commodity prices and cybersecurity threats.

Required:
Evaluate the weaknesses in **NIA Energy Ltd's** management commentary and recommend improvements.

Question 3: Voluntary disclosures and financial summaries

Scenario:

FARA Bank Plc voluntarily included a 5-year financial summary in its annual report but failed to cross-reference the figures to the audited financial statements. Additionally, **FARA Bank** selectively highlighted profit growth while omitting recent regulatory fines incurred.

Required:
Critically assess the effectiveness and limitations of **FARA Bank Plc's** voluntary disclosures.

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4.8.2 Suggested solutions

Solution 1

The omissions violate Nigerian Code of Corporate Governance requirements and SEC regulations, which mandate disclosure of:

a. Composition of board committees, including names of chairpersons and members.
b. Number of board and committee meetings held during the year and directors' attendance records.

Implications:

a. Lack of transparency undermines stakeholder confidence.
b. Potential regulatory sanctions for non-compliance.
c. Negative investor perception regarding corporate governance practices.

Solution 2

Weaknesses Identified:

a. Failure to disclose principal risks and uncertainties contradicts best practice under IFRS Practice Statement on Management Commentary.
b. Commentary is unbalanced, highlighting only positive performance without addressing material risks.

Recommendations:

a. Disclose material risks such as commodity price fluctuations and cybersecurity threats.
b. Explain risk mitigation strategies and management's view of future challenges.
c. Present a balanced and forward-looking narrative to enhance decision-usefulness for investors.

Solution 3

Effectiveness: Providing a 5-year financial summary offers useful trend information for users.

Limitations

a. Lack of cross-referencing reduces the reliability and verifiability of disclosed figures.
b. Selective disclosure (highlighting only favourable information) presents a biased view, undermining the credibility of the report.

Conclusion: Voluntary disclosures should be complete, transparent, cross-referenced, and balanced to ensure they genuinely enhance users' understanding.

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CHAPTER 5

BEYOND FINANCIAL REPORTING

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5 Beyond Financial Reporting

5.0 Learning objective

This chapter discusses principles-based knowledge and analytical skills needed to prepare, evaluate and communicate corporate social responsibility (CSR), sustainability and integrated reports that meet current professional and regulatory expectations.

5.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. discuss corporate social responsibility and distinguish it from legal compliance;
b. explain typical content elements and performance metrics found in CSR reports;
c. explain the concept of sustainability and outline the progression from environmental reporting to triple-bottom-line reporting;
d. compare the key principles and disclosure requirements of the Global Reporting Initiative (GRI) Standards and the US Sustainability Accounting Standards Board (SASB) framework;
e. appraise the effect of social, environmental and ethical factors on corporate performance measurement;
f. describe the purpose, guiding principles and content elements of the International Integrated Reporting Council (IIRC) <IR> Framework;
g. discuss the benefits of integrated reporting for preparers and users, and assess progress towards global adoption;
h. draft, analyse and critique CSR, sustainability and integrated reports in line with best practice and the ICAN syllabus.

5.2 Corporate social responsibility

5.2.1 Introduction

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

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

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

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

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

5.2.2 Corporate social responsibility explained

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

CSR has been defined in various ways:

(a) It is 'a concept whereby companies integrate social and environmental concerns in their business operations and their interaction with their stakeholders on a voluntary basis.'

(b) 'While there is no single, commonly-accepted definition of corporate social responsibility … it generally refers to business decision-making linked to ethical values, compliance with legal requirements, and respect for people, communities and the environment' (Business for Social Responsibility).

An important element of CSR is that it goes beyond compliance with legal and regulatory obligations, and involves voluntary initiatives and investment in people and the environment, and better relations with all stakeholder, not just shareholders and other investors.

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

However, this requirement for a business review applies only in the EU, not internationally.
The practice of CSR increases the transparency and accountability of an organisation. Transparency is important as stakeholders want to know about an organisation's activities. (They want to 'see into' an entity, to understand what it is doing and which strategic directions it is taking.) For example, if a local community believe that a company is dumping waste in the local area, then it will be important to understand what is actually happening.

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

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

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

There is now growing recognition of the need to provide social and environmental information as quantified performance measurements, so that actual achievements can be assessed better against targets or benchmarks.

Sustainability reports provide quantified measurements of performance in three areas of achievement: financial performance, social performance and environmental performance. Since these reports provide quantified performance measurements or results, sustainability reports are also described as triple bottom line reporting.

Scope of CSR

CSR covers the following areas:

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

Possible approaches

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

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

5.2.3 Reporting requirements

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

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

USA

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

European Union

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

In the European Union, quoted companies are now required to present certain information in the annual directors' report, as a narrative business review. This review should contain

information about the main trends and factors likely to affect the future development, performance and position of the company's business, and information about:

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

The review should also include:

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

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

5.2.4 Voluntary CSR reporting

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

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

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

Contents of an environmental report

Typically, an environmental report will include an outline of:

(a) the entity's policies towards environmental issues
(b) any improvements since previous years
(c) an assessment of the key risks faced and how the company intends to respond
(d) government legislation on environmental matters and how the entity ensures compliance with the legislation
(e) significant initiatives taken by the company to improve environmental issues
(f) key environmental performance indicators: targets of the industry and the relative performance of the entity.

(g) financial information relating to environmental costs, including the entity's accounting policy.

Contents of a Social Report

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

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

Voluntary guidelines for the content of social and environmental reports

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

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

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

UN Global Compact

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

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

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

The ten principles are that businesses should:

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

5.2.5 Consequences of poor track record on CSR issues

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

(a) Bad publicity about social and environmental issues could damage the public image of the company and its brands ('brand reputation risk').

(b) Companies may be affected by preferences of stakeholders, for companies with positive policy objectives on social and environmental issues. There are some investment organisations that focus on these issues. More significantly, perhaps, high-quality employees may prefer to work for 'ethical' companies.

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

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

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

5.3 Sustainability reporting

5.3.1 Introduction

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

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

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

The impact on oil group BP of the explosion at a drilling rig in the Gulf of Mexico in 2010, and the subsequent environmental damage it caused, is a clear example of the potential

risks and the need for companies to consider social and environmental issues, particularly in industries such as oil extraction, mining and energy production.

Interest in sustainable development has come from several sources:

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

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

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

5.3.2 Sustainability

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

Sustainability can also be defined as maintaining the world's resources rather than depleting or destroying them. This will ensure they support human activity now and in the future. Sustainable business is the actions, activities and obligations of business in achieving sustainability. It involves reconnecting business, society and the environment and recognising their interdependence. There are a number of mechanisms which can be used by individuals, societies and governments to enhance sustainability supported by reliable information on which assurance has been provided by the accountant.

Three key aspects of sustainability reporting

Economic	Information provided goes beyond that required by law. It should demonstrate how a company generates value in a wider sense e.g., by creating human capital
Environment	This may provide information about the impact of products on the environment e.g., emissions, waste
Social	Information may be provided on a range of social issues, including ethnic and gender diversity, child labour, working hours and wages

As well as adopting social and environmental policies it is important that companies communicate these policies to stakeholders. Increasingly companies are providing information on sustainability. This type of report typically includes information about these three aspects of performance and is often referred to as triple bottom line reporting.

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

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

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

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

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

5.3.3 Sustainability reporting

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

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

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

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

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

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

(i) increased efficiency;
(ii) higher levels of employee retention; and
(iii) lower cost of capital.

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

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

5.3.4 Global Reporting Initiative

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

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

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

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

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

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

(a) Universal standards (100 series)
  (i) GRI 101: Foundation – sets out reporting principles;
  (ii) GRI 102: General disclosures – contextual information about the organisation and its sustainability practices;
  (iii) GRI 103: Management approach – how an organisation manages a material topic and to be used for each material topic in a sustainability report.

(b) Topic specific standards
  (i) 200 series (economic topics)
  (ii) 300 series (environmental topics)
  (iii) 400 series (social topics)

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

Reporting principles

The reporting principles are fundamental to achieving high quality sustainability reporting. An organisation is required to apply the reporting principles if it wants to claim that its sustainability report has been prepared in accordance with the GRI Standards. The reporting principles are divided into two groups.

Reporting Principles for Defining Report Content:

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

Reporting principles for defining report quality:

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

5.3.5 Approach to using GRI Standards

GRI Standards may be used in different ways:

They may be used as a set to prepare a sustainability report in accordance with the standards in one of the following ways:

(i) **Core:** This option indicates that a report contains the minimum information needed to understand the nature of the organisation, its material topics and related impacts, and how these are managed.

(ii) **Comprehensive:** This builds on the core option by requiring additional disclosures on the organisation's strategy, ethics and integrity, and governance. In addition, the organisation is required to report more extensively on its impacts by reporting all the topic- specific disclosures for each material topic covered by the GRI Standards.

Alternatively, selected standards (or parts thereof) can be used to report specific information:

(i) This option is referred to as a 'GRI-referenced' claim.

(ii) It is appropriate for an organisation that wants to report on specific economic, environmental, and/or social impacts, but which is not looking to use the GRI Standards to provide a full picture of its material topics and related impacts.

Advantages and disadvantages of sustainability reporting

The advantages are as follows:

(i) Employee satisfaction leads to improved customer service.

(ii) Improved stakeholder satisfaction leads to increased financial performance.

(iii) Investors want to see a company adopt practices that are more environmentally sustainable.

(iv) Abuses of environment/human rights can damage reputations and hence share prices.

(v) Using resources efficiently can save money.

The disadvantages are as follows:

(i) Focus should be strictly on satisfying shareholders' desire for financial return. • Shareholders' value may be reduced if profits are lost.

(ii) Initially costs are incurred to become 'green'.

(iii) Allegations of 'greenwashing' may lead to a damaged reputation.

5.3.6 The Sustainability Accounting Standards Board (SASB)

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

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

(a) disclosure guidance; and

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

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

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

Activity Metrics

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

Activity metrics disclosed should:

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

Example: SASB material sustainability topics – oil and gas exploration and production

(a) Greenhouse gas emissions
(b) Air quality
(c) Water management
(d) Biodiversity impacts
(e) Security, human rights and Indigenous peoples' rights
(f) Community relations
(g) Health, safety and emergency management
(h) Business ethics and payments transparency
(i) Reserves valuation and capital expenditures
(j) Management of the regulatory environment

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

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

CAN 2025

5.3.7 Other bodies

The Sustainable Stock Exchanges

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

Partner exchanges to the SSE initiative include the following:

(a) the Nigerian Exchange Group;
(b) Johannesburg Stock Exchange (JSE);
(c) London Stock Exchange Group (LSE);
(d) the NYSE;
(e) the NASDAQ OMX; and
(f) Deutsche Börse.

The Institute of Social and Ethical Accountability

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

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

5.3.8 Sustainability in Nigeria

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

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

5.3.9 Nigerian Stock Exchange sustainability disclosure

(a) Introduction

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

(b) Principles and core elements

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

These include:

(i) Governance

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

(ii) Social

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

(iii) Environment

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

(c) Reporting Requirements

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

Securities and Exchange Commission (SEC) guidelines on sustainability Reporting

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

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

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

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

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

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

The Nigerian Sustainable Banking Principles

Principle 1: Business activities – environmental and social risk management
Embed environmental and social factors into every business-activity decision, aiming to avoid, reduce or offset adverse impacts.

Principle 2: Business operations – environmental and social performance
Prevent, minimise or compensate for negative effects of day-to-day operations on the environment and host communities, and, where possible, create positive outcomes.

Principle 3: Human rights
Respect and protect human rights in all operations and client-related activities.

Principle 4: Women's economic empowerment
Promote a gender-inclusive workplace and design products and services that support women's economic participation.

Principle 5: Financial inclusion
Extend appropriate financial services to individuals and communities traditionally excluded from the formal banking system.

Principle 6: Environmental and sustainability governance
Maintain robust, transparent environmental and sustainability governance within each institution and assess the corresponding practices of clients.

Principle 7: Capacity building

Develop the skills and resources, at individual and institutional levels, needed to identify, assess and manage environmental and social risks and opportunities.

Principle 8: Collaborative partnerships

Work with industry peers and international partners to accelerate collective progress, aligning with global standards and Nigeria's development priorities.

Principle 9: Reporting

Regularly review and disclose progress in meeting these principles at both institutional and sector levels.

Nigerian code of corporate governance 2018

(a) Introduction

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

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

Principle 26 of this code deals with sustainability.

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

(b) Recommended practices

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

The policies should include the following:

(i) The company's business principles, practices and efforts towards achieving sustainability;
(ii) The management of safety issues including workplace accidents, fatalities, occupational and safety incidents;
(iii) Plans and strategy for addressing and managing the impact of serious diseases on the Company's employees and their families;
(iv) The most environmentally beneficial options particularly for companies operating in disadvantaged regions or in regions with delicate ecology, in order to minimise environmental impact of the company's operations;
(v) The nature and extent of employment equity and diversity (gender and other issues);
(vi) Training initiatives, employee development and the associated financial investment;
(vii) Opportunities created for physically challenged persons or disadvantaged

individuals;

(viii) The environmental, social and governance principles and practices of the Company;

(ix) Corruption and related issues;

(x) The Board should monitor the implementation of sustainability policies; and

(xi) Report on the extent of compliance with the policies.

5.3.10 IFRS S1 and S2

On 26 June 2023 the International Sustainability Standards Board (ISSB) released its first two International Sustainability Disclosure Standards (IFRS SDS or the Standards) that become effective for periods beginning on or after 1 January 2024.

Overview of IFRS S1 and IFRS S2

Together IFRS S1 and IFRS S2 mark the start of a new era of requiring companies to make sustainability-related disclosures.

ISSB background

The ISSB was launched by the IFRS Foundation at COP26 with the aim of improving the consistency and quality of sustainability reporting across the globe, by matching the importance of sustainability reporting with the current regulations around financial reporting. To reinforce this message, the ISSB sits alongside the International Accounting Standards Board (IASB) and is overseen by the trustees of the IFRS Foundation and the Monitoring board.

The ISSB brings together the Climate Disclosure Standards Board (CDSB) and the Value Reporting Foundation (VRF), the name behind the Integrated Reporting Framework and the Sustainability Accounting Standards Board (SASB) Standards.

International support for global standards

Sustainability reporting is becoming increasingly important for stakeholders, with many larger companies already adopting some form of sustainability reporting to accommodate the demands of their key stakeholders. One of the key challenges faced by many investors and other stakeholders is they have not had access to good quality and globally comparable sustainability information, a stark difference to financial data. The developments being made by the ISSB are therefore, game changer to sustainability reporting globally.

This is recognised by the international community. The ISSB has international support and is backed by the G7, G20, the International Organisation of Securities Commissions (IOSCO) and the Financial Stability Board, amongst others. The Standards issued by the ISSB will help combat the challenges of companies 'greenwashing', meaning stakeholders will be able to make better-informed decisions with confidence.

IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information

The main objective of this Standard is to disclose all information about sustainability-related risks and opportunities that could reasonably be expected to affect a company's prospects.

IFRS S1 provides the basic requirements for sustainability disclosures, which should be used with IFRS S2 as well as the future Standards the ISSB releases.

The standard:

(a) requires disclosure of material information about sustainability-related risks and opportunities with the financial statements, to meet investor information needs;

(b) requires industry specific disclosures and refers to the industry-based SASB standards for guidance when identifying disclosures about sustainability-related risks or opportunities;

(c) refers to sources to help companies identify sustainability-related risks and opportunities and information (for everything other than in the scope of IFRS S2); and-+

(d) requires disclosures that enable investors to understand the connections between the sustainability-related risks and opportunities and the sustainability-related financial disclosures and financial statements.
is GAAP agnostic.

IFRS S2: Climate-related Disclosures

The two Standards are designed to be applied together. However, IFRS S2 has been developed to capture climate-specific requirements which includes:

(a) Strategy disclosures that distinguish between physical and transitional risks;

(b) Disclosure of plans to respond to climate-related risks and opportunities, including how climate-related targets are set and any targets it is required to meet by law or regulation;

(c) Companies should perform scenario analysis to explain how various climate-related events may impact the business in the future;

(d) Climate-related metrics and target disclosures should include:
   (i) Cross-industry metrics that are relevant to all companies e.g. greenhouse gas emissions, refer to our publication on 'What are sustainability scope 1, 2 and 3 emissions?' for more information on greenhouse gas emissions;
   (ii) Industry-based metrics relevant to companies within the related industries; and
   (iii) Company specific metrics considered by the board or management when measuring progress towards set targets.

Practical next steps for preparing to report

(a) Get ready – Be prepared for the possibility of reporting on 2024 information – remember the sustainability report will have to be reported on at the same time as your financial statements which will cause increased pressure on year-end reporting (the ISSB exemption noted above may be allowed for the first reporting period, but is dependent upon local jurisdictions and regulators).

(b) Understand your current position – evaluate your current governance structure and sustainability strategy to ensure it is fit for purpose going forwards and perform gap analysis to identify areas where work is needed to enable compliance with the Standards.

(c) Create a sustainability roadmap – After understanding your current position, establish how you can address the gaps identified, adopting a timeline of key milestones for your sustainability journey, identifying individuals within your organisation responsible and any potential constraints.

(d) Ensure good quality data – ensure adequate controls and processes are in place now to help collate and analyse good quality sustainability data that will compliment your disclosures.

(e) Familiarise yourself with the Standards – Companies who are already reporting on sustainability information will likely have an advantage but it's important to note there will be some differences in the Standards which you will need to identify. Not having a good understanding of all the applicable standards could result in lengthy reports containing duplication or omitted information

resulting in non-compliance.

(f) Educate your organisation – Ensure all levels of your business have a sound understanding on the importance of sustainability to help drive, grow and implement your sustainability strategy, ensuring there is buy-in at the top of your organisation to encourage the correct mindset to filter down.

5.4 Integrated Reporting

5.4.1 Introduction

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

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

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

Definition

An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term - *International Integrated Reporting Council (IIRC)*

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

Integrated reporting is borne out of an increasing demand for companies to disclose a more holistic view of how a company creates value. The Integrated Reporting Framework seeks to determine value creation through the communication of qualitative and quantitative performance measures.

Rise of integrated reporting

In recent years there has been increasing demand for the senior management in large organisations to provide greater detail on how they use the resources at their disposal to create value. Traditional corporate reporting which focuses on financial performance is said to tell only part of the story. Integrated reporting is concerned with conveying a wider message on an entity's performance. It is not solely centred on profit or the organisation's financial position but details how its activities interact to create value over the short, medium and long term.

The integrated reporting framework by IFRS Foundation classifies the capitals as follows:

Capital	Commentary
Financial Capital	The pool of funds that is: available to an organisation for use in the production of goods or the provision of services; and obtained through financing, such as debt, equity or grants, or generated through operations or investments.
Manufactured capital	Manufactured physical objects (as distinct from natural physical objects) that are available to an organisation for use in the production of goods or the provision of services. Manufactured capital is often created by other organisations, but includes assets manufactured by the reporting organisation for sale or when they are retained for its own use.
Intellectual capital	Organisational knowledge-based intangibles
Human capital	People's competencies, capabilities and experience, and their motivations to innovate
Natural capital	All environment resources and processes that support the prosperity of an organization
Social and relationship capital	The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective wellbeing

International Integrated Reporting Council (IIRC)

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

The aims of the IIRC are as follows:

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

5.4.2 IIRC Framework

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

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

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

Using the framework

An integrated report should be a designated, identifiable communication. Any communication claiming to be an integrated report and referencing the

Framework should apply all the requirements identified in bold unless:

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

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

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

An integrated report should include a statement from those charged with governance that includes:
(i) an acknowledgement of their responsibility to ensure the integrity of the integrated report;
(ii) an acknowledgement that they have applied their collective mind to the preparation and presentation of the integrated report;
(iii) their opinion or conclusion about whether the integrated report is presented in accordance with this *Framework*;

An integrated report that does not include such a statement, should explain:
(i) the role those charged with governance played in its preparation and presentation;
(ii) the steps being taken to include such a statement in future reports; and
(iii) the time frame for doing so, which should be no later than the organisation's third integrated report that references this *Framework*.

Guiding Principles

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

The information in an integrated report should be presented on a basis that is consistent over time and in a way that enables comparison with other organisations to the extent it is material to the organisation's own ability to create value over.

An integrated report should answer the following questions

(a) What does the organisation do and what are the circumstances under which it operates?
(b) How does the organisation's governance structure support its ability to create value in the short, medium and long term?
(c) What is the organisation's business model?
(d) What are the specific risks and opportunities that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?
(e) Where does the organisation want to go and how does it intend to get there?
(f) To what extent has the organisation achieved its strategic objective: for the period and what are its outcomes in terms of effects on the capitals?
(g) What challenges and uncertainties is the organisation likely to encounter in pursuing its

strategy, and what are the potential implications for its business model and future performance?

(h) How does the organisation determine what matters to include in the integrated report and how are such matters quantified or evaluated?

Implications of introducing integrated reporting

Implications	Comment
IT costs	The introduction of integrated reporting will most likely require significant upgrades to be made to the organisation's IT and information system infrastructure. Such developments will be needed to capture KPI data. Due to the broad range of business activities reported on using integrated reporting (customer, supplier relations, finance and human resources) it is highly likely the costs of improving the infrastructure will be significant.
Time/staff costs	The process of gathering and collating the data for inclusion in the report is likely to require a significant amount of staff time. This may serve to decrease staff morale if they are expected to undertake this work in addition to existing duties. This may require additional staff to be employed.
Consultancy costs	Organisations producing their first integrated report may seek external guidance from an organisation which provides specialist consultancy on integrated reporting. Consultancy fees are likely to be significant.
Disclosure	There is a danger that organisations may volunteer more information about their operational performance than intended. Disclosure of planned strategies and key performance measures are likely to be picked up by competitors.

5.5 Chapter review

Before moving to the next chapter, ensure that you can:

a. Define CSR and differentiate it from legal compliance;
b. Outline the typical contents of a standalone CSR report;
c. Discuss why sustainability matters for long-term corporate value and stakeholder trust;
d. Compare GRI and SASB in terms of purpose, materiality lens and target audience;
e. Identify social, environmental and ethical factors that influence performance metrics;
f. Describe the six capitals and show how they interrelate in an integrated report;
g. Explain each guiding principle of the <IR> Framework with a brief real-world illustration; and
h. Advise management on system upgrades and controls needed for reliable non-financial data.

5.6 End of chapter questions and suggested solutions

5.6.1 Questions

Question 1:

Today's corporations operate in an environment of intense media, investor, regulatory and public scrutiny. The financial scandals of recent years have created a significantly more constrained regulatory environment. At the same time, increasing public and stakeholder concern about the social and environmental impacts of business practices is forcing companies in many jurisdictions to come to terms with a much broader set of interests and expectations.

Required:

(a) Explain why corporate social reporting (CSR) has become important.
(b) Describe the main principles of corporate social reporting (CSR) that are necessary for a company to be socially responsible.

Question 2

Peculiar Mess company is a multinational group company. During the year a number of situations have arisen and the board is to meet soon to determine an appropriate treatment. You have been approached to explain on the appropriate accounting treatment on the following situations.

Site A

This site is occupied by a small refinery. The site and some adjacent land have been contaminated by chemical spillages. The cost of remedying the contamination is ₦50 million, but under the local laws there is no requirements to clean up the site.

Site B

Similar contamination has arisen but the local government, and a neighbouring land owner, require the contamination to be remedied soon. The cost of cleaning up the site is ₦45 million, but an extra ₦15 million could be spent to raise the standard of the operation in line with the undertakings given to the local government some years back.

Site C

Considerable contamination needs to be remedied, but the managing director is of the opinion that no provision is required this year since the amount concerned could not be estimated with accuracy.

Site D

Spillage of chemicals has reduced the value of the site from ₦75 million tp its book value of ₦30 million, its current realIsable value. By spending ₦15 million on rectification, the site value will be increased to ₦60 million. The spillage has seeped into a local river and fines of ₦9 million are now payable.

Required:

Explain the appropriate accounting treatment of the situations in site A to D..

Question 3

Firms are now considering the impact of non-financial, ethical and environmental information in their business models and strategic plans.

Required:

Discuss, and provide examples of the types of non-financial, ethical and environmental issues that might influence the objectives of companies.

Your answer should consider the impact of these non-financial, ethical and environmental issues on the achievement of primary financial objectives such as the maximisation of shareholder wealth.

5.6.2 Suggested Solutions:

Solution 1

(a) Reasons why CSR became important

(i) Corporations exist for a business purpose (i.e. to make profits). To sustain the profitability of its business, a company may need to consider its social and environmental responsibilities.

(ii) Many stakeholders including global bodies, NGOs and governments argue that enterprises should make a contribution towards the sustainable development of the planet.

(iii) A socially responsible company may be preferred by customers and employees (e.g.

(iv) customers may prefer to buy products from an environmentally-friendly, non-polluting company and employees prefer to be a part of a company that takes up social causes such as providing better schools in the locality where it is situated).

(v) Contribution to social causes such as education, healthcare and safety measures

(vi) will, in turn, help to create a safe and stable external environment for the organisation and reduce the external risks it faces (for example, provision of free vaccinations to residents of the area in which the company's factory is located will help the company to avoid the risk of the lack of required manpower, which it obtains from the local area).

(vii) CSR also includes acting within the legal parameters set by the state authorities and hence when a corporation contributes to social causes that are the province of the state, this may enable the corporation to gain certain favours from the government that will benefit the business in the long term; a classic example that "ethics pays" and an approach that may, by voluntary responsibility, avoid statutory regulation, interference and costs.

(b) Main principles

(i) A company needs to conduct its business ethically. The manner in which the company conducts its business is a reflection of what the company is and of the people who actually run the company. Accordingly, every company should have guidelines on the ethical behaviour that each employee, director, manager and any person working with the company should follow.

(ii) Employees should be treated fairly and should be provided with a good work atmosphere so that they feel taken care of. Providing education and training to employees so that they are given the opportunity to develop their skills is also a part of CSR. This is important since employees today prefer to work with companies that actively follow CSR policies since they feel motivated if they contribute to local and international activities through their company.

(iii) The company needs to respect human rights and hence should ensure that it does not follow any practices in the company that are against the rights of any particular section of society. For example, it should not make its workers work in hazardous conditions that may lead to health problems. Safe working conditions should be provided, especially if the company deals in harmful chemicals, explosives, etc.

(iv) A company is an artificial person recognised by law and hence it should act in a responsible manner as a citizen of the community. This requires it to contribute effectively towards the community by supporting social causes such as education, health, the environment, etc.

The company should contribute generously to promoting the welfare of the environment. This is essential since if it does not protect the environment it works in, this will have an adverse effect on the working of the company itself. Examples of measures it can take include:

(i) installing waste disposal and recycling plants to safely dispose of the waste emitted by the company;
(ii) using renewable energy resources, such as wind and water, instead of exhaustible, non-renewable energy resources such as coal and oil;
(iii) ensuring that the resources used by the company are replaced (e.g. if the company has felled trees in an area, then it should plant equal number of trees in the surrounding area so that the ecosystem is not disturbed); and
(iv) taking measures to reduce the overall air, water and noise pollution so that it may operate in a safe environment that enables the business to continue for a longer period.

Solutions 2:

Site A

The mere existence of contamination does not establish an obligation on the part of the company and without an obligation there is no need to make any provision.

Site B

An obligation does exist which the local government and a neighbour can prove in court. At least ₦45 million must be provided, but there may be a constructive obligation, wider than a legal obligation, to spend an extra ₦15 million to raise the standard of rectification. Concern for its long-term reputation may influence the company to honour its undertaking given to the local community.

Site C

While the exact amount of the expenditure may not be known with certainty, it should be possible to arrive at a realistic and prudent estimate. It is not acceptable to omit a liability on the grounds that its amount is not known with certainty, this would amount to a distortion.

Site D

The fines of ₦9 million are a current cost to be charged to the income statement. The spillage has impaired the value of the site, which must be written down to its new market value of ₦60 million after rectification. The cost of the write-down (₦15 million) and the cost of the rectification (₦15 million) are charged to the income statement. The sale is now carried in the books at its recoverable amount.

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Solutions 3:

Non-financial, ethical and environmental issues in many cases overlap, and have become of increasing significance to the achievement of primary financial objectives such as the maximisation of shareholder wealth. Most companies have a series of secondary objectives that encompass many of these issues.
Traditional non-financial issues affecting companies include:

(i) Measures that increase the welfare of Employees such as the provision of housing, good and safe working conditions, social and recreational facilities. These might also relate to managers and encompass generous perquisites ("perks").
(ii) Welfare of the local community and Society as a whole. This has become of increasing significance, with companies accepting that they have some responsibility beyond their normal stakeholders in that their actions may affect the environment and the quality of life of third parties.
(iii) Provision of, or fulfilment of, a service. Many organisations, both in the public sector and private sector provide a service (e.g. to remote communities) which would not be provided on purely economic grounds.
(iv) Growth of an organisation, which might bring more power, prestige, and a larger market share, but might adversely affect shareholder wealth.
(v) Quality. Many engineering companies have been accused of focusing upon quality rather than cost effective solutions.
(vi) Survival. Although to some extent linked to financial objectives, managers might place corporate survival (and hence retaining their jobs) ahead of wealth maximisation. An obvious effect might be to avoid undertaking risky investments.

Ethical issues faced and taken by companies have been brought increasingly into focus by the actions of, for example, Enron and the banking crisis. Whilst there has always been a trade-off between applying a high standard of ethics and increasing cash flow or maximisation of shareholder wealth, the concept of corporate social responsibility places a greater emphasis on the need for ethical behaviour to encourage maximisation of shareholder wealth.
Typical ethical dilemmas and questions include:

(i) Rewarding directors "for failure" (e.g. payment of bonuses when growth, profits and dividends have been in decline); "golden parachutes" when directors are forced to resign or are sacked; activation of share options or generous pension schemes despite failure.
(ii) Should bribes be paid to facilitate the company's long-term aims?
(iii) Are wages being paid in some countries below subsistence levels? Should they be?
(iv) Are working conditions of an acceptable standard?
(v) Do the company's activities involve experiments on animals, genetic modifications, etc?
(vi) Should the company deal with or operate in countries that have a poor record of human rights?

What is the impact of the company's actions on pollution or other aspects of the local environment (because it is cheaper to pay fines than follow the law)? Environmental issues have very direct effects on most companies. For example:

(i) If natural resources become depleted the company may not be able to sustain its activities;
(ii) Weather and climatic factors can influence the achievement of corporate objectives (e.g. climate change, sustainability of water supplies, etc).
(iii) Extreme environmental disasters (e.g. typhoons, floods, earthquakes, and volcanic eruptions) will also affect a companies' cash flow, as will obvious environmental considerations (e.g. the location of mountains, deserts, or communications facilities).
(iv) Should companies develop new technologies that will improve the environment, such as cleaner petrol or alternative fuels? Such developments might not be the cheapest alternative.

(v) Environmental legislation is a major influence in many countries. This includes limitations on where operations may be located and in what form, and regulations regarding waste products, noise and physical pollutants.

(vi) All of these issues have received considerable publicity and attention in recent years. Environmental pressure groups are prominent in many countries; companies are now producing social and environmental accounting reports, and/or corporate social responsibility reports as well as recognising the valid contribution and expertise such groups can make as stakeholders.

Companies increasingly have multiple objectives that address some or all of these three issues. In the short term non-financial, ethical and environmental issues might result in a reduction in shareholder wealth; in the longer term it is argued that only companies that address these issues will succeed.

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Professional Level

Strategic Business Reporting

CHAPTER 6

IAS 8: ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

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6 IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

6.0 Learning objective

This chapter equips readers with the principles-based knowledge and practical skill needed to select, apply and disclose accounting policies, deal with changes in accounting estimates and correct prior-period errors in strict accordance with IAS 8.

6.1 Learning outcomes

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

a. **discuss accounting** policy, accounting estimate and prior-period error.
b. apply the IAS 8 hierarchy when no IFRS covers a transaction, ensuring information is relevant and reliable.
c. identify whether a change is mandatory or voluntary, apply it retrospectively where practicable and draft all required disclosures.
d. explain, with examples, how measurement-basis and recognition changes differ from revisions to estimates.
e. adjust current and future periods prospectively, supported by clear narrative disclosure when material.
f. restate comparative figures or, if impracticable, apply prospective treatment and disclose the rationale.
g. evaluate common judgement areas such as impracticability claims and the reliability–relevance trade-off.
h. prepare extracts of financial statements and notes that satisfy IAS 8 presentation and disclosure requirements.

6.2 Accounting policies

6.2.1 Introduction to IAS 8

The objective of IAS 8 is to enhance the relevance, reliability and comparability of financial statements, and it should be applied by an entity to select and apply its accounting policies. In addition, IAS 8 should be applied where an entity changes its accounting policies or estimates, and for the correction of errors arising in prior periods.

The *IASB Framework* identifies comparability as one of the key qualitative characteristics of financial information. Comparability allows both the identification of trends over time in relation to a single entity and the evaluation of comparative performance across different entities.

To facilitate comparability, it is important that:

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(a) different entities take account of the same types of income and expenditure in arriving at the profit or loss for the period;
(b) information is available about the accounting policies adopted by different entities;
(c) different entities treat changes in accounting policies or estimate and the accounting for errors in the same way; and
(d) the scope for accounting policy changes is constrained.

IAS 8 enhances comparability of the entity's financial statements to previous periods and to the financial statements of other entities by prescribing:

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

Terminologies

The following definitions are given in the standard.

Accounting policies	are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.
A change in accounting estimate	This 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.
Prior period errors	These are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that: – Was available when financial statements for those periods were authorised for issue, and – Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.
Retrospective application	This is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied
Retrospective restatement	This is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

Prospective application	of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are: – Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and – Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.
Impracticable	Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following apply. – The effects of the retrospective application or retrospective restatement are not determinable. – The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period. – The retrospective application 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) at which those amounts are to be recognised, measured or disclosed; and would have been available when the financial statements for that prior period were authorised for issue, from other information.

6.2.2 Accounting Policies

The use of the word "policies" suggests that entities are allowed to choose between alternative accounting treatments. However, some of an entity's accounting policies will be dictated by an international standard which permits no choice of treatment. For instance:

(a) IAS 2 Inventories requires that inventories are measured at the lower of cost and net realisable value.
(b) IAS 37 Provisions, Contingent Liabilities and Contingent Assets prevents entities from recognising contingent assets and liabilities.
(c) IAS 38 Intangible Assets prevents entities from recognising internally-generated goodwill in their financial statements.

But some standards permit a choice. For instance:

(i) IAS 2 Inventories allows the cost of "interchangeable" inventory items to be assigned by using either the first-in, first out (FIFO) cost formula or the weighted average cost formula.
(ii) IAS16 Property, Plant and Equipment allows items of property, plant and equipment to be measured using either the cost model or the revaluation model.
(iii) Similarly, IAS 38 Intangible Assets allows intangible assets to be measured using

either the cost model or the revaluation model.

(iv) International standard IAS 1 requires entities to disclose their significant accounting policies in the notes which form a part of the financial statements.

IFRS 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.

6.2.3 Selection of accounting policies

Selection of accounting policies – Areas covered by IFRS

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

Selection of accounting policies – Area not covered by IFRS

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

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

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

(i) the requirements and guidance in IFRS dealing with similar and related issues;
(ii) 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 IASB Framework and may

refer to accounting literature and accepted industry practices as long as these do not conflict with the international standards, interpretations on the Conceptual Framework.

6.2.4 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. In accordance with the provision of IAS 8, an existing accounting policy should only be changed under the following two circumstances:

(a) A change is required by IFRS; or its interpretation and,
(b) A change will result in the financial statements providing reliable and more relevant financial information.

Determining when there is a change in accounting policy

A change in accounting policy can be established when one of the following events occurs

(i) A change in recognition criteria (e.g. capitalising or writing off certain types of expenditure)
(ii) A change in measurement basis (e.g. measuring non-current assets at cost or valuation)
(iii) A change in 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.

Illustrative Example 1: Determining When there is a Change in Accounting Policy

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

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

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

a. recognition – the interest cost previously recognised as an expense had to be recognised as an asset; and

b. presentation – the interest cost previously presented in the statement of comprehensive income had to be presented in the statement of financial position.

The following are not change in accounting policy:

(i) The application of an accounting policy to transactions or events or condition that differ in substance from those previously occurring.
(ii) Applying an accounting policy to a transaction or event that did not exist in the past.
(iii) A change in the method of depreciation.

Additionally, the initial application of a new accounting policy to revalue assets in accordance with IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets* should be dealt with under the rules of those standards.

6.2.5 Application of Changes in Accounting Policy

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.

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.

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.

Illustrative Example 2: Retrospective Application

A company presents comparatives for the previous year only.

During the year ended December 31, 2019, 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 2019 and December 2018 only.

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

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

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

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

6.2.6 Limitation on Retrospective Application

Definition: Impracticable

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

(a) the effects of the retrospective application or retrospective restatement are not determinable;
(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or
(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
    (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and
    (ii) would have been available when the financial statements for that prior period were authorised for issue from other information.

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.

There are different degrees of impracticability.

Period Specific Effect

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

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

Cumulative effect

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

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

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

6.2.7 Disclosure of a change in accounting policy

When a change in accounting policy has an effect on the current period or any prior period (or would have an affected that period except that it is impracticable to determine the amount of the adjustment) or might have an effect on future periods, IAS 8 requires extensive disclosures as follows:

(a) the change nature of the change in accounting policy
(b) the current period and each prior period presented, to the extent practicable, the amount of adjustments for:
    (i) each financial statement line item affected; and
    (ii) basic and diluted earnings per share, if IAS 33, Earnings per Share applies to the entity.
(c) the amount of the adjustment relating to periods prior to those included in the comparative information
(d) the fact that comparative information has been restated or that it is impracticable to do so.
(e) change of accounting policy required by IFRS
    (i) title of the IFRS
    (ii) the change in accounting policy made in accordance with its transitional provisions, if applicable.

(iii) a description of transitional provision, if applicable
(iv) transitional provisions that might have an effect on future periods, if applicable

(f) Voluntary changes in accounting policy
(i) the nature of the change in accounting policy
(ii) the reasons why applying the new accounting policy provides reliable and more relevant information.

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

6.3 Accounting Estimates

6.3.1 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. Judgements are made based on the most up to date information and the use of such estimates is a necessary part of the preparation of financial statements. It does not undermine their reliability.

Here are some examples of accounting estimates.

(a) a necessary irrecoverable debt allowance
(b) useful lives of depreciable assets
(c) provision for obsolescence of inventory
(d) the fair value of financial assets or liabilities;
(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 rule here is that the effect of a change in an accounting estimate should be included in the determination of net profit or loss in one of:

(i) The period of the change, if the change affects that period only
(ii) The period of the change and future periods, if the change affects both

Changes may occur in the circumstances which were in force at the time the estimate was calculated, or perhaps additional information or subsequent developments have come to light.

An example of a change in accounting estimate which affects only the current period is the bad debt estimate. However, a revision in the life over which an asset is depreciated

would affect both the current and future periods, in the amount of the depreciation expense.

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

Illustrative Example 3: 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 on the straight-line basis.

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.

Background

- Cost of asset (acquired at the start of Year 1) = ₦200,000
- Original useful life = 10 years
- Residual value = ₦Nil
- Depreciation method = Straight line

Position at the start of Year 2

- One year's depreciation recognised = ₦20,000 (₦200,000 ÷ 10 years)
- Carrying amount = ₦180,000 (₦200,000 – ₦20,000)

Revised estimate

A technical review at the end of Year 1 shows that rapid innovation has reduced the total useful life to six years. From the start of Year 2, the asset therefore has five years remaining (Years 2 to 6).

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Prospective treatment

IAS 8 requires changes in accounting estimates to be applied prospectively. The revised annual depreciation charge becomes:

$$\text{New annual charge} = \frac{\text{Carrying amount at start of Year 2}}{\text{Remaining useful life}}$$

$$= ₦180{,}000/5 \text{ years} = ₦36{,}000$$

This ₦36,000 expense will be recognised in Year 2 and in each of Years 3 to 6.

No restatement of prior-year figures is permitted because no error has occurred; only the forward-looking amounts are updated.

Disclosures

Where a change in an accounting estimate has a material effect in the current period (or which is expected to have a material effect in subsequent periods) the following should be disclosed:

(i) nature of the change in accounting estimate;
(ii) amount of change (if impracticable to estimate, this fact should be disclosed).

6.4 Accounting errors (material)

6.4.1 Accounting 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.

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

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

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A more formal definition of Prior error is given in definition above. Most of the time these errors can be corrected through net profit or loss for the current period. Where they are material prior period errors, however, this is not appropriate. The standard considers two possible treatments.

6.4.2 Accounting treatment of prior errors

Prior period errors: correct retrospectively. This involves:

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

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

6.4.3 Limitation on retrospective restatement

A prior period error must be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.

Period specific effect

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

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

Cumulative effect

It might be impracticable to determine the cumulative effect, at the beginning of the current period, of correcting an error in all prior periods,

In this case a company must correct the error prospectively from the earliest date practicable.

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6.4.4 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);
(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.

6.5 Judgements – IAS 8

Applying IAS 8 involves several professional judgements and estimation decisions that directly affect the figures presented in the financial statements. Key areas include the following:

Area	Practical Focus and Guidance
1. Developing accounting policies where no specific IFRS applies	When a transaction, event or balance is outside the scope of existing standards, management must design an accounting policy that yields information which is both relevant and faithfully representative. The hierarchy in IAS 8 directs preparers to consider similar IFRS requirements, the Conceptual Framework and accepted industry practice. *Example*: determining how to capitalise and amortise expenditure on a novel digital asset when no standard yet addresses it.
2. Categorising items to ensure consistent policy application	Items with similar characteristics must be grouped and treated consistently. Misclassification can distort comparability and trend analysis. *Example*: deciding whether software licences should be treated as intangible assets or prepaid services affects both balance-sheet presentation and amortisation.
3. Assessing whether a voluntary policy change enhances reliability and relevance	A voluntary change is permitted only if it improves the quality of information for users. Management must document its rationale and prepare full retrospective restatements unless impracticable. *Example*: moving from cost to revaluation for a class of property, plant and equipment to better reflect current values in a hyper-inflationary context.

4. Distinguishing policy changes from estimate revisions	A policy change alters the measurement basis or recognition criteria; an estimate revision updates inputs within an existing policy. This distinction dictates whether adjustments are retrospective (policy) or prospective (estimate). *Example*: switching from straight-line to units-of-production depreciation is a policy change, whereas shortening an asset's useful life after a technical review is an estimate revision.
5. Demonstrating impracticability	IAS 8 allows relief from full retrospective application only when it is genuinely impracticable to determine prior-period effects. Preparers must justify the claim by showing that restatement cannot be achieved after exhausting all reasonable efforts. *Example*: loss of historical data following a cyber incident that makes it impossible to calculate prior-year impacts of a new revenue-recognition policy.

A clear, principles-based approach to these judgements strengthens transparency and helps candidates craft disclosures that meet both examiner expectations and real-world stakeholder needs.

6.6 Chapter review

Before moving to the next chapter, ensure that you can:

a. Explain the objective and scope of IAS 8.
b. Draft a note that justifies the selection of a new accounting policy for a transaction not covered by a specific IFRS.
c. Determine whether a change represents a new policy or merely a revision of an estimate, giving one practical illustration of each.
d. Show the retrospective application of a voluntary policy change in both the statement of financial position and the statement of profit or loss and other comprehensive income.
e. Calculate and record the prospective impact of a revised depreciation estimate, including updated carrying amounts.
f. Prepare a reconciliation that restates prior-year figures after discovery of a material cut-off error.
g. Draft full disclosure notes for a change in accounting policy, a change in estimate and a prior-period error.
h. Assess whether a claim of impracticability is credible, citing the tests set out in IAS 8.

6.7 End of chapter questions and suggested solutions

6.7.1 Questions

Question 1:

Fadekemi Limited purchased a building in 2021 for ₦10,000,000. The building, which was used by company's personnel was included in the financial statements at a cost. In December 2023, the building was vacated and was let to an unrelated party at a market commercial rate. The building was included in the financial statements at December 31, 2023 at its fair value of ₦16,000,000.

Required:
Outline how the building should be accounted for by Fadekemi Limited and state whether it is a change in accounting policy or not with valid reason.

QUESTION 2:

Samba Ltd During the year to September 30, 2016, the following events occurred in relation to Samba Ltd.

(i) A claim for tax relief, submitted in 2013, was rejected by the Tax Commissioner of the Board. No appeal will be made. The resulting liability of ₦5,000,000 was not provided at September 30, 2015, since the company had expected the claim to succeed.
(ii) A cut-off error in respect of inventories at September 30, 2015, was discovered which would have reduced the carrying amount of inventories by ₦2,400,000. This error is material but not fundamental.
(iii) Non-current assets which had been written down to their estimated realisable value of ₦1,700,000 at 30 September 2015 were sold for ₦700,000.

Required:
How much should be accounted for retrospectively as an adjustment to retained earnings brought forward at October 1, 2015?

Question 3:

Platinum Ltd commenced its trading activities on January 1, 2020, preparing financial statements to December 31, each year. During 2023, the company decided to change its accounting policy regarding one of its operating expenses. Total operating expenses calculated using the previous accounting policy and shown in the company's financial statements for the first three years of trading were as follows:

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	₦'000	
Year to December 31, 2020,	240	
Year to December 31, 2021,		260
Year to December 31, 2022,		290
	790	

If the new accounting policy had been applied in previous years, the total operating expenses would have been:

	₦000
Year to December 31, 2020,	390
Year to December 31, 2021,	310
Year to 1 December 31, 2022,	230
	930

Furthermore, the company's liabilities at December 31, 2022 would have been higher by ₦140,000 (₦930,000 – ₦790,000).

A summary of the company's statement of comprehensive income for the year to December 31, 2023 (before adjusting comparative figures to reflect the change in accounting policy) shows the following:

	2023		2022	
	₦000		₦000	
Profit before operating expenses	1,510		1,450	
Operating expenses	190		290	
Profit before taxation	**1,320**		**1,160**	
Taxation		264		232
Profit for the year		**1,056**		**928**

Retained earnings were originally reported to be ₦2,371,000 on December 31, 2022. No dividends have been paid in any year. It may be assumed that the company's tax expense is always equal to 20% of the profit before taxation.

Required:

(a) Prepare an extract from the statement of comprehensive income so as to reflect the change in accounting policy, in accordance with the requirements of IAS 8.
(b) Prepare an extract from the company's statement of changes in equity for the year to 31 December 2019, showing changes to retained earnings.

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4.7.2 Suggested Solutions

Solution 1

Classification at December 31, 2023

The building meets the definition of an investment property as at 31 December 2023 because it is now rented to a third party. Accordingly, Fadekemi Limited must present it as investment property and, having selected the fair-value model, carry it at fair value in line with IAS 40.

Whether the reclassification is a policy change

IAS 40 makes it clear that owner-occupied property cannot be treated as investment property. In the 2021 and 2022 financial statements the building was owner-occupied, so Fadekemi Limited was prohibited from using IAS 40. Once the asset became income-producing in December 2023, it first satisfied the investment-property criteria.

The entity is therefore reacting to a change in the asset's substance, not altering its accounting policy. Under IAS 8 this is a reclassification triggered by changed circumstances; no retrospective restatement is required.

Solutions 2

Classification of the three items

Item	Natureunder IAS 8	Accounting treatment	Effect on current-period retained earnings
(i)	Normal estimation difference	Recognise in profit or loss for the current year. Treated prospectively because it refines an existing estimate, not an error.	None – flows through this year's profit or loss only.
(ii)	Prior-period error	Correct by restating the comparative financial statements. Reduce opening retained earnings for the earliest comparative period by ₦2,400,000.	No direct adjustment required at the start of the current year once comparatives have been restated.
(iii)	Normal estimation difference	Recognise in profit or loss for the current year for the same reasons as item 1.	None – flows through this year's profit or loss only.

Key points of principle

a. **Estimation revisions versus errors**

i. Items i and iii arise because better information has become available. IAS 8 treats such revisions prospectively; the new figures affect only the period in which the information emerges.

ii. Item ii is a genuine error in a prior period. IAS 8 requires full retrospective correction unless impracticable.

b. **Restating comparatives**

i. By restating the 2022 figures to reduce retained earnings by ₦2,400,000, Samba Ltd presents the financial history as though the error had never occurred.

ii. Because that adjustment is embedded in the comparative column, opening retained earnings for 2023 remain unchanged.

c. **No double impact**

The error is dealt with once, via the comparative restatement, avoiding any duplication in current-period equity.

This approach ensures the financial statements provide relevant, faithfully representative information and comply fully with IAS 8.

Solutions 3

(a) (**Restated**)

	2023		**2022**	
	₦'000		**₦'000**	
Profit before operating expenses	1,510		1,450	
Operating expenses		190		230
Profit before taxation	**1,320**		**1,220**	
Taxation	264		244	
Profit after taxation		**1,056**		**976**

(b)

	Retained earnings
	₦'000
Balance b/f as previously reported	2,371
Change in accounting policy	(112)
Restated balance	**2,259**
Profit for the year to December 31, 2023	1,056
Balance c/f	**3,315**

Note: The change in accounting policy results in additional operating expenses of ₦140,000 for 2020, 2021 and 2022 combined. Tax saved at 20% is ₦28,000. Therefore, retained earnings at December 31, 2022 fall by ₦112,000.

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Professional Level

Strategic Business Reporting

CHAPTER 7

IMPACT OF DIFFERENCES IN ACCOUNTING POLICIES

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7.1	Learning outcomes
7.2	Introduction to the issues
7.3	Creative accounting and earnings management
7.4	Chapter review
7.5	End of chapter questions and suggested solutions

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7 Impact of Differences in Accounting Policies

7.0 Learning objective

This chapter discusses how *alternative accounting policies and estimates* influence reported financial position, performance and cash flows, and how to detect and address **creative accounting** and **earnings-management** practices in line with IAS 1/IFRS 18, IAS 8 and related IFRS guidance.

7.1 Learning outcomes

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

a. **Define fair presentation** and explain how IAS 1/IFRS 18, the true-and-fair override and IAS 8's policy hierarchy safeguard it.
b. **Analyse the numerical effect** of different measurement bases (for example cost versus revaluation) and estimates on key ratios such as ROCE, gearing and EPS, using illustrative data.
c. **Identify IFRS mechanisms that enhance comparability**, including the restriction of policy choices, enhanced disclosures of judgements and fair-value guidance.
d. **Recognise and evaluate creative accounting and earnings management techniques**, their incentives and the red-flag indicators that auditors and analysts monitor.
e. **Formulate principled recommendations** on disclosure, policy selection and ethical practice when confronted with potential manipulation scenarios.

7.2 Introduction to the issues

7.2.1 What is fair presentation?

Directors are required to issue financial statements that present fairly the financial position, financial performance and cash flows of an entity.

IAS 1 requires financial statements to give a fair presentation of the financial position, financial performance and cash flows of an enterprise. In virtually all circumstances, a fair presentation is achieved by compliance with applicable IFRS's. A fair presentation also 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 sets out a hierarchy of authoritative guidance that management considers in the absence of a Standard or an interpretation that specifically applies to an item;
(b) To present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.
(c) To provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

Auditors are required to give an independent opinion on whether financial statements are presented fairly. If in the opinion of the auditor fair presentation is not achieved the auditor will issue a qualified audit report.

These requirements do not result in a statement of financial position that is correct in the sense that there is only one possible answer to different accounting questions.

In reality, a fair presentation can encompass a range of different figures. This is due to the fact that:

(a) alternative accounting policies can produce different results: and
(b) the application of accounting policies in accordance with IAS 8 is often based on estimates and judgements. Indeed, valuation and estimation are key factors in drafting financial information.

Example: Different Accounting Policy

This example explains the impact of revalution of a depreciable asset. **Year 1**

A company buys plant for ₦100,000 on the first day of the accounting period. The company's depreciation policy is to write the asset off on a straight-line basis over its useful life which is estimated to be 10 years. Carrying amount at the year-end is ₦90,000.

The example no compares the figures at the end of the following year on two bases:

(a) The company continues to account for the asset on a cost basis;
(b) The company revalues the asset to ₦135,000 on the first day of year 2(leading to a surplus of ₦135,000 - ₦90,000 = ₦45,000)

Further information is introduced.

		(a)		(b)
Statement of financial position	₦000	₦000		
Non-current assets		80		120
Current assets		120		120
		200		**240**
Equity (1)	100		140	
Loan (2)	100		100	
		200		**240**
Statement of profit or loss				
Profit before depreciation	50		50	
Depreciation		(10)		(15)
Profit for the year	**40**		**(35)**	
Statement of changes in equity				
Brought forward	60		60	
Profit for the year	40		35	
Revaluation surplus		-		45
		100		**140**
Ratios:				
ROCE (3/1+2)		20.0%		14.6%
Gearing (2/1+2)		50.0%		41.7%

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W1*:* The year 2 depreciation of the revalue asset = 135,000/9 years (the remaining useful life = ₦15,000)

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In the above example, there has been no underlying change in the business but figures would look very different were the asset to be revalued.

The gearing would be improved by the revaluation (falling from 50% to 41.7%) but ROCE would fall. Also note that the smaller profit would cause EPS to fall.

Example: Differing estimates when applying an accounting policy:
Two companies each buy identical plant for ₦100,000 on the first day of the accounting period.

Company A estimates that the useful life of the plant is 10 years and that it will have a residual value of ₦20,000.

Company B estimates that the useful life of the plant is 8 years and that it will have zero residual value.

	Company A	Company B
Annual depreciation charge	**₦**000	**₦**000
Non-current assets (cost)	100.0	100.0
Accumulated depreciation	(8.0)	12.5
	102.0	**87.5**
Annual depreciation charge	**8.0**	**12.5**

Differences such as those above might arise in the normal course of events with no attempt to engineer the figures. This can lead to loss of comparability.

Also, the situations described and others like them allow for accountants to manipulate figures to achieve a certain result. This is called creative accounting and is covered later in this chapter.

The problem is exacerbated by the fact that some transactions are not covered by IFRS. Also, some transactions might be very complex making it very difficult to devise an accounting approach. Different accountants might arrive at different figures for such transactions.

The framework provisions
The conceptual framework for financial reporting considers that a fair presentation would mean that the financial statements must show a true and fair view.

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True and fair override

IAS 1 recognises that there may be occasions when application of an IAS might be misleading and departure from IAS treatment is permitted. This is referred to as the fair override provision. If a company makes use of the override it is required to explain why compliance with IASs would be misleading and also give sufficient information to enable the user to calculate the adjustments required to comply with the standard.

The true and fair concept is familiar to the UK and Netherlands accounting professions. Many countries, however, view the concept of the true and fair view with suspicion since it runs counter to their legal systems. In Germany the fair override provision has not been directly implemented and laws are interpreted according to their function and objectives. It appears that the role of true and fair view in the European context is to act as a protection against over-regulation. Since the wider acceptance of IASs and adoption of IFRS's in recent years, the financial statements of many more companies and countries are fulfilling the principle of a true and fair view.

The company act also states that the directors may depart from any of it provisions if these are inconsistent with the requirement to give a true and fair view. This is commonly referred to as the 'true and fair override. It has been treated as an important loophole in the law and has been the cause of much argument, and dissatisfaction within the accounting profession.

When might entities use the fair override?

This can occur for a number of reasons.

(a) Accounting standards may prescribe one method, which contradicts the statutory requirement and thus requires an override.
(b) Accounting standards may offer a choice between accounting procedures, at least one of which contradicts the statutory requirement. If that choice is adopted, the override should be invoked.
(c) Accounting standards may allow some choice but prefer a particular method which is consistent with the statutory requirement, but the alternative may not be consistent.
(d) There may be a statutory requirement but no accounting standard. Failure to comply with the statute would require an override, e.g. current assets being reported at market value rather than at cost.
(e) There may be an accounting standards requirement which is overridden.

7.2.2 Mechanisms to reduce the problem

IFRS has tried to reduce the impact of the above in a number of ways including:

(a) Removing choices of accounting policy – there are fewer areas of choice now than there were 10 years ago.
(b) Providing rules on the selection of accounting policies (IAS 8);
(c) Requiring disclosure of judgements, estimates and key sources of measurement uncertainty (IAS 1/IFRS 18);
(d) Requiring disclosure of significant accounting policies (IAS 1/IFRS 18);
(e) Including firmer guidance on fair values (IFRS 13).

The IAS 1 disclosure requirements in respect of accounting policies do not ensure comparability but they do allow a user to understand the potential impact of any differences in approach.

7.3 Creative accounting and earnings management

7.3.1 Creative accounting

Definition

Creative accounting: Accounting practices that follow required laws and regulations, but deviate from what those standards intend to accomplish.

Creative accounting: The use of aggressive and/or questionable accounting techniques in order to produce a desired accounting result.

Management may use various forms of **creative accounting** to manipulate the view given by the financial statements while complying with all applicable accounting standards and regulations.

Creative accounting is not necessarily illegal but the practice might cross the line into fraudulent reporting.

Introduction

One of the factors affecting the overall level of financial statement risk is the potential for creative accounting.

Directors have choices and they may exercise those choices to recognise values that do not reflect economic reality. A prime example is the choice of the cost model when an asset's fair value is significantly higher than cost. (Note: If an asset's fair value and value in use were lower than cost, then an impairment would be required under IAS 36

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and directors would not have the discretion to disclose at cost.) Directors are more likely to make use of their discretion to mislead financial statement users if they have the opportunity (for example., imprecise accounting regulations, weak auditors) and incentives (e.g., approaching the breach of a debt covenant, an impending takeover, profit-based bonus) to do so.

7.3.2 The nature of creative accounting

Creative accounting: The active manipulation of accounting results for the purpose of creating an altered impression of the underlying financial position or performance of an enterprise by using accounting rules and guidance in a spirit other than that which was intended when the rules were written. This well-documented practice is a potential problem for auditors in assessing the underlying performance and position of a company and recent evidence suggests that it is one of the major issues facing financial reporting. Accounting measures involve a degree of subjectivity, choice and judgement and it would be wrong to describe all such activity as creative accounting. Moreover, creative accounting normally falls within permitted regulation and is not, therefore, illegal. It is therefore often a question of fine judgement as to when creative accounting is of such an extent that it becomes misleading.

The spectrum of creative accounting practices may include the following (commencing with the most legitimate):

(a) Exercise of normal accounting policy choice within the rules permitted by regulation (for example, first in, first out and average cost for inventory valuation).
(b) Exercise of a degree of estimation, judgement or prediction by a company within reasonable bounds (e.g. non-current asset lives).
(c) Judgement concerning the nature or classification of a cost (e.g. expensing and capitalising costs).
(d) Systematic selection of legitimate policy choices and estimations to alter the perception of the position or performance of the business in a uniform direction.
(e) Systematic selection of policy choice and estimations that fall on the margin of permitted regulation (or are not subject to regulation) in order to alter materially the perception of the performance or position of the business.
(f) Setting up of artificial transactions to create circumstances where material accounting misrepresentation can take place.
(g) Fraudulent activities

7.3.3 Causes of creative accounting – Opportunity

The causes of creative accounting have two key elements:
(a) Opportunity; and
(b) Incentives

Where these two elements exist together, the risks of creative accounting taking place are greatest. This section looks at opportunity. The following section looks at incentives. It is important to be aware of the causes of creative accounting in order to highlight the circumstances, where there is the greatest risk or incentives for creative accounting to take place.

The causes of opportunity for creative accounting include the following:
(a) Subjectivity – Areas of subjectivity lend themselves to a greater degree of choice, judgement and uncertainty.
(b) Complexity – Complex industries and transactions are difficult to regulate precisely and give more scope for manipulation.
(c) Inadequate corporate governance – Inadequate or inappropriate controls over directors may permit greater discretion.
(d) Insufficiently independent auditors – Auditors may come under increased managerial pressure to approve creative accounting practices.
(e) Imprecise regulations – Where regulations are imprecise or inadequate, companies have greater scope to exercise discretion, and auditors have a poor benchmark to challenge the selected accounting procedures.
(f) Inadequate sources of information – Where reliable sources of audit evidence exist (e.g., to challenge management estimations) the scope for effective manipulation is more limited.
(g) Inadequate penalties – Where creative accounting is discovered to have misled users, the penalties for the company, and for the directors, are regarded by some as inadequate to provide sufficient disincentives.

Causes of creative accounting – Incentives

The following have been put forward as incentives for companies/managers engaging in creative accounting:
(a) Income smoothing – Companies normally prefer to show a steady trend of growth in profits, rather than volatility with significant rises and falls. Income smoothing techniques (e.g. declaring higher provisions and deferring income recognition in good years) contribute to reducing volatility in reported earnings.
(b) Achieving forecasts – Where forecasts of future profits have been made, reported earnings may be manipulated to tie in with these forecasts.
(c) Profit enhancement – This is where current year earnings are boosted to enhance the short-term perception of performance.
(d) Maintain or boost share price – Where markets can be made to believe that increased earnings represent improved underlying commercial performance, then

share price may rise, or at least be higher than it would be in the absence of creative accounting.

(e) Accounting-based contracts – Where accounting-based contracts exist (e.g. loan covenants, profit- related pay) then, any accounting policy that falls within the terms of the contract may significantly impact on the consequences of that contract. For example, the breach of a gearing-based debt covenant may be avoided by the use of off-balance sheet financing.

(f) Incentives for directors – There may be personal incentives for directors to enhance profit in order to enhance their remuneration. Examples might include: bonuses based on earnings per share (EPS) or share incentive schemes and share option schemes that require a given EPS before they become operative. Directors may also benefit more indirectly from creative accounting by increasing the security of their position.

(g) Taxation – Where accounting practices coincide with taxation regulations there may be an incentive to reduce profit in order to reduce taxation. In these circumstances, however, it may be necessary to convince not only the auditor but also Tax Authority.

(h) Regulated industries – Where an industry is currently, or potentially, regulated then there may be an incentive to engage in creative accounting to reduce profit in order to influence the decisions of the regulator. This may include utilities where regulators may curtail prices if it is perceived that excessive profits are being earned. It may also be relevant to avoid a reference to the Competition Commission.

(i) Internal accounting – A company as a whole may have reason to move profits from division to division (or subsidiary to subsidiary) in order to affect tax calculations or justify the closure/expansion of a particular department.

(j) Losses – Companies making losses may be under greater pressure to enhance reported performance.

(k) Commercial pressures – Where companies have particular commercial pressures to enhance the perception of the company there is increased risk of creative accounting; for example, a takeover bid, or the raising of new finance.

Thus, a range of stakeholders may have incentives to engage in creative accounting. In particular, however, an appropriate degree of professional scepticism should be applied where benefits arise for directors, as they are also the group responsible for implementing creative accounting practices.

7.3.4 The consequences of creative accounting

It is important for the auditor to understand the consequences of creative accounting, as:

(a) It enables an understanding of the motivations and reasons for the company's directors to engage in the practice. (For instance, the existence and nature of a debt covenant that may be affected by creative accounting.)

(b) It enhances the understanding of whether the practice is material i.e. whether it would reasonably influence decisions made.

(c) It enables an understanding of the continued impact of a particular creative accounting practice in future years 'financial statements and whether the impact will be sustainable year on year.

The consequences of creative accounting depend crucially upon whether or not it is disclosed. Overt creative accounting refers to practices, which may change reported profits or the statement of financial position, but that are disclosed externally to financial statement users. Examples may include:

i. not depreciating non-current assets;
ii. capitalising development costs;
iii. significant provisioning; and
iv. changing depreciation policy.

Covert creative accounting refers to practices that are used to enhance profitability or asset values but are not disclosed. Examples might be:

i. the timing of revenue recognition on complex long-term transactions;
ii. the treatment of overhead allocations;
iii. many decisions to capitalise or expense cash outlays.

As a result, such covert practices are not readily identifiable by outside users, who are thus unable, in some cases, to distinguish increases in reported earnings arising as a result of accounting manipulation, from those arising from improvements in substantive underlying transactions. The potential consequences of covert creative accounting (e.g. for share price movements) are therefore likely to be more substantial than for overt creative accounting.

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7.3.5 Sustainability

Some creative accounting practices are sustainable in the long term while others may only serve to enhance the current year's profit, but only with the effect that future profits are correspondingly reduced.

Sustainable Practices	Unsustainable Practices
Income smoothing	Capitalisation of expenses
Concealed gearing (Off balance sheet financing	Revenue recognition

Sustainable practices may include the following:

(a) Income smoothing – assuming it is smoothed at a normal level of profitability, it may be sustained indefinitely; and
(b) Off balance sheet financing

Unsustainable practices include the following:

(a) Capitalisation of expenses – if, for instance, annual development costs are inappropriately capitalised and amortised over 10 years then, after that period, assuming constant expenditure, the profit will be equivalent for either write-off or amortisation policies (though not the statement of financial position) as there will be 10 amounts of 10% amortisation recognised in profit or loss; and
(b) Revenue recognition – bringing forward the recognition of revenues may initially enhance profit, but at the cost of reducing future profits.

7.3.6 Some specific consequences

Share price effects:

Where creative accounting practices are disclosed then one would expect that, in a semi-strong efficient market, investors would see through the manipulation and correctly price shares, with creative accounting having little effect. However:

i. the market may not always be efficient;
ii. accounting-based contracts may be affected; and
iii. complex series of transactions may mean that markets fail to appreciate fully the impact of creative accounting.

Covert creative accounting is likely to include all the above effects but in addition, even where the market is semi-strong efficient, it cannot always 'see through' the creative accounting and shares could be mispriced. This may result in shareholders suffering an undue loss.

Recent revelations regarding creative accounting have resulted in significant falls in the share prices of the companies concerned providing evidence of previous mispricing. However, shares prices also fell in other companies, as markets generally placed less trust in reported earnings and auditors were perceived as being unable to prevent creative accounting.

Accounting-based contracts

Whether creative accounting is covert or overt, it can affect the application of accounting-based contracts, so long as the selected accounting treatment falls within the terms of that contract. Typically, a restrictive covenant on gearing, or interest cover, may be avoided by enhancing equity or earnings. This may benefit one stakeholder (eg, shareholders) but disadvantage another (e.g. debtholders).

7.3.7 Red flags and detection

The best detection techniques for creative accounting are a good knowledge of financial reporting regulations and a good understanding of the business. There may, however, be more general techniques and indicators that can suggest that a company is engaging in creative accounting practice. These include the following:

(a) Cash flows – Operating cash flows are systematically out of line with reported operating profits over time.

(b) Reported income and taxable income – Is financial reporting income significantly out of line with taxable income with inadequate explanation or disclosure?

(c) Acquisitions – Where a significant number of acquisitions have taken place, there is increased scope for many creative accounting practices.

(d) Financial statement trends – Indicators include: unusual trends, comparing revenue and EPS growth, atypical year-end transactions, flipping between conservatism and aggressive accounting from year to year, level of provisions compared to profit indicating smoothing, EPS trend, timing of recognition of exceptional items.

(e) Ratios – Ageing analyses revealing old inventories or receivables, declining gross profit margins but increased net profit margins, inventories/receivables increasing more than sales, gearing changes.

(f) Accounting policies – Consider if there is the minimum disclosure required by regulation, changes in accounting policies, examine areas of judgement and discretion. Consider risk areas of off-balance sheet refinancing, revenue recognition, capitalisation of expenses, significant accounting estimates.

(g) Changes of accounting policies and estimates – Is the nature, effect and purpose of these changes adequately explained and disclosed?

(h) Management – Estimations proved unreliable in the past, minimal explanations provided.

(i) Actual and estimated results – Culture of always satisfying external earnings forecasts, absence of profit warnings, inadequate or late profit warnings leading to 'surprises', interim financial statements out of line with year-end financial statements.
(j) Incentives – Management rewarded on reported earnings, profit-orientated culture exists, other reporting pressures e.g. a takeover.
(k) Audit qualifications – Are they unexpected and are any auditors' adjustments specified in the audit report significant?
(l) Related party transactions – Are these material and how far are the directors affected?

The above is not a comprehensive list, but merely includes some main factors. Also, it is not suggested that the above practices necessarily mean there is creative accounting but, where a number of these factors exist simultaneously, then the auditor should be put 'on inquiry' to make further investigations.

7.3.8 Examples of creative accounting techniques

A number of examples of creative accounting have been given above and throughout these learning materials in the context of their application. The following list draws some of these together and provides further examples under key headings. The list is not meant to be comprehensive.

Timing of Operating Expenses	Revenue Recognition
Under provisioning in poor years or overprovisioning in good years	Premature recognition of revenue (Recognition of revenue before it is earned)
Manipulation of reserves	Recognition of revenue of service contracts before the service being performed
Aggressive capitalisation of costs	Recording out of period revenue
Optimistic asset lives	Recognition of sales before physical movement of goods
Accelerating expenses in good years	Misapplication of cut off procedures
Increased write down and write off in good years	Front-end recognition of sales that should be spread over more than one accounting period
Exceptional gains timed to offset exceptional losses	Percentage of completion estimates in construction industry

Off balance sheet financing

In some circumstances transactions may be structured in order to allow a particular accounting treatment (e.g., making a finance lease appear to be an operating lease)

rather than presenting the fairest view. This is one of the primary reasons for the large quantity of disclosure standards (as against measurement standards) in previous years.

7.3.9 Earnings management

Earnings management is a type of creative accounting.

Definition

Earnings management: An attempt by management to influence or manipulate reported earnings by using specific accounting methods or changing the methods used.

Earnings management techniques include deferring or accelerating expense or revenue transactions, or using other methods designed to influence short-term earnings.

Aggressive earnings management results in stakeholders being misled to some extent about an entity's performance and profitability. At the extreme, aggressive earnings management can involve acts that may constitute a criminal offence.

Commercial pressures

The strength of a regulatory framework may be undermined by commercial pressures on those responsible for preparing financial statements.
Examples of these commercial pressures are:

(a) Adverse market reactions to the share price of a listed entity when results fail to meet the market's expectations (which directors and management may have encouraged), whether or not the expectations were reasonable;
(b) Directors and management's incomes being highly geared to results and/or heavily supplemented by stock options;
(c) The importance of meeting targets to ensure protection of the jobs of directors, management and other employees:
(d) The desire to understate profits to reduce taxation liabilities;
(e) Legal and regulatory requirements to meet specific financial thresholds or ratios; and
(f) The need to ensure compliance with loan covenants or to pacify bankers.

Illustrations of recognition

Here are examples of recognition.

Example: Revenue Recognition

The before column represents the draft financial statements. The after column shows the figures after the inclusion of extra sales of ₦100,000 (Cost ₦50,000). This would

increase current asset by ₦50,000 (being an extra ₦100,000 receivables less ₦50,000 inventory).

	Before	After
	₦000	₦000
Non-current assets	300	300
Current assets	500	
550		
	800	
850		
Share capital	50	
50		
Retained earnings	360	410
	410	`
460		
Non-current liabilities	90	
90		
	500	
550		
Current liabilities	300	300
	800	
850		
Revenue	650	750
Cost of sales	(350)	
(400)		
Gross profit	**300**	
350		
Operating expenses	(200)	
(200)		
	100	
150		
Interest	(20)	(20)
Profit for the year	**80**	**130**

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ROCE	20%	27.3%
GP%	46.2%	46.7%
EPS	16	26
Gearing	18%	16.4%

Note: The impact that this has on the ratios. A common creative accounting technique is to book a sale before the year end and then reverse it in the next year. This is called **window dressing.**

Example: Asset recognition

The before column represents the draft financial statement. The after column shows the figures after capitalising an expense that was initially recognised in profit or loss.

	Before	After
	₦000	₦000
Non-current assets	300	320
Current assets	500	500
	800	**820**
Share capital	50	50
Retained earnings	360	380
	410	**430**
Non-current liabilities	90	90
	500	**520**
Current liabilities	300	300

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			800	
820				
	Revenue	650		650
	Cost of sales		(350)	
(350)				
	Gross profit		**300**	
300				
	Operating expenses		200	
200				
			100	
100				
	Interest	(20)		-
	Profit for the year	**80**		**130**
	ROCE		20%	
19.2%				
	GP%		46.2%	
46.2%				
	EPS		16	20
	Gearing	18%		17.3%

Asset measurement:

The impact of asset measurement was illustrated by the examples in section 1.1 of this chapter.

Example: Liability recognition

The before column represents the draft financial statements. The after column shows the figures after they have been adjusted to remove a liability of ₦50,000. This also reduces expenses in the statement of profit or loss.

	Before	After
	₦000	₦000
Non-current assets	300	300

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Current assets		500		500
		800		**800**
Share capital		50		50
Retained earnings	360		410	
		410		**460**
Non-current liabilities		90		90
		500		**550**
Current liabilities	300		250	
		800		**800**
Revenue	650		650	
Cost of sales		(350)		(350)
Gross profit		**300**		**300**
Operating expenses		(200)		(150)
		100		**150**
Interest	(20)		(20)	
Profit for the year	**80**		**130**	
ROCE		20%		27.3%
GP%		46.2%		46.2%
EPS		16		26
Gearing	18%		16.4%	

If the adjustment had been made against an expense related to cost of sales the gross profit margin would have improved.

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Liability measurement

A similar picture would be obtained by remeasuring a liability by ₦50,000.

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7.3.10 Reducing the current year profit

Creative accountants do not always work to increase profit. Sometimes they want to decrease the current year profit.

The reason for this is that it might allow them to increase profits in the future. For example, if an asset is written off this year but used in the future there will be no future expense to set against the future revenue.

Similarly, if a liability were to be set up this year it would reduce profit. If the liability was found to be unnecessary in the future it could be reversed back to the statement of profit or loss.

Big bath accounting

This refers to recognising all the bad news in one year so that later years can look stronger. If a company expects disappointing results it might decide to make them even worse by writing down assets and recognising liabilities. In future years the assets could be used without any corresponding cost and a decision made that the liabilities are no longer required. They would then be reversed back through the statement of profit or loss.

IFRS of course has rules to prevent or limit such flagrant abuses.

IAS 37: Provisions, contingent liabilities and contingent

Before the publication of IAS 37 the absence of accounting rules for provisions allowed entities to 'manipulate' their financial statements, especially their reported profit or loss in each year, by making provisions, increasing provisions or reducing provisions to suit management's reporting requirements.

Companies made provisions based simply on 'management intent' and used the argument of prudence to support their accounting treatment of provisions.

Creating a provision would reduce profit in the current year.

However, by creating a provision for expenses that would otherwise be charged in future years, a company was able to improve reported profits in future years.

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Quite often management would 'change their mind' about the intention that had led to the creation of the provision, and the provision would be 'released back' to increase profit in a subsequent year.

Provisions might contain a mixture of items such as provisions for future reorganisation costs, redundancy costs, closure costs, warranty claims and staff re-training costs. It was apparent that companies were exploiting the absence of rules and using provisions to move profit from one year to the next.

Alternatively, provisions might be created in a year of poor performance so as to report the 'bad news' in the current year so that future profits could be made to seem much better.

Example: Provisions

A company had a disappointing year in 2021.

As a result, the chief executive officer (CEO) resigned and a replacement CEO was appointed two months before the year-end. The CEO introduced several initiatives and performance is expected to slowly recover over the coming two years.

In order to make his appointment appear highly successful, the new CEO might want to create provisions to report a very bad year in 2021 and blame this on his predecessor, and use the provisions to improve results in later years.

For example, this might be achieved by the creation in 2021, a ₦1 million provision for the cost of future restructuring plans.

In 2the company might then decide to abandon the restructuring plans and so reduce the provision to zero, thereby increasing profit in 2022.

Using the illustrative figures below, this would allow the company to show a breakeven position in 2022 under the management of the CEO following losses in 2021, and then to report even better results in 2023

	2021	2022	20X3
	₦000	₦000	₦000
Original result	(2,000)	(1,000)	1,000
Provision	(1,000)		
Release of the provision	-	1,000	-
Reported results	(3,000)	1,000	

IAS 37 includes rules which try to prevent situations like this from happening. For example, it prohibits the recognition of a restructuring provision until that point in time where the company has no realistic alternative but to proceed with the restructuring.

However, IAS 37 is a standard that requires use of estimates and remeasurement of the provisions at each reporting date. There is still potential to use provisions to transfer profit form one period to the next.

Closing Comment

Any rule where a different amount might be recognised or recognition could be delayed or accelerated could be used in creative accounting.

The syllabus expects you to be able to identify the impact of different accounting policies (which would include the estimates inherent in their application).

It is recommended that whenever you study a standard that you try to think of areas in which judgements and estimates are required. Try to consider the impact of different judgements and estimates on the figures presented. It would also be useful if you were to think in terms of the impact on key ratios (for example, ROCE, gearing and EPS).

7.4 Chapter review

Before moving to the next chapter, ensure that you can:

Discuss the following focus areas and the application of their applicable IAS/IFRS:

FOCUS AREA	CRUCIAL TAKEAWAY	IFRS LINK
Fair presentation concept	A fair view usually follows full IFRS compliance, but directors may invoke the *true-and-fair override* where literal compliance would mislead and must then explain the adjustments made.	IAS 1/IFRS 18, IAS 8
Policy selection discipline	IAS 8 prescribes a hierarchy for new or uncommon transactions and demands consistent application plus retrospective restatement when policies change voluntarily.	IAS 8

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FOCUS AREA	CRUCIAL TAKEAWAY	IFRS LINK
Measurement choices and ratios	Revaluing assets can raise equity and cut gearing yet depress ROCE because of higher depreciation, without any real economic change.	Example tables
Creative accounting spectrum	Practices range from legitimate policy choices to borderline estimations and on to outright fraud; motivation grows where opportunity and incentive coexist.	
Earnings-management techniques	Common ploys include early revenue recognition, aggressive capitalisation, provision batching and window-dressing year-end sales.	Examples
IFRS safeguards	Fewer policy options, mandatory disclosure of key judgements and fair-value rules (IFRS 13) aim to curb comparability problems.	IFRS 13, IAS 1/IFRS 18
Red-flag indicators	Persistent profit–cash gaps, volatile margins, unusual year-end transactions, frequent policy changes and heavy director incentives warrant scepticism.	Indicators list

7.5 End of chapter questions and suggested solutions

7.5.1 Questions

Question 1:

Bonny Camp is a public limited company operating in the retail sector. It has recently appointed a new managing director who is reviewing the draft financial statements for the year ended September 30, 2029.

The managing director is keen to present the financial results from his first period of leadership in the best possible light. He considers EBITDA to be the most important measure of performance and has suggested that the reported profits under IFRS and alternative measures such as EDITBA can be managed to ensure Bonny Camp reports strong performance. He wants to know whether the finance team have taken advantage of all of the options available to enable this and has reminded the financial controller that he will receive a substantial bonus if earnings targets are met.

Required:

Discuss, from the perspective of investors and potential investors, the benefits and shortfalls of reporting EBITDA and comment on the nature of, and incentives for, 'management of earnings' and whether such a process can be deemed to be ethically acceptable.

Question 2:

During 20X6 Emirate acquired a development project through a business combination and recognised it as an intangible asset. The commercial director decided that the return made from the completion of this specific development project would be sub-optimal. As such, in October 2017, the project was sold to a competitor. The gain arising on derecognition of the intangible asset was presented as revenue in the financial statements for the year ended December 31, 2017 on the grounds that development of new products is one of Emirate's ordinary activities. Emirate has made two similar sales of development projects in the past, but none since 2010.

Required:

Give advice about whether the accounting treatment of this sale is correct.

Question 3:

As a result of rising property prices, Sincere Concept purchased five buildings during the current period in order to benefit from further capital appreciation. Sincere Concept has never owned an investment property before. In accordance with IAS 40 *Investment Property*, the directors are aware that they can measure the buildings using either the fair value model or the cost model. However, they are concerned about the impact that this choice will have on the analysis of Sincere Concept's financial performance, position and cash flows by current and potential investors.

Required:

Discuss the potential impact which this choice in accounting policy will have on investors' analysis of Sincere Concept's financial statements. Your answer should refer to key financial performance ratios.

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7.5.2 Suggested solutions 1

Solution 1

EBITDA and the management of earnings

EBITDA is a widely used measure of corporate earnings, but it is also a controversial figure.

EBITDA attempts to show earnings before tax, depreciation and amortisation. Depreciation and amortisation are expenses that arise from historical transactions over which the company now has very little control, and are often arbitrary in nature as they involve subjectivity in estimating useful lives and residual values. As they are non-cash, it is argued that they do not have any real impact on a company's operations. Companies also argue that they are not in control of tax and it should therefore not be a component of earnings. Interest is the result of financing decisions which are also often historic and influenced by a company's financing decisions. EBITDA is said to eliminate the effect of financing and accounting decisions and therefore gives investors and potential investors better insight into the performance of management and the impact of management decisions.

There are, however, criticisms of EBITDA. The main criticism is that EBITDA is not defined inIFRS and therefore is open to manipulation as companies can choose which items to include/exclude from its calculation. The fact that EBITDA is not defined can also reduce its usefulness to investors and potential investors as comparisons with previous years or to other companies may not be meaningful.

The managing director is proposing EBITDA is managed to report Bonny Camp in a favourable light.

'Earnings management' involves exercising judgement with regard to financial reporting and structuring transactions so as to give a **misleadingly optimistic picture** of a company's performance. Commonly it involves manipulating earnings in order to meet a target predetermined by management.

Earnings management can take place in respect of reported profit under IAS 1, or in alternative performance measures such as EBITDA is as suggested here. Earnings management is done with the intention, whether consciously or not, of **influencing outcomes that depend on stakeholders' assessments**. It is the **intent** to deceive stakeholders that is unethical even if the earnings management remains within the acceptable boundaries of GAAP. For example, a potential investor may decide to invest

in a company or an existing investor may be encouraged to increase their shareholding on the basis of a favourable performance or position. A director may wish to delay a hit to profit or loss for the year in order to ensure a particular year's results are well received by investors, or to secure a bonus that depends on profit. Indeed earnings management, sometimes called 'creative accounting', may be described as manipulation of the financial reporting process for private gain.

The directors may also wish to present the company favourably in order to maintain a **strong position within the market**. The motive is not always private gain – they may be thinking of the company's stakeholders, such as employees, suppliers or customers – but in the long term, earnings management is not a substitute for sound and profitable business, and cannot be sustained. In this case, the financial controller has been reminded that he will receive a substantial bonus if earnings targets are met. This represents a self-interest threat under ICAN Code of Conduct as the financial controller will personally benefit from the management of earnings. The 'reminder' from the managing director could also be interpreted as an intimidation threat if the financial controller feels unduly pressured as a result of the statement.

'Aggressive' earnings management is a form of fraud and differs from reporting error.

Nevertheless, all forms of earnings management may be **ethically questionable**, even if not illegal.

The flexibility allowed by IFRSs may cause some variability to occur as a result of the accounting treatment options chosen, but the accounting profession has a responsibility to provide a framework that does not encourage earnings management.

A more positive way of looking at earnings management is to consider the **benefits of not manipulating earnings, which include:**

(a) Stakeholders can rely on the data. Word gets around that the company 'tells it like it is' and does not try to bury bad news.
(b) It encourages management to safeguard the assets and exercise prudence.
(c) Management set an example to employees to work harder to make genuine profits, not arising from the manipulation of accruals.
(d) Focus on cash flow rather than accounting profits keeps management anchored in reality.

Earnings management goes against **the principle of corporate social responsibility**. Companies have a duty not to mislead stakeholders, whether their own shareholders, suppliers, employees or the government. Because the temptation to indulge in earnings management may be strong, particularly in times of financial crisis, it is important to

have **ethical frameworks** (such as ICAN Code of Conduct) **and guidelines** in place. The letter of the law may not be enough.

Solutions 2:

IFRS 15 *Revenue from Contracts with Customers* defines revenue as income arising from an entity's ordinary activities. Emirate's ordinary activities do not involve selling development projects. In fact, Emirate has made no such sales since 2010. It would seem that Emirate's business model instead involves developing products for its customers, who then take over its production, marketing and sale. Stage payments and royalties are the incomes which arise from Emirate's ordinary activities and should be treated as revenue.

Based on the above, Emirate is incorrect to recognise the gain as revenue. In fact, IAS 38 *Intangible Assets* explicitly prohibits the classification of a gain on derecognition of an intangible asset as revenue.

IAS 38 defines an intangible asset as an identifiable non-monetary asset without physical substance. Intangible assets held for sale in the ordinary course of business are outside the scope of IAS 38 and are instead accounted for in accordance with IAS 2 *Inventories*. The fact that the development project was classified as an intangible asset upon initial recognition further suggests that it was not held for sale in the ordinary course of business.

If the development was incorrectly categorised in the prior year financial statements as an intangible asset, then, as per IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, this should be corrected retrospectively. However, based on the infrequency of such sales, it seems unlikely that the development was misclassified.

Solution 3

In accordance with IAS 40 *Investment Property*, the buildings should be initially measured at cost.

- If the ***cost model*** is applied, then the buildings will be recognised at cost less accumulated depreciation and impairment losses.
- If the ***fair value model*** is applied, then the buildings will be remeasured to fair value at each reporting date. Gains and losses on remeasurement are recognised in the statement of profit or loss. No depreciation is charged.

Statement of financial position

If property prices rise, the fair value model will lead to an increase in reported assets on the statement of financial position. In contrast, investment property measured using the cost model is depreciated, which reduces it carrying amount. This means that the fair value model may make Sincere Concept appear more asset rich. Some stakeholders may place importance on an entity's asset base, as it can be used as security for obtaining new finance. However, reporting higher assets can sometimes be perceived negatively. For example, asset turnover ratios will deteriorate, and so Sincere Concept may appear less efficient.

If assets increase, then equity also increases. As such, the fair value model may lead to Sincere Concept reporting a more optimistic gearing ratio. This may reduce the perception of risk, encouraging further investment.

Statement of profit or loss

In times of rising prices, the use of the fair value model will lead to gains being reported in the statement of profit or loss. This will increase profits for the period. In contrast, the depreciation charged under the cost model will reduce profits for the period. Therefore, earnings per share, a key stock market and investor ratio, is likely to be higher if the fair value model is adopted.

However, it should be noted that fair values are volatile. In some years, fair value gains may be much larger than in other years. If property prices decline, then the fair value model will result in losses. As such, reported profits are subject to more volatility if the fair value model is adopted. This may increase stakeholders' perception of risk. In contrast, the depreciation expense recorded in accordance with the cost model will be much more predictable, meaning that investors will be better able to predict Sincere Concept's future results.

Many entities now present alternative performance measures (APMs), such as EBITDA (earnings before interest, tax, depreciation and amortisation). Other entities present 'underlying profit' indicators, which strip out the impact of non-operating or non-recurring gains or losses (such as the remeasurement of investment properties). Although the use of APMs has been criticised, Sincere Concept may consider them to be useful in helping investors to assess underlying business performance through the eyes of management and to eliminate the impact of certain accounting policy choices.

Statement of cash flows

Accounting policy choices have no impact on the operating, investing or financing cash flows reported in the statement of cash flows.

Disclosure

It should be noted that entities using the cost model for investment properties are required to disclose the fair value. Such disclosures enable better comparisons to be drawn between entities which account for investment property under different models.

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Professional Level

Strategic Business Reporting

CHAPTER 8

IFRS 15: REVENUE FROM CONTRACTS WITH CUSTOMERS

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8 IFRS 15: Revenue from Contracts with Customers

8.0 Learning objective

This chapter discusses IFRS 15 - Revenue from Contracts with Customers, including how to identify, measure, present and disclose revenue so that the nature, amount, timing and uncertainty of cash flows from customer contracts are faithfully portrayed and support strategic, decision-useful reporting.

8.1 Learning outcomes

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

a. **Explain** the core principle of IFRS 15 and its five-step model for recognising revenue;
b. **Apply** the five-step model to straightforward and complex contracts, including those with multiple performance obligations;
c. **Assess** and allocate variable consideration, including the effect of constraints, sales- or usage-based royalties and changes in estimates;
d. **Determine** whether a significant financing component exists and account for the time value of money in the transaction price;
e. **Account** for contract acquisition and fulfilment costs, including subsequent amortisation and impairment tests;
f. **Distinguish** between principal and agent relationships and recognise revenue on a gross or net basis, as appropriate;
g. **Analyse** specialised arrangements, returns, bill-and-hold, consignment, repurchase agreements and licences, and propose compliant treatments; and
h. **Prepare** journal entries and disclosures for contract assets, contract liabilities and receivables, linking them coherently to financial-statement line items.

8.2 Introduction to IFRS 15: Revenue from Contracts with Customers

8.2.1 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.

Revenue is income arising in the course of an entity's ordinary activities.

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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.

Core principle

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".

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; and
(b) at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

8.2.2 5 step Model

Revenue is recognised by applying the following steps:

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.

Illustrative Example 1:

X Ltd is a specialist software developer. It has been agreed to:

(a) **Licence** its software to the customer
(b) **Install** that software
(c) Provide **unspecified updates and technical support** for two years

These promised goods and services fall within the scope of IFRS 15 *Revenue from Contracts with Customers*.

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Applying the Five-Step Model

Step	Key Question	Practical Focus for This Contract
Step 1 Scope	Does the agreement create enforceable rights and obligations that place it within IFRS 15?	Confirm that the licence, installation and support form a customer contract and are not leases or service concessions regulated by other standards.
Step 2 Performance Obligations	Are the licence, installation and the two-year updates/support distinct goods or services?	Assess whether each promise is separately identifiable. The licence and installation are generally distinct. The updates and support form a stand-ready obligation over the support period.
Step 3 Transaction Price	What consideration is the entity entitled to receive and should it be adjusted for the time value of money or variable elements?	Identify any fixed and variable components (for example, usage-based fees) and assess whether a significant financing component exists.
Step 4 Allocation of the Price	How should the total consideration be split between each performance obligation?	Allocate on a relative stand-alone selling-price basis, estimating standalone prices if they are not directly observable.
Step 5 Revenue Recognition	When is control of each good or service transferred to the customer?	Licence revenue is typically recognised at the licence start date if it provides a right-to-use. Installation revenue is recognised when the service is complete. Updates and support revenue is recognised evenly over the two-year support period.

Key points to remember

- IFRS 15 offers detailed guidance for contracts with multiple deliverables, ensuring consistent treatment of complex revenue arrangements.
- Revenue recognition and invoicing are separate activities. An invoice may coincide with revenue recognition, but timing often differs.
- Clear documentation of judgments about distinct performance obligations, transaction-price allocation and timing of revenue is essential for transparent reporting.

8.2.3 The 5 step model

Step 1: Identify the contract(s) with a customer

A contract is an agreement between two or more parties that creates enforceable rights and obligations. A contract does not exist if each party has an enforceable right to terminate a wholly unperformed contract without compensating the other party.

The contract can be written, verbal or implied. For instance, in retail sales the contract is implied. The first step in IFRS 15 is to identify the contract, this helps to establish the enforceable rights and obligations.

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) all parties have approved the contract and are committed to perform their respective obligations:

(b) the entity can identify each party's rights regarding the goods or services to be transferred;

(c) the entity can identify the payment terms;

(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 that the entity will collect the consideration to which it will be entitled in exchange for the goods or services.

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Illustrative Example 2: Application criteria

Background

X Ltd, a property developer, agrees to sell a completed building to Mr A for ₦1,000,000. Mr A intends to run a restaurant in the premises. The location is already saturated with restaurants and Mr A has limited experience in the sector.

a. Mr A pays a non-refundable deposit of **₦50,000**.
b. The remaining **95 percent** is financed through a long-term, **non-recourse** loan payable from the restaurant's future profits.
c. If Mr A defaults, X Ltd may take back (repossess) the building but may not pursue any further claim against Mr A.

Step-by-step assessment of the contract criteria under IFRS 15

Criterion	Assessment	Conclusion
1. Contract approval and commitment to perform	Signed sale and loan agreements are in place.	**Yes**
2. Identification of each party's rights	Rights and obligations of seller and buyer are clearly stated in the contracts.	**Yes**
3. Identification of payment terms	Deposit, loan amount, interest and repayment schedule are specified.	**Yes**
4. Commercial substance	The transaction is expected to change the entity's future cash flows.	**Yes**
5. Probable collection of consideration	Collection is **not** probable because:	

- Repayment depends on a start-up restaurant in a competitive market.
- Mr A has no other significant assets or income sources.
- The loan is non-recourse, limiting X Ltd's recourse to the property only.

Since criterion 5 is not met, the agreement is **not** treated as a contract with a customer under IFRS 15 at inception.

Accounting Implication for the Non-Refundable Deposit

(a) The ₦50,000 received **cannot be recognised as revenue**.
(b) X Ltd records the amount as a **contract liability** until one of the following occurs:

- X Ltd has fully satisfied its performance obligations and has collected substantially all of the consideration, making the amount effectively non-refundable, or
- The contract is terminated and the deposit, by agreement, is non-refundable.

Only at that point may the deposit be reclassified from liability to revenue.

Key learning points

a. Probable collection of consideration is a mandatory gate for revenue recognition.
b. Non-refundable cash received before the criteria are met is deferred as a liability.
c. Non-recourse financing and the customer's limited capacity to pay indicate heightened credit risk, often preventing initial revenue recognition.

Step 2: Identify the performance obligations in the contract

A **performance obligation** is a promise to transfer to the customer either:

(a) A **distinct good or service** (or bundle of goods or services); or
(b) A **series of distinct goods or services**

A good or service is distinct if:

(i) The customer can benefit from the good or service on its own or with other resources that are readily available; and
(ii) The promise to transfer the good or service is separately identifiable from other promised 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 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 (described by reference to promises satisfied over time, and progress to completion assessment).

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A good or service is distinct if **both** of the following criteria are met:

(i) 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

(ii) the entity's promise to transfer the good or service is **separately identifiable** from other promises in the contract.

If a promised good or service is not distinct, it must be combined with other promised goods or services until a bundle of goods or services that is distinct can be identified. This could mean that all of the goods or services promised in a contract might be accounted for as a single performance obligation.

This sounds quite complicated but simply means that at the inception of a contract an entity must determine whether the contract is for the sale of a single deliverable or several deliverables. This is important as revenue is recognised as these separate goods and services are delivered to the customer.

Illustration example 3: **Facts of the contract**

X Ltd, a licensed reseller of the software suite **Phage**, signs an agreement to supply a customer with:

- a right-to-use software licence,
- installation of the software,
- any updates that become available during the next three years (up to three years), and
- technical support over the same three-year period.

Each item can be bought separately from X Ltd or from alternative vendors. The installation is a straightforward set-up that does not alter or customise the code. The software will operate as intended even without future updates or support.
What are the performance obligations?

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Suggested solutions:

Assessment Under IFRS 15

IFRS 15 criterion	Licence	Installation	Updates	Support	Result
Capable of being distinct – the customer can benefit from the good or service on its own or together with other readily available resources	✓	✓	✓	✓	All meet the test
Distinct within the context of the contract – the promise is separately identifiable from other promises	✓	✓	✓	✓	No significant integration, modification or customisation is necessary

Conclusion

Each promise is **distinct**, so there are **four separate performance obligations**:

- Software licence
- Installation service
- Stand-ready obligation to deliver updates for up to three years
- Stand-ready obligation to provide technical support for three years

Alternative Scenario – Customised Installation

If the installation required tailoring the software so that it interfaces with the customer's existing applications, the licence and installation would be **interdependent**. In that case, they would be combined into a **single performance obligation** because:

- the two services are highly interrelated, and
- X Ltd provides a significant integration service that transforms the licence and installation into one combined output.

The updates and support would remain distinct stand-ready obligations.

Illustrative Example 4: Assessing Whether Goods and Services are Distinct

Contract Overview

X Ltd, acting as the main contractor, signs an agreement to design and construct a hospital for a customer. The contract scope covers:

a. engineering and design,
b. site clearance and foundations,
c. erection of the super-structure,
d. installation of medical and non-medical equipment, and
e. interior finishing and commissioning.

X Ltd manages the entire project from planning through hand-over.

Suggested Solutions

IFRS 15 analysis

Test required by IFRS 15	Assessment	Outcome
Capable of being distinct – Can the customer benefit from each good or service either on its own or together with readily available resources?	Yes. X Ltd and other contractors routinely sell engineering, construction and installation services separately. The customer could, in principle, obtain economic benefit from each component on a stand-alone basis.	Criterion met
Distinct within the context of the contract – Is each promise separately identifiable or is X Ltd providing a combined output?	No. X Ltd offers an overarching integration service that transforms the various inputs into one combined output – a functioning hospital. The individual services are highly interrelated and X Ltd is responsible for managing the integration risk.	Criterion **not** met

Conclusion

Because the second criterion fails, the bundle of goods and services forms **one performance obligation**: delivery of a completed, operational hospital. X Ltd will therefore recognise revenue by measuring progress towards satisfying this single performance obligation, typically using an input or output method that faithfully depicts project performance.

Practical Implication

Progress payments raised during construction may differ from the pattern of revenue recognition. X Ltd must present contract assets or contract liabilities to reflect any timing differences between work performed and consideration invoiced.

Illustrative Example 5: Assessing whether promises are distinct

Contract Overview

X Ltd, a software developer, agrees to:

a. grant a right-to-use licence for its software;
b. carry out a routine installation;
c. supply any future software updates that may be released within the next two years; and
d. provide technical support for two years after installation.

Each item is sold separately by X Ltd and can also be obtained from alternative suppliers. The installation does not modify or customise the underlying code and the software remains fully functional without the updates or support.

Suggested solutions

IFRS 15 assessment

IFRS 15 Test	Licence	Installation	Updates	Support	Result
Capable of being distinct – the customer can benefit from the good or service on its own or together with other readily available resources	✓	✓	✓	✓	All criteria met
Separately identifiable within the context of the contract – the promise is not highly integrated with, nor	✓	✓	✓	✓	No significant integration or modification required

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IFRS 15 Test	Licence	Installation	Updates	Support	Result
significantly modifies, other promises					

Conclusion

Each promise is distinct, giving rise to **four stand-alone performance obligations**:

a. the software licence;
b. the installation service;
c. the stand-ready obligation to provide updates for up to two years; and
d. the stand-ready obligation to deliver technical support over the same period.

Revenue must be allocated to, and recognised for, each obligation in line with the requirements of IFRS 15.

Step 3: Determining the transaction price

The **transaction price** is the amount of consideration that the entity reasonably expects to receive in exchange for the goods or services promised in the contract. Arriving at a reliable figure requires a structured, principles-based assessment:

Area of focus	Practical guidance	Examination hint
Identify all forms of consideration	Include fixed cash, variable amounts, non-cash items, and any consideration payable to the customer. Explicitly exclude VAT and sums collected on behalf of third parties.	Common variable elements include performance bonuses, penalties, volume rebates, price concessions, and usage-based royalties.
Assess the contract and customary practice	Read the signed agreement alongside the entity's customary trading behaviour. If past practice shows that only a portion of the contractual price is routinely enforced, constrain the transaction price to that lower amount.	A pattern of granting price concessions may indicate that part of the list price is not enforceable.
Estimate variable consideration	Choose the *expected value* (probability-weighted) or the *most likely amount* method,	Watch for sales with rights of return. The refund liability and return

Area of focus	Practical guidance	Examination hint
	whichever better predicts the outcome. Apply the **constraint** – include variable consideration only to the extent it is *highly probable* that a significant revenue reversal will not occur when uncertainties resolve.	asset must be recognised at contract inception.
Consider the time value of money	Where payment timing gives rise to a significant financing component (generally, gaps longer than one year), discount the promised cash flows using a rate that reflects the customer's credit risk or the rate in a separate financing transaction.	Interest income or expense is presented separately from revenue.
Account for non-cash consideration	Measure at fair value on the contract date. If fair value cannot be measured reliably, use the stand-alone selling price of the goods or services transferred.	Shares or barter credits received from the customer are common examples.
Consideration payable to the customer	Treat as a reduction of the transaction price unless it is payment for a distinct good or service that the customer transfers to the entity.	Cashback vouchers issued to a retailer normally reduce revenue.

Illustrative Example 6: Mini-illustration

X Ltd sells licences with an advertised price of ₦1,200,000 per unit but usually grants a 10 percent early-settlement discount. Payment is due in 18 months. Past practice shows the discount is always granted. The customer's incremental borrowing rate is 8 percent per annum.

a. Step 1: List price ₦1,200,000 less expected discount ₦120,000 = ₦1,080,000.
b. Step 2: Discount the deferred settlement (18 months) at 8 percent: present value ≈ ₦1,008,000.
c. Recorded transaction price = ₦1,008,000.

Step 4: Allocating the transaction price to performance obligations

Once the overall transaction price is fixed, it must be spread across the identified performance obligations in a manner that reflects the value of each promise to the customer. The allocation follows four disciplined stages:

1. **Determine the stand-alone selling price (SSP) of each distinct good or service at contract inception.**
   - **Observable price** – use the published list price if routinely sold on a stand-alone basis.
   - **Adjusted market assessment** – estimate the price customers in that market would pay, considering margins and competitor pricing.
   - **Expected cost plus margin** – forecast the direct costs and add an appropriate gross margin.
   - **Residual approach** – permitted only when the SSP of at least one promise is highly variable or uncertain.

2. **Allocate the consideration proportionately.**
   - Calculate the ratio of each SSP to the total of SSPs and multiply by the transaction price.

3. **Allocate discounts selectively only when strict criteria are met.**
   - Allocate a discount in full to a specific performance obligation (or a group) *only* if:
     - each distinct good or service is normally sold separately,
     - regular bundles of some items are sold at a discount, and
     - the contractual discount is broadly the same as the usual bundle discount.
   - If these tests fail, spread the discount across all obligations on a relative SSP basis.

4. **Allocate variable consideration to specific obligations when appropriate.**
   - If the variable amount relates entirely to one performance obligation and doing so is consistent with the allocation objective, assign it to that obligation alone. Otherwise, apportion it across all obligations.

Illustrative Example 7: Numeric Illustration of Discount Allocation

Contract: Licence A (SSP ₦800,000), Installation B (SSP ₦200,000), Two-year Support C (SSP ₦400,000). Total SSP = ₦1,400,000. Contract price = ₦1,200,000 (overall discount ₦200,000).

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Scenario 1 – no evidence that discounts are regularly applied to any individual item:

Allocate discount across A, B, C based on SSP ratio. Licence A receives ₦686,000, Installation B ₦171,000, Support C ₦343,000.

Scenario 2 – entity routinely sells a licence plus installation bundle at ₦900,000:

The ₦200,000 discount is allocated entirely to A + B because criteria (a) to (c) are satisfied. Support C is allocated its full SSP of ₦400,000, leaving ₦800,000 to split between licence and installation in proportion to their SSPs (₦640,000 to A and ₦160,000 to B).

Key Examination Reminders

- The allocation exercise is performed at contract inception, then revisited only if the contract is modified or the transaction price changes.
- Clear narrative disclosure is required where estimation techniques are used, especially for variable consideration, discount allocation, and residual pricing.
- Use comma separators for large numbers and keep a logical audit trail of all calculations.

Mastering the mechanics of transaction-price determination and allocation equips candidates to address complex IFRS 15 scenarios confidently and to articulate the rationale in a professional examination or workplace setting.

Illustrative Example 8: Allocation of A Contract Discount

X Ltd sells three products at the following stand-alone selling prices:

	Stand-alone selling price(₦)
Product A	40
Product B	55
Product C	45

X Ltd sells one each of the products to Y Plc for ₦100 in total. Products B and C are sold regularly together for ₦60.

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The products are to be delivered at three different points in time. The delivery of each product is a separate performance obligation.

X Ltd regularly sells Products B and C together for ₦60 and Product A for ₦40. Therefore, the entire discount should be allocated to the promises to transfer Product B and C.

The discount of ₦40 is allocated as follows: in total. Products B and C are sold regularly together for ₦60.

Suggested Solutions:

Facts of the Contract

Item	Stand-Alone Selling Price (₦)
Product A	40
Product B	55
Product C	45
Total	**140**

X Ltd sells one unit of each product to Y Plc for a single contract price of **₦100**.

a. Products B and C are routinely sold together for **₦60**.
b. Product A is routinely sold on its own for **₦40**.
c. Delivery of A, B and C will occur at three different points in time.
d. Each product is a separate performance obligation.

The contract therefore includes an overall discount of **₦40** (₦140 – ₦100).

Step-by-Step Analysis Under IFRS 15

1. **Identify whether the discount relates to all goods or to a specific bundle.**
   - Products B and C are regularly bundled at a discounted price of **₦60**.
   - Product A is normally priced at **₦40** on a stand-alone basis.

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2. **Check the three IFRS 15 conditions for allocating the entire discount to fewer than all obligations.**
   a. Each product or bundle is sold separately on a stand-alone basis – *Yes*.
   b. A bundle of B and C is frequently sold at a discount – *Yes*.
   c. The discount in the contract (₦40) is broadly the same as the normal bundle discount – *Yes*.

Because all three conditions are satisfied, the full discount is allocated to Products B and C.

Numeric allocation – Different delivery dates

Item	Stand-Alone Price (₦)	Allocated Discount (₦)	Allocated Transaction Price (₦)
Product A	40	–	**40**
Product B	55	22	33
Product C	45	18	27
Total	**140**	**40**	**100**

Alternative scenario – Combined delivery of B And C

If the contract required **Products B and C to be delivered together** (for example, at the same time and place), X Ltd could treat the bundle as a **single performance obligation**. The discount would then be allocated in full to that bundle.

Item	Stand-Alone Price (₦)	Allocated Discount (₦)	Allocated Transaction Price (₦)
Product A	40	–	**40**
Products B and C (bundle)	100	40	**60**
Total	**140**	**40**	**100**

Key Learning Points

a. A contract discount is allocated entirely to specific performance obligations only when the IFRS 15 criteria are met in full.
b. When the criteria are not met, the discount is shared across all obligations in proportion to their stand-alone selling prices.
c. The timing of delivery can influence whether individual products are treated separately or combined into a single obligation, thereby affecting discount allocation and subsequent revenue recognition.

Illustrative Example 8: Allocation of discount

X Ltd sells three products at the following stand-alone selling prices:

	Stand-alone selling price (₦)
Product A	50
Product B	25
Product C	75

Products are not usually sold at a discount but X Ltd agrees to sell one each of the products to Y Plc for ₦100 in total.

The products are to be delivered at three different points in time. The delivery of each product is a separate performance obligation.

There is no observable evidence about which performance obligation has attracted the discount.

The discount of ₦50 is allocated on a proportionate basis as follows:

Suggested solutions:

Because no single obligation can be shown to have earned the discount, IFRS 15 requires the **proportionate** method. The discount of ₦50 (₦150 – ₦100) is spread using each product's share of the total SSP.

Product	SSP (₦)	Proportion of SSP	Discount Allocated (₦)	Allocated Transaction Price (₦)
A	50	50/150 = 0.3333	0.3333 × 50 = **17**	50 – 17 = **33**
B	25	25/150 = 0.1667	0.1667 × 50 = **8**	25 – 8 = **17**
C	75	75/150 = 0.5000	0.5000 × 50 = **25**	75 – 25 = **50**
Total	**150**		**50**	**100**

Each product's revenue will be recognised independently when its performance obligation is satisfied, using the allocated transaction prices shown above.

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Step 5: Recognise revenue when or as performance obligations are Satisfied

Under IFRS 15, revenue is booked **only when the entity fulfils a performance obligation by transferring control of the promised good or service to the customer**. The amount recognised equals the portion of the transaction price previously allocated to that obligation.

Meaning of "control"

Control exists when the customer can **direct the use** of the asset and **gain substantially all remaining benefits** from it (or prevent others from doing so). Goods and services, even if consumed immediately, are assets until control passes.

Recognition patterns

Recognition pattern	When applied	Practical outcome
Point-in-time	Control passes at a single moment.	Book revenue at that moment.
Over-time	Control transfers continuously throughout performance.	Recognise revenue progressively, measuring progress towards completion.

Point-in-time recognition

The transfer point is identified by **commercial evidence** that control has moved:

a. The entity now **has the right to payment**.
b. The customer **holds legal title**.
c. **Physical possession** has changed hands.
d. The customer has assumed the **significant risks and rewards** of ownership.
e. The customer has **formally accepted** the asset.

No single indicator is decisive; apply judgement in the round.

Over-Time Recognition

At contract inception decide whether any performance obligation meets **one of three criteria**:

Criterion	Typical Examples
(a) Simultaneous receipt and consumption – the customer benefits as the work is done.	Routine cleaning services; payroll processing.
(b) Customer controls the asset as created or enhanced.	Construction on the customer's land; bespoke software developed on the customer's servers.
(c) No alternative use + enforceable right to payment for performance to date.	Made-to-order equipment with customer-specific design, where the customer must pay for work completed if the contract is cancelled.

If **any** criterion is met, recognise revenue over time.

Measuring Progress

Choose the method that best depicts performance:

1. **Output methods** – value delivered to the customer to date, for example, units delivered, milestones certified, surveys of work performed.

2. **Input methods** – effort or resources consumed to date e.g. costs incurred, labour hours, machine hours.

Apply the chosen basis consistently for similar obligations.

Early-stage contracts – where the outcome cannot yet be estimated reliably but costs are recoverable, recognise revenue **only to the extent of costs incurred** until a clearer measure of progress is available.

Key Examination Pointers

a. Always link revenue recognition to **transfer of control**, not merely to billing or cash collection.
b. Provide logical, well-documented judgement when selecting indicators of control or methods of measuring progress.
c. Disclose the chosen policies and any significant judgements, as required by IFRS 15.

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A disciplined application of these principles ensures that reported revenue faithfully portrays the pattern in which economic benefits flow to the customer and, ultimately, to the reporting entity.

Illustrative Example 9: Assessing Whether Payroll-Processing Services are Satisfied Over Time

Contract Snapshot

a. **Service** – Monthly payroll processing.
b. **Duration** – One-year contract.
c. **Question** – Does the performance obligation meet the IFRS 15 test for over-time recognition?

Over-Time criteria checklist

Test (IFRS 15)	Assessment	Result
(a) Customer simultaneously receives and consumes the benefit	Each payroll run is processed and immediately used by the customer.	✓ *Criterion met*
(b) Customer controls the asset as it is created or enhanced	The "asset" is the up-to-date payroll data; control rests with the customer as soon as processing occurs.	✓
(c) No alternative use to the entity and enforceable right to payment for work to date	X Ltd could not readily redirect the tailored payroll output; the contract gives an enforceable right to payment for each month completed.	✓

Key point – Satisfying a single criterion is sufficient. Here, all three are met.

Conclusion

The payroll-processing obligation is **satisfied over time**. X Ltd must therefore recognise revenue **month by month**, measuring progress in proportion to the payroll services delivered (output method).

Practical application

a. Raise revenue after each payroll run rather than on contract inception or completion.
b. Present any difference between cumulative revenue and invoices as a **contract asset** or **contract liability**.

Output methods

Definition

Output methods recognise revenue by **measuring the value already transferred to the customer** in proportion to the total goods or services promised in the contract.

Common techniques

Technique	Typical Aapplication	Evidence generated
Surveys of performance to date	Professional services, long-term research projects	Independent surveyor's certificate or client sign-off
Appraisals of results achieved	Facilities management, asset maintenance	Condition report confirming agreed service levels
Milestones reached	Construction, software implementation	Contractual milestone certificate or customer acceptance form
Time elapsed	Straight-line services such as hosting or retainer contracts	Passage of time documented by contract schedule
Units produced or delivered	Manufacturing, print runs, energy supply	Delivery notes or production logs

Key principles

a. **Faithful representation** – The chosen measurement must depict accurately the entity's performance in satisfying the obligation.
b. **Consistency** – Apply the same output measure to similar obligations for comparability across periods.
c. **Customer value focus** – Revenue reflects benefits actually received by the customer, not merely the supplier's effort.

Practical limitations to consider

a. **Observability** – Some outputs are difficult to track objectively; professional judgement may be required.
b. **Data availability** – Gathering reliable progress data may be costly or impractical.
c. **Cost–benefit balance** – Where outputs are not readily observable, switching to an **input method** (for example, costs incurred) may provide a more pragmatic and cost-effective solution.

When selecting an output method, document the rationale, evidence relied upon, and any inherent estimation uncertainty to meet IFRS 15 disclosure expectations.

Illustrative Example 10: Health-club access: Revenue recognised over time

Contract overview

Feature	Detail
Supplier	X Ltd, owner and operator of several health clubs
Customer promise	Unlimited access to any club for one year
Consideration	₦100 per month, payable monthly
Distinct good or service	Stand-ready service – keeping facilities available for the member's use

Required: Is the performance obligation satisfied over time?

Step-by-step IFRS 15 analysis

Test	Discussion	Result
Simultaneous receipt and consumption	Each day the club is open, the member can enter and obtain the service. Benefits are received and consumed as X Ltd performs.	✓ Criterion met
Customer controls the asset as created or enhanced	The "asset" is the ongoing right of access; control passes continuously because the member can use the facilities at any moment.	✓ Criterion also met
No alternative use + right to payment	Although not needed (one criterion is enough), X Ltd could re-market unused slots to other members, so this test is not determinative here.	–

Since at least one criterion is satisfied, the performance obligation is **satisfied over time**.

Measuring progress towards completion

a. *Best depiction* – a **time-based output method**.
b. *Rationale* – The promise is to stand ready throughout the contractual period. Time elapsed best reflects the value transferred to the customer.

Revenue pattern

Month	Revenue recognised (₦)	Journal entry (Simplified)
Each month 1 – 12	100	**Debit**: Contract asset/Cash 100; **Credit**: Revenue 100

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X Ltd therefore recognises **₦100 per month**, regardless of whether the member actually attends the club. What matters is X Ltd's continuous fulfilment of its stand-ready obligation.

Input methods

Definition

Input methods recognise revenue by **tracking the effort the entity has applied** to a performance obligation and comparing that effort with the total expected effort necessary to complete it. The underlying premise is that the **inputs consumed proportionately reflect the transfer of control to the customer**.

Common Metrics

Metric	Typical use case	Basic calculation
Labour hours	Professional services, construction supervision	Hours worked to date ÷ Total budgeted hours
Costs incurred (cost-to-cost)	Engineering contracts, shipbuilding	Direct costs incurred to date ÷ Total forecast contract costs
straight-line time	Evenly delivered services such as website hosting or insurance administration	Days or months elapsed ÷ Total contract term

Straight-line time can be regarded as an input approach when the service effort is expected to be level throughout the contract period.

Key considerations

a. **Link between inputs and outputs**
Ensure that the chosen input metric reliably depicts the value transferred to the customer. If significant costs are incurred before any progress is made (for example, mobilisation or start-up costs), adjust the calculation to exclude such costs until they contribute to performance.

b. **Forecast accuracy**
Input methods rely on robust budgets for total hours or total costs. Regular re-forecasting is required; any change in estimate is treated prospectively.

c. **Unproductive or wasted effort**
Exclude wasted inputs that do not contribute to satisfying the obligation.
Including them would overstate progress and accelerate revenue inappropriately.

1. **Data availability and practicality**
Labour-hour and cost information must be collected promptly and at a reasonable cost. If obtaining reliable input data would be onerous, an output method may provide a more pragmatic measure.

Illustrative example 11:

Contract: X Ltd is building a bespoke machine for ₦1,000,000, budgeted to cost ₦800,000.
At year-end: costs incurred are ₦320,000, forecast total costs remain at ₦800,000.

Percentage complete = ₦320,000/₦800,000 = **40%**

Revenue recognised = 40% × ₦1,000,000 = **₦400,000**

The journal entry would debit Contract Asset and credit Revenue for ₦400,000 less any revenue recognised in prior periods.

A carefully selected input method, properly adjusted for unproductive costs and supported by reliable budgets, provides a logical and transparent revenue profile that mirrors the entity's performance in satisfying its contractual obligations.

Illustrative example 12: Measure of progress using the input method

Contract facts

Matter	Detail
Contract	Construction of a building
Transaction price	₦3,200,000
Performance obligation	Single obligation satisfied over time
Method selected	Cost-to-cost input method

Cost profile

Cost element	₦
Costs incurred to date	1,500,000
Forecast costs to complete	1,000,000
Total expected costs	**2,500,000**

X Ltd has not yet recognised any revenue on this contract.

Measure of progress and revenue recognition

Percentage complete = 1,500,000/2,500,000 × 100 = **60%**

Revenue = 60% × ₦3,200,000 = **₦1,920,000**

Debit: Contract Asset ₦1,920,000

Credit: Revenue ₦1,920,000

A corresponding cost of sales of ₦1,500,000 is recognised in profit or loss.

When The input method must be adjusted

Applying IFRS 15, X Ltd must exclude or adjust costs that do not faithfully represent progress:

a. **Inefficient costs**
   Significant wastage, rework or other inefficiencies, if not priced into the contract, must be stripped out of the progress calculation.
b. **Disproportionate costs**
   Where a cost is incurred that is not proportional to performance to date, revenue should be limited to the amount of that cost until the imbalance reverses.

Careful judgement and robust documentation are required to ensure that reported progress mirrors the real transfer of control to the customer.

Illustrative Example 13: Adjustment to progress measure when inefficiencies arise

Contract facts

Detail	Information
Contractor	X Ltd
Deliverable	Construction of a building
Contract price	₦3,200,000
Performance obligation	Single obligation satisfied over time
Progress method	Cost-to-cost input method

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During the year a sudden frost caused the freshly poured foundation to fail. X Ltd replaced the defective work at its own cost because the customer is not liable for rectification.

Cost profile at reporting date

Cost element	₦	Comment
Efficient costs incurred to date	1,400,000	Contribute to progress
Rectification cost	100,000	Inefficient, does **not** create progress
Efficient costs forecast to complete	1,000,000	
Total expected efficient costs	2,400,000	Basis for progress measure

The full ledger shows costs incurred of ₦1,500,000 (₦1,400,000 efficient plus ₦100,000 rectification). Under IFRS 15 inefficient spend is eliminated when measuring progress.

Progress Calculation Excluding Inefficiencies

Percentage complete = ₦1,400,000/₦2,400,000 × 100% = **58.33%**

Revenue recognised = 58.33%×₦3,200,000 = **₦1,866,667**

Journal Entry (Simplified)

Debit: Contract asset ₦1,866,667

Credit: Revenue ₦1,866,667

Cost of sales recognised equals the efficient costs incurred to date, ₦1,400,000.

Why rectification costs are excluded

a. **No contribution to performance** – The defective foundation did not increase the customer's control of the building.
b. **Not priced in the contract** – The contract price did not include an allowance for this inefficiency.
c. **Faithful depiction of progress** – Including wastage would overstate completion and accelerate revenue.

Period-end clarification

Assume the frost damage occurred on the last day of the accounting period. Before discovery, X Ltd had spent ₦1,400,000 of efficient costs and assessed progress at 58.33 per cent. The need to redo the work revealed that the project was **not further along**

than 58.33 per cent. The rectification merely restored the asset to its former state; it did **not** advance progress and therefore does not justify additional revenue.

Cumulative measurement of progress

a. **Principle** – Progress is assessed on a cumulative, life-to-date basis. At each reporting date the entity calculates how much revenue **ought to have been recognised in total** given the percentage of completion achieved.
b. **Practical implication** – Where no revenue has been booked in earlier periods, the full amount indicated by the current progress calculation is recognised in the period just ended (as shown in the examples above).
c. **Incremental adjustment** – If some revenue was recorded in a prior period, recognise **only the incremental amount** required to bring cumulative revenue up to the new total.

Incremental revenue for the period = *(Total revenue to date at current period-end)* − *(Total revenue recognised up to previous period-end)*

This approach ensures that revenue reported each period faithfully tracks the entity's performance and prevents double counting.

Examination Pointers

a. Eliminate abnormal waste, rework and scrap from the input measure.
b. Reforecast total efficient costs promptly; adjust the percentage complete prospectively.
c. Disclose significant judgements concerning the exclusion of inefficient costs, as required by IFRS 15.

Illustrative Example 14: Progressive revenue recognition using input (cost-to-cost) method

Contract facts

Item	Detail
Deliverable	Construction of a building (single performance obligation)
Transaction price	**₦3,200,000**
Progress method	Costs incurred to date ÷ Total expected costs

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Cost profile

Year	Costs Incurred to Date (₦)	Latest Forecast of Total Efficient Costs (₦)	Percentage Complete
1	1,500,000	2,500,000	60 percent
2	2,000,000	2,500,000	80 percent

Total expected costs remain unchanged at ₦2,500,000 across the two years.

Revenue calculation – Cumulative and Incremental

Year	Cumulative revenue entitled (₦)	Revenue recognised in prior years (₦)	Incremental revenue this year (₦)
1	60% × 3,200,000 = **1,920,000**	–	**1,920,000**
2	80% × 3,200,000 = **2,560,000**	1,920,000	**640,000**

The incremental figure brings cumulative revenue up to the new entitlement at each reporting date.

Journal Entries (Simplified)

Year	Debit: Contract Asset (₦)	Credit: Revenue (₦)
1	1,920,000	1,920,000
2	640,000	640,000

Corresponding cost of sales equals the efficient costs incurred in each period (₦1,500,000 in Year 1 and ₦500,000 in Year 2).

Key takeaways

a. **Cumulative approach** – Always recalculate total revenue earned to date, then post only the incremental amount needed to reach that total.

b. **Estimate consistency** – Unchanged cost forecasts simplify the percentage-complete calculation; any forecast revision would adjust both progress and future revenue.

c. **Transparent audit trail** – Separate disclosure of cumulative and incremental figures aids users in tracking contract performance over successive periods.

Illustrative example 15: Bundle sale of a handset and a twenty-four-month network contract

This example walks through **Steps 3 to 5** of the IFRS 15 model (time-value-of-money adjustments are ignored at this stage).

Step 3: Determine the transaction price

Item	Stand-alone price (₦) – Sold separately	Bundle cash flows (₦) – Contract basis
Handset (up-front)	53,100	—
Monthly network fee	2,500	5,000
Contract term (months)	24	24
Cash total	**113,100**	**120,000**

The bundle transaction price is therefore **₦120,000** (24 × ₦5,000).

Step 4: Allocate The Transaction Price To Distinct Performance Obligations

Performance obligation	Stand-Alone selling price (SSP) (₦)	Allocation ratio	Allocated revenue (₦)
Handset	53,100	53,100 ÷ 113,100 = 0.469	**56,340**
Network access (24 months)	60,000	60,000 ÷ 113,100 = 0.531	**63,660**
Total	**113,100**	—	**120,000**

Allocation is on a relative SSP basis because there is no evidence that a specific item attracts the entire discount or premium.

Step 5: Recognise Revenue

Timing	Accounting treatment	Debit (₦)	Credit (₦)	Explanation
Contract inception – handset delivered	Recognise handset revenue and a receivable (no cash yet)	Receivable 56,340	Revenue 56,340	Control of the handset passes to the customer.
Each month, 24 ×	Cash received; split between revenue for network service and reduction of handset receivable	Cash 5,000	Revenue 2,653	Network revenue recognised evenly: 63,660 ÷ 24.
			Receivable 2,347	The residual cash reduces the handset receivable; after 24 months the receivable is nil.

Proof – Over twenty-four months:

- Cash = ₦120,000
- Revenue = 56,340 (handset) + 63,660 (network) = **₦120,000**
- Receivable released = 56,340

Commercial insight

- **Handset** – Revenue is recognised at delivery because control transfers immediately.
- **Network service** – Revenue is recognised over the service period because control transfers continuously.
- **Receivable** – Represents the handset portion funded by the future network payments.
- **Cash-revenue mismatch** – Each monthly receipt exceeds the network revenue recognised; the excess clears the receivable.

Time-value-of-money note

The example treats the handset SSP (payable up front in a stand-alone sale) and the network SSP (payable over two years) as comparable, ignoring financing effects. In practice, an entity would assess whether the payment profile contains a significant financing component and, if so, discount the future cash flows before allocating the transaction price. This adjustment is illustrated later in the chapter.

Examination pointers

a. Identify all distinct obligations before performing any allocation.
b. Allocate using the relative SSP unless IFRS 15 permits a more targeted allocation.
c. Separate receivable, contract asset, and contract liability balances clearly in your double entries.
d. Always check for possible financing components when cash timing differs across promises.

8.3 Factors affecting the transaction price

8.3.1 Variable consideration

The amount of consideration for the sale of goods and services might be variable due to the existence of discounts, price concessions, incentives, performance bonuses, penalties and similar items.

Consideration can also vary if its amount is contingent on the occurrence or non-occurrence of a future event. For example, where a product is sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a

specified milestone.

The variability relating to the consideration promised by a customer may be explicitly stated in the contract. However, in addition to the terms of the contract, the consideration is variable if either of the following circumstances exists:

(a) 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.

(b) 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).

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The method used should be the method expected to better predict the amount of consideration and should be applied consistently throughout the contract.

Variable consideration is only included in the transaction price to the extent that it is higly probable that there will not be a significant reversal of revenue when the uncertainty associated with the variable consideration is resolved. Any changes to the variable consideration are allocated to all of the performance obligations in the contract. It should be noted that any changes to variable consideration will be treated as a **refund liability.**

Refund liabilities

An entity might expect to return some (or all) of the consideration received from a customer. Such consideration must be recognised as a refund liability.

A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled. It must be updated at the end of each reporting period for changes in circumstances.

Illustration Example 16: Variable consideration

X Ltd sells 100 products to customers at a cost of ₦100 per product. Cash is received when control of a product transfers.

X Ltd allows customers to return any unused product within 30 days and receive a full refund.

The cost of each product to X Ltd is ₦60.

X Ltd has considerable experience of selling this type of product. Based on this experience it estimates that 97 products will not be returned. Therefore X Ltd will not recognise the revenue on three products.

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Suggested solutions:

X Ltd will recognise the following on the inception of the contracts:

	Debit ₦	Credit ₦
Cash (100 *₦100)	10,000	
Revenue (97 *₦100)		9,700
Refund liability (3 *₦100)		300

In addition, X Ltd will recognise an asset of ₦180 (3*₦60) for its right to recover products on setting 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

(b) the allocation is consistent with the IFRS 15 allocation objective.

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Royalties

Regardless of the above, revenue for a sales-based or usage-based royalties promised in exchange for a licence of intellectual property is recognised only when (or as) the later of the following events occurs:

(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).

8.3.2 Financing component

A financing component exists where the customer receives a benefit from financing due to the consideration being transferred after the satisfaction of the performance obligation.

The agreed timing of payments in a contract might have the effect of the contract containing a significant financing component. This may be the case regardless of whether the financing is explicit or implied terms in the contract.

In such cases, the transaction price must be **discounted** to reflect 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.

The significant financing component is the difference between the cash price and the amount that will be paid by the customer. The significant financing component is separately accounted for as finance income over the period between the date of the transaction and the date the full consideration is received. 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.

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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.

Illustration example 17: Financing component

A car retailer offers its customers a choice of paying for a car at its cash price today, January 1, 2017, of ₦17,150, or to pay a nothing today and make a single payment of ₦20,000 in two years' time. The car retailer has calculated a finance cost of 8% applies to the transaction. A customer purchased a car on January 1, 2017 and chose to pay ₦20,000 on 1 January 2019.

Determine how the sale of the car is accounted for in the year ended December 31, 2017?

Suggested solutions: Significant financing component (deferred payment for a car)

Contract facts

Detail	Information
Cash price of the car (if paid on January1, 2017)	**₦17,150**
Deferred-payment option	Pay nothing up-front and settle **₦20,000** on January1, 2019 (two years later)
Implied annual interest rate	8 percent (vendor's calculation)
Contract inception	January1, 2017
Year-end for reporting	December 31, 2017

The two-year deferral gives the customer a financing benefit; therefore, the arrangement contains a **significant financing component** under IFRS 15.

Step-by-step accounting for year 1 (2017)

a. Initial recognition – January1, 2017

Recognise revenue at the cash selling price and a receivable for the same amount.

Journal	Debit (₦)	Credit (₦)
Receivable	17,150	
Revenue – car sale		17,150

b. Accrue financing income to December 31, 20X7

Apply the 8 percent effective rate to the opening receivable.

Finance income = ₦17,150 × 8% = ₦1,372

c. Carrying amount of receivable –December31, 20X7

Closing receivable = 17,150 + 1,372 = ₦18,522

Balance sheet	**₦**
Trade receivable (non-current)	**18,522**

Schedule of finance income over the two-year term

Year	Opening Balance (₦)	Interest @ 8% (₦)	Closing Balance (₦)
1 (20X7)	17,150	**1,372**	18,522
2 (20X8)	18,522	**1,478***	20,000

** Rounded to bring the receivable exactly to the contractual settlement of ₦20,000.*

Key principles demonstrated

a. **Revenue at fair-value of goods** – Recognise revenue at the cash selling price (₦17,150), reflecting the value of the car **exclusive of financing**.

b. **Separate interest component** – The spread between ₦17,150 and ₦20,000 (₦2,850) is interest, recognised as finance income over the deferral period using the effective-interest method.

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c. **Receivable unwinds to cash due** – The receivable accretes to ₦20,000 by January1, 2019, when cash is collected and the receivable is extinguished.

This treatment ensures that revenue, finance income and the receivable each portray the economic substance of the transaction and the passage of time.

Illustrative Example 18: Revenue recognition where transaction price covers more than one deliverable with time value (Bundle of Handset and Network Contract Including Time-Value Adjustment

X Plc sells mobile phones and network contracts either together or separately at the following prices.

The handset and contract are sold separately at a price of ₦53,100 for the handset and ₦2,500 per month for 24 months for the contract) or as a bundle for ₦5,000 per month for 24 months for the contract. The discount rate is 1% per month.

Revenue from selling a bundle (handset together with a network contract) would be recognised using the following steps.

The 24 monthly payments are discounted to their [resent value (putting it into the same price terms as the handset).

Suggested solutions:

Contract facts

Item	Sold separately	Sold as bundle
Handset	₦53,100 paid up-front	₦0
Network access	24 × ₦2,500 per month	24 × ₦5,000 per month
Discount rate	1 percent per month	1 percent per month
Present-value factor (24-month annuity, 1 percent)	**21.24**	**21.24**

All cash flows are discounted to **present value** so that handset and service prices are on a comparable basis.

Step 3: Determine the transaction price

Bundle cash flows

- 24 months × ₦5,000 × 21.24 = ₦106,200
- Transaction price **₦106,200**.

Step 4 allocate the transaction price

Performance obligation	Stand-alone selling Price (₦)	Allocation ratio	Allocated revenue (₦)
Handset	53,100	53,100/106,200 = 50%	**53,100**
Network service	53,100	50%	**53,100**
Total	**106,200**	–	**106,200**

Step 5 recognise revenue

Timing	Journal entry (simplified)	Explanation
Contract start – handset delivered	Debit: Receivable 53,100 Credit: Revenue 53,100	Control of handset passes immediately.
Each month (24×)	Debit: Cash 5,000 Credit: Revenue (network) 2,500 Credit: Receivable (handset) 2,500	Network revenue recognised evenly; residual cash extinguishes the handset receivable.

After twenty-four months the receivable balance is zero.

Analysing the financing component

The handset receivable represents the **present value** of 24 monthly instalments of ₦2,500 relating to the handset. The implicit financing charge (1 percent per month) is embedded in the actuarial amortisation of the receivable:

Month	Opening receivable (₦)	Interest @ 1% (₦)	Cash applied (₦)	Closing receivable (₦)
1	53,100	531	(2,500)	51,131
…	…	…	…	…
24	2,503	25	(2,528)	0

Interest income is reported separately in finance income; handset revenue remains fixed at ₦53,100.

Key learning points

a. **Discount future service fees** to present value before comparing with the up-front handset price.
b. **Allocate on relative present-value SSPs.** Here the split is exactly 50 per cent each.
c. **Separate interest from revenue.** The effective-interest method ensures the receivable unwinds to the contractual cash collected.

This approach faithfully depicts both the sale of the handset at fair value and the time-based transfer of network services, in line with IFRS 15 requirements.

Period	Opening Receivable (₦)	Interest @ 1% (₦)	Cash Flow (₦)	Closing Receivable (₦)
1	53,100.00	531.00	(2,500.00)	51,131.00
2	51,131.00	511.31	(2,500.00)	49,142.31
3	49,142.31	491.42	(2,500.00)	47,133.73
4	47,133.73	471.34	(2,500.00)	45,105.07
5	45,105.07	451.05	(2,500.00)	43,056.12
6	43,056.12	430.56	(2,500.00)	40,986.68
7	40,986.68	409.87	(2,500.00)	38,896.55
8	38,896.55	388.97	(2,500.00)	36,785.52
9	36,785.52	367.86	(2,500.00)	34,653.38
10	34,653.38	346.53	(2,500.00)	32,499.91
11	32,499.91	325.00	(2,500.00)	30,324.91
12	30,324.91	303.25	(2,500.00)	28,128.16
13	28,128.16	281.28	(2,500.00)	25,909.44
14	25,909.44	259.09	(2,500.00)	23,668.53
15	23,668.53	236.69	(2,500.00)	21,405.22
16	21,405.22	214.05	(2,500.00)	19,119.27
17	19,119.27	191.19	(2,500.00)	16,810.46
18	16,810.46	168.10	(2,500.00)	14,478.56
19	14,478.56	144.79	(2,500.00)	12,123.35
20	12,123.35	121.23	(2,500.00)	9,744.58
21	9,744.58	97.45	(2,500.00)	7,342.03
22	7,342.03	73.42	(2,500.00)	4,915.45
23	4,915.45	49.15	(2,500.00)	2,464.60
24	2,464.60	35.40*	(2,500.00)	**0.00***

Handset receivable amortisation schedule (1% effective monthly rate, 24-month term)

Note:
The final-period interest is adjusted by ₦10.75 so that the closing receivable becomes exactly zero, eliminating cumulative rounding differences.

8.4 Other Aspects of IFRS 15

Overview

Entities often incur expenditure **both** to win a customer contract and to deliver on it. IFRS 15 sets clear guidance on when such expenditure is capitalised and when it is charged straight to profit or loss.

8.4.1 Costs to obtain a contract

Type of cost	Example	Accounting treatment
Incremental – would not arise unless the contract is signed	Sales commission that becomes payable only on contract signature	**Capitalise** as a contract-cost asset *if* the entity expects to recover the amount through future revenue. Amortise on a systematic basis that reflects the transfer of goods or services.
Non-incremental – incurred irrespective of the contract outcome	Salaries of in-house sales staff, general bid costs	**Expense immediately**, unless they are recoverable from the customer even if the contract is not won.

Key test – **Would the cost have been avoided if the contract had not been obtained?**

Yes ➔ potentially capitalise.

No ➔ expense.

8.4.2 Costs to fulfil a contract

Expenditure necessary to **set up or fulfil** a contract (for example, design work, mobilisation or materials) is recognised as an asset when **all** of the following apply:

(a) The costs relate directly to an identified contract (or to an anticipated specific contract).
(b) They generate or enhance resources that will be used in satisfying future performance obligations.
(c) They are expected to be recovered from the customer.

If any of these conditions fail, the costs are expensed as incurred.

Subsequent Measurement

Capitalised contract-cost assets are:

- **Amortised** in line with the pattern of revenue recognition, and
- **Impaired** when the expected remaining consideration under the contract is insufficient to cover the unamortised balance.

Careful tracking and timely amortisation ensure that profit or loss faithfully reflects the economic substance of contractual activities.

Illustrative Example 19: Accounting for costs to obtain a consulting contract

Cost item	Amount (₦)	Incremental?	Treatment under IFRS 15
Sales commission – payable only when contract is won	10,000	**Yes**	**Capitalise** as a contract-cost asset (unless practical expedient below applies).
External legal fees for due-diligence review	15,000	No – incurred irrespective of outcome	**Expense immediately**.
Travel to present proposal	25,000	No – would have been incurred even if bid lost	**Expense immediately**.
Total costs incurred	**50,000**	—	—

Key Points

a. **Incremental definition** – A cost is incremental only if it would not have arisen without securing the contract.
b. **Capitalisation** – Incremental costs (here, the ₦10,000 commission) are recognised as an asset and amortised over the period the related revenue is recognised.
c. **Practical expedient** – If the amortisation period for the contract-cost asset is **one year or less**, the entity may elect to expense the commission as incurred.

Costs to fulfil a contract

Initial assessment:

a. **Check other standards first** – Determine whether the costs fall within IAS 2, IAS 16 or IAS 38.
b. **Apply IFRS 15 only when no other standard captures the costs.**

Capitalisation criteria

Costs are capitalised **only if all three tests are met**:

Test	Practical meaning	Typical evidence
(a) Direct link to a specific contract	Costs can be traced to a current or clearly identified future contract.	Job-cost sheet, contract ID on purchase order.
(b) Resource creation or enhancement	Expenditure creates or improves an asset that will help satisfy future performance obligations.	Custom tooling, detailed design documents.
(c) Recoverability	Management expects to recover the outlay through the contract price.	Approved margin analysis, signed variation order.

Examples of Capitalisable Costs

a. Direct labour and materials.
b. Allocated costs (for example, dedicated equipment depreciation).
c. Expenditure explicitly chargeable under the contract.
d. Sub-contractor fees incurred **because** the entity entered the contract.

Costs Expensed Immediately

- Head-office administrative overheads, **unless** the contract allows recharge.
- Wasted materials, labour or other resources not priced into the contract.
- Costs linked to performance obligations that are already satisfied.

8.4.3 Amortisation and Impairment

Amortisation policy

a. Amortise each contract-cost asset **systematically** as the related goods or services are transferred.
b. Update the pattern if the expected timing of transfer changes significantly.

Impairment Test

Perform the test at each reporting date:

Carrying amount > [Remaining consideration expected] − [Unrecognised costs to finish the contract]

a. If the carrying amount exceeds the net figure, recognise an impairment loss in profit or loss.
b. **Reversal** – When the impairment indicator reverses, reinstate the asset up to the amount that would have existed had no impairment been recorded, net of amortisation.

Illustrative Workflow

Step	Action	Accounting impact
1	Identify fulfilment costs not covered by IAS 2, IAS 16 or IAS 38.	—
2	Apply the three-point capitalisation test.	Capitalise or expense.
3	Amortise on the same basis as revenue recognition.	Debit: Contract-cost amortization Credit: Contract-cost asset.
4	Perform impairment check at each period end.	Record loss or reversal as required.

This framework ensures that only contract-specific, recoverable fulfilment costs appear on the statement of financial position and that those assets are written off in line with performance, preserving faithful representation of profit and financial position.

Illustrative example 20: Time-based amortisation (five-year service contract)

Particulars	₦
Costs incurred to date (end of Year 1)	10,000
Forecast future costs	18,000
Total expected costs	**28,000**

Contract facts

a. Single performance obligation satisfied **over time**.
b. Revenue pattern – **straight-line** over the 5-year term.

Amortisation Logic

Expense contract costs in line with revenue recognition.

Annual amortisation = Total expected costs × 1/5 = ₦28,000 × 20% = **₦5,600** per year.

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Illustrative Example 21: Output-based Amortisation (Two-Year Build Contract)

Particulars	₦
Costs incurred to date (end of Year 1)	10,000
Forecast future costs	18,000
Total expected costs	**28,000**

Contract Facts

a. One performance obligation – construct an asset, progress measured on an **output basis**.
b. At the end of Year 1 the project is **60% complete**.

Amortisation Logic

Match cost recognition to percentage-of-completion.

Cost to be expensed Year 1

= Total expected costs × 60% = ₦28,000 × 60% = **₦16,800**.

The balance (₦11,200) remains capitalised and will be amortised as the remaining 40% of performance is delivered in Year 2.

8.4.4 Presentation

This section explains how contracts are presented in the statement of financial position. In order to do this it explains the double entries that might result from the recognition of revenue. The double entries depend on circumstance.

An unconditional right to consideration is presented as a receivable.

The accounting treatment to record the transfer of goods for cash or for an unconditional promise to be paid consideration is straightforward.

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Double entry on recognition of revenue

	Debit	Credit
Cash	XX	
Receivable	XX	
Revenue		XX

Illustrative Example 22: Double Entry – Unconditional Right to Consideration

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.

Suggested Solutions:

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	Debit (₦)	Credit (₦)
Receivables	400	
Revenue		400

31March: X Ltd transfers Product B to Y plc **31March**

	Debit (₦)	Credit (₦)
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.

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Contract assets

A supplier might transfer goods or services to a customer before the customer pays consideration or before payment is due. In this case the contract is presented as a contract asset (excluding any amounts presented as a receivable).

A contract asset is a supplier's right to consideration in exchange for goods or services that it has transferred to a customer. A contract asset is reclassified as a receivable when the supplier's right to consideration becomes unconditional except for the passage of time.

Illustrative Example 23: Double Entry – Recognition of a contract asset

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.

Suggested solution:

Revenue is recognised when control of each product transfers to Y Plc. Payment for the delivery of Product A is conditional on the delivery of Product B. (i.e. the consideration of ₦1,000 is due only after X Ltd has transferred both Products A and B to Y Plc). This means that X Ltd does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to Y Plc.

The following entries would be required to reflect the progress of the contract

Contract progress

The following accounting entries would be necessary:

28 February: X Ltd transfers Product A to Y plc

X Ltd does not have an unconditional right to receive the ₦400 so the amount is recognised as a **contract asset**.

At February,28	Debit (₦)	Credit (₦)
Contract asset	400	
Revenue		400

March 31: X Ltd transfers Product B to Y plc

X Ltd now has an unconditional right to receive the full ₦1,000. The ₦400 previously recognised as a contract asset is reclassified as a **receivable** and the ₦600 for the transfer of product B is also recognised as **receivable**.

March,31	Debit (₦)	Credit (₦)
Receivable	1,000	
Contract asset		400
Revenue		600

Contract Liabilities

A contract might require payment in advance or allow the supplier a right to an amount of consideration that is unconditional (i.e. a receivable), before it transfers a good or service to the customer.

In these cases, the supplier presents the contract as a contract liability when the payment is made or the payment is due (whichever is earlier).

The contract liability is a supplier's obligation to transfer goods or services to a customer for which it has received consideration (an amount of consideration is due) from the customer.

Illustrative Example 24: Double Entry – Recognition of a Contract Liability

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.

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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	Debit (₦)	Credit (₦)
Receivable	1,000	
Contract liability		1,000

February 28: X Ltd transfers Product A to Y Plc

At February 28	Debit (₦)	Credit(₦)
Contract liability	400	
Revenue		400

March 31: X Ltd transfers Product B to Y Plc

At March 31	Debit (₦)	Credit (₦)
Contract liability	600	
Revenue		600

8.5 Application of IFRS 15

8.5.1 Principal versus agent considerations

A person or company might act for another company. In this case the first company is said to be an agent of the second company and the second company is described as the principal.

Principal

An entity is a principal if it controls a promised good or service before it is transferred to a customer. However, an entity is not necessarily acting as a principal if it obtains legal title of a product just before legal title is transferred to a customer.

A principal is responsible for satisfying a performance obligation. It may do this by itself, or it may engage another party (for example, a subcontractor) to help do this.

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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.

Illustrative Example 25: Principal *versus* Agent Consideration

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 December,31 2013 Y plc transferred legal title of goods to X Ltd which cost Y plc ₦1,000,000. These are to be sold at a mark-up of 20%. X Ltd is entitled to 5% of the selling price of all goods sold.

As at December 31, 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.

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Suggested solutions:

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:	**Debit (₦)**	**Credit (₦)**
Cash (90% *(₦1,000,000 *120%))	1,080,000	
Revenue (5% *90% *(₦1,000,000 *120%))		**54,000**
Liability		**1,026,000**
Y plc would recognise:	Debit (₦)	**Credit (₦)**
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 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.

8.5.2 Sale With a Right to Return

Some contracts result in the transfer of control of a product to a customer but also grant the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

(a) 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:

(i) 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);
(ii) a refund liability; and
(iii) an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

Illustrative Example 26:

A Ltd supplies popcorn machines to retailers across the globe. It only supplies wholesale to department stores and other independent retailers. The popcorn machines are sold to retailers for ₦100 each, with each popcorn machine costing ₦50 to manufacture.

A Ltd estimates that 8% of its popcorn machines will be returned by customers.

A Ltd has a contract term with all of its customers to allow any returns for a full refund within three months of the date of sale.

On April 1, 2018, Wholesaler Ltd sold 500 machines to one of its largest customers, the popular home store Likeland.

How should the revenue be recognised?

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Suggested solutions:

Contract data

- Units shipped – 500
- Selling price per unit – ₦100
- Cost per unit – ₦50
- Expected return rate – 8%

Revenue and refund liability

Calculation	₦
Gross consideration (500 × 100)	50,000
Less: expected returns (8% × 500 × 100)	(4,000)
Net revenue recognised	**46,000**

Journal (1 April)

Debit: Bank / Receivable		50,000
Credit: Revenue		46,000
Credit: Refund liability	4,000	

Cost Of Sales & Return Asset

Calculation	₦
Gross cost (500 × 50)	25,000
Less: expected returns (8% × 500 × 50)	(2,000)
Cost of sales recognised	**23,000**

Journal (1 April)

Debit: Return-asset	2,000	
Debit: Cost of sales	23,000	
Credit: Inventory		25,000

The ₦2,000 return-asset and ₦4,000 refund liability are reversed when the three-month return window expires (or adjusted when actual returns differ from expectations).

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8.5.3 Repurchase agreements

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset.

A customer does not obtain control of the asset when the selling entity has an obligation or a right to repurchase the asset.

Even though the customer may have physical possession of the asset, the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from the asset.

If the repurchase agreement is a financing arrangement, the entity must continue to recognise the asset and also recognise a financial liability for any consideration received from the customer.

The difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer is recognised as interest.

Illustrative Example 27:

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.

Suggested solutions:

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 (Debit: Cash/ Credit: Liability).

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The double entry is as follows:

January 1	Debit (₦)	Credit (₦)
Cash Liability	1,000,000	
		1,000,000
Year to December , 31		
Interest expense (statement of profit or loss)		
	100,000	
Liability		100,000
Being: Recognition of interest on loan		
Liability Cash	1,100,000	
Being: Repayment of loan		1,100,000

8.5.4 Bill and Hold Sales

A bill-and-hold arrangement is a contract under which goods are sold to a customer but held at the selling entity's premises until the customer requests delivery. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product.

Revenue for a bill-and-hold sale is recognised in the usual way, according to whether the customer has obtained control of the asset.

The selling entity needs to determine when it satisfies its performance obligation to transfer a product by evaluating when a customer obtains control of that product.

For some contracts, this could occur (and revenue be recognised) when the product is shipped from the selling entity's site or delivered to the customer's site depending on the terms of the contract.

However, a customer might have the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. In this case the selling entity does not control the product. In this case, revenue would be recognised when the goods were originally sold.

For a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

(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

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(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.

Illustrative Example 28: Bill and Hold Arrangement

X Ltd enters into a contract with Y Plc for the sale of a machine and spare parts.

Y Plc pays for the machine and spare parts on December 31, 20X9, but only takes physical possession of the machine, requesting that the spare parts be stored at X Ltd's warehouse because of its close proximity to Y Plc's factory.

Further information

i. Y Plc has legal title to the spare parts and the parts can be identified as belonging to Y Plc.
ii. 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.
iii. X Ltd does not have the ability to use the spare parts or direct them to another customer.
iv. X Ltd expects to hold the spare parts for three years.

Suggested Solutions:

Analysis:

The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time.

The promise to provide custodial services is a service provided to Y Plc, distinct from the machine and spare parts. It is a performance obligation.

X Ltd should account for three performance obligations in the contract (the promises to provide the machine, the spare parts and the custodial services).

The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control transfers to Y Plc.

Revenue Recognition

Control of the machine transfers to Y Plc on 31 December 20X9 when Y Plc takes physical possession.

X Ltd assesses the indicators in IFRS 15 to determine the point in time at which control of the spare parts transfers to Y Plc.

X Ltd concludes that all of the necessary criteria are met for X Ltd to recognise revenue in a bill-and-hold arrangement. X Ltd recognises revenue for the spare parts on 31 December 20X9 when control transfers to Y Plc.

Theperformanceobligationtoprovidecustodialservicesissatisfiedovertimeas 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.

8.5.5 Consignment arrangement

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).

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Illustrative example 29: 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 carriages 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.

Suggested Solutions:

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.

Contract Fact-Pattern

Aspect	Detail
Principal	**X Ltd** (manufacturer)
Consignee	Independent motor dealer
Goods	New cars delivered on a consignment basis
Key terms	• Either party may return unsold cars within **six months**. • Dealer pays X Ltd a **monthly display fee** (covers insurance & carriage). • Legal title passes to the dealer **only when** the car is sold to the retail customer (so that title can pass onward). • At six months the dealer must **either** pay the trade price (as at delivery date) **or** return the car.

IFRS 15 Analysis

Question	Assessment	Reference
Is this a consignment?	Yes – the dealer has physical possession but **does not yet control** the cars, because: • X Ltd can require their return. • Dealer is not obliged to pay until retail sale or six-month trigger. • X Ltd retains significant risks (price volatility & physical loss).	IFRS 15

Question	Assessment	Reference
When is revenue for the car recognised?	**Only when control passes**, i.e. **earlier of**: 1. Sale to end customer, or 2. Dealer's six-month purchase commitment.	IFRS 15
How is the monthly display fee treated?	It is a **separate stand-ready service** that X Ltd provides to the dealer (right to display / insure inventory). Revenue is recognised **over time**, straight-line each month.	IFRS 15
Inventory presentation	Cars remain inventory of X Ltd, reclassified to a "**inventory on consignment**" line until control transfers.	IAS 2

Journal templates (simplified)

Assume wholesale (trade) price = ₦6 million per car, cost = ₦4 million, display fee = ₦40,000 per month.

Delivery to dealer (Day 1)

Accounting entry	Description	₦	Note
Debit: Inventory on consignment	Cars (at cost)	4,000,000	Physical transfer, no sale
Credit: Finished-goods inventory		4,000,000	—

(No revenue recognised.)

Monthly display fee (Month-end)

Accounting entry	₦	Note
Debit: Cash / A/R	40,000	Invoiced to dealer
Credit: Display-service revenue	40,000	Recognised over time

Dealer sells the car to retail customer (Within 6 months)

Accounting entry	₦	Note
Debit: A/R – dealer (Trade price)	6,000,000	Dealer now obliged to pay
Credit: Revenue – car sale	6,000,000	Control passes
Debit: Cost of sales	4,000,000	Derecognise inventory
Credit: Inventory on consignment	4,000,000	—

Dealer returns the car (Within 6 months)

Accounting entry	₦	Note
Debit: Finished-goods inventory	4,000,000	Car back in manufacturer's warehouse
Credit: Inventory on consignment	4,000,000	No revenue

(Accumulated display-service revenue is unaffected.)

Dealer keeps the car at six-month deadline (Has not yet sold)

Accounting entry	₦	Note
Dr A/R – dealer (Trade price)	6,000,000	Obligation triggered
Cr Revenue – car sale	6,000,000	Control passes
Dr Cost of sales	4,000,000	
Cr Inventory on consignment	4,000,000	—

Disclosure reminders

i. **Significant judgements** – disclose basis for concluding it is a consignment (IFRS 15 123).
ii. **Contract balances** – show refund liabilities (if any returns expected close to period-end) and contract assets arising from display fees.
iii. **Performance-obligation information** – disclose timing (point-in-time for cars, over-time for display service) and transaction-price allocation.

These treatments ensure revenue is reported when, and only when, X Ltd has transferred control of each car, while separately presenting the ongoing service income from the consignment arrangement.

8.5.6 Licensing

The grant of a licence may form a separate performance obligation within a contract or, if the promise to grant the licence is not distinct from the other promised goods or services in the contract, all the promises are treated as a single performance obligation.

Where the granting of a licence is a separate performance obligation, the grantor must determine, on the basis of the contract, whether the licence transfers to the customer over time or at a point in time. A licence to access intellectual property as it existed when the licence was granted is a point in time transfer and results in the related revenue being recognised at the grant date; a licence to access intellectual property as it exists throughout a licence period (ie, reflecting updates) is an over time transfer and results in the related revenue being recognised over the licence period.

Decision level	Key question	Practical guidance	Outcome
Step 1 – Is the licence distinct?	Can the customer benefit from the licence either on its own or together with readily available resources *and* is it separately identifiable within the context of the contract?	• Stand-alone software or a brand-name franchise agreement is often **distinct**. • A software licence that requires significant customisation or integration with an implementation service is **not distinct** – it is combined into a single performance obligation.	**Distinct ➔** assess timing of transfer (Step 2). **Not distinct ➔** combine with related goods/services and follow the recognition pattern for the combined obligation.
Step 2 – Timing of transfer for a distinct licence	Does the customer obtain: • a right **to use** the IP as it exists at the start, *or* • a right **to access** the IP as it is updated or changed over the licence term?	Use contract wording and business intent: – "Right to use" (functional IP, static): e.g. perpetual software, film distribution rights. – "Right to access" (symbolic IP, dynamic): e.g. SaaS platform with ongoing updates, sports-team branding rights with continuous promotional activities.	**Right to use ➔** revenue recognised **at a point in time** (grant date). **Right to access ➔** revenue recognised **over time** (straight-line or other progress measure).

Point-in-time licence (*right to use*)

Example – A customer pays ₦5 million for a perpetual licence to use version 3.0 of X Ltd's engineering software as it exists on delivery date.

Accounting –

Debit: Cash/Receivable 5,000,000

Credit: Licence revenue 5,000,000

No further revenue unless a new version is separately contracted.

Over-time licence (*Right to access*)

Example – A three-year franchise agreement allows the franchisee to use the brand and receive ongoing marketing support and menu updates. Consideration is ₦4 million per year, payable quarterly.

Accounting – Recognise revenue evenly (or another appropriate measure) over the three-year term because the franchisor continues to perform by maintaining and enhancing brand IP.

Practical tips and common pitfalls

Area	Reminder
Updates and upgrades	If updates are substantive and promised, this generally indicates "right to access" even for software.
Minimum terms and renewal options	Determine whether renewal options are material rights that form separate performance obligations.
Sales- or usage-based royalties	For licences of IP, IFRS 15 dictates that revenue is recognised **only when the later of**: (a) subsequent sale or usage occurs, and (b) the performance obligation has been satisfied (B63–B65).
Multiple licences in one contract	Assess each licence individually; some may be point-in-time, others over-time.

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Disclosure checklist

a. Describe the nature of promised licences and the timing of revenue recognition (IFRS 15 119-120).
b. Disclose significant judgements, especially in distinguishing “right to use” vs “right to access”.

This structured approach helps ensure revenue from licensing arrangements is recognised in a way that faithfully reflects both the economics of the contract and the pattern of X Ltd’s performance.

8.6 Chapter review

Before moving to the next chapter, ensure that you can:

a. explain revenue as the transfer of control of promised goods or services to customers at an amount reflecting expected consideration;
b. Discuss the five-step model: identify the contract, identify performance obligations, determine the transaction price, allocate that price, recognise revenue as obligations are satisfied.
c. Discuss when variable consideration is included, when it is highly probable that no significant reversal will occur.
d. explain the treatment of significant financing component, interest income and expense;
e. discuss the treatment of contract costs;
f. explain presentation of receivables (unconditional rights), contract assets (conditional rights) and contract liabilities (obligations for advance consideration).

8.7 End of cf chapter questions and suggested solutions

8.7.1 Questions

Question 1:

Benji Ltd, a manufacturing company, sold a property with a carrying amount of ₦4.5 million for ₦5 million to Jonta Ltd on 1 January 20X4. Benji Ltd retains the right to occupy the property and has an option to repurchase the property after two years for ₦6 million. Property prices are expected to rise and the current market value is ₦8 million. The annual rate for 20% over two years is 9.5%.

Required:

In accordance with IFRS, 15 Revenue from Contracts with Customers what should be recognised in the financial statements relating to this transaction for the year ended December 31, 2014.

Question 2

You are the accountant of Lawali, a listed limited liability company that prepares consolidated financial statements. Your Managing Director, who is not an accountant, has recently attended a seminar at which key financial reporting issues were discussed. She remembers being told the following"

i. Financial statements of an entity should reflect the substance of its transactions.
ii. Revenue from the contracts with customers should only be recognised when certain conditions have been satisfied. Transfer of legal title to the goods is not necessarily sufficient for an entity to recognise revenue from their 'sale'.

The year end of Lawali is 31 August. In the year to 31 August 20X1, the company entered into the following transactions.

Transaction 1:

On March 1, 2011, Lawali sold property to a bank for ₦5 million. The market value of the property at the date of the sale was ₦10 million. Lawali continues to occupy the property rent-free. Lawali has the option to buy the property back from the bank at the end of every month from March 31, 2011, until February 28, 2016. Lawali has not yet exercised this option. The repurchase price will be ₦5 million plus ₦50,000 for every complete month that has elapsed from the date of sale to the date of repurchase. The bank cannot require Lawali to repurchase the property, and the facility lapses after February 28, 2016. The directors of Lawali expect property prices to rise at around 5% each year for the foreseeable future.

Transaction 2

On September 1, 2020, Lawali sold one of its branches to Vehcole for ₦8 million. The net assets of the branch in the financial statements of Lawali immediately before the sale were ₦7 million. Vehcole is a subsidiary of a bank and was specifically incorporated to carry out the purchase – it has no other business operations. Vehcole received the ₦8 million to finance this project from its parent in the form of a loan.

Lawali continues to control the operations of the branch and receives an annual operating fee from Vehcole. The annual fee is the operating profit of the branch for the 12 months to the previous August 31l, ess the interest payable on the loan taken out by Vehcole for the 12 months to the previous August 31. If this amount is negative, then Lawali must pay the negative amount to Vehcole.

Any payments to or by Lawali must be made by September 30, following the end of the relevant period. In the year to August 31, 2021, the branch made an operating profit of ₦2,000,000. Interest payable by Vehcole on the loan for this period was ₦800,000.

Required:

(a) Explain the conditions that need to be satisfied before revenue can be recognised. You should support your answer with reference to IFRS 15.

(b) Explain how the transactions described above will be dealt with in the consolidated financial statements (statement of financial position and statement of profit or loss and other comprehensive income) of Lawali for the year ended August 31, 2021 in accordance with IFRS 15.

Question 3:

Kilimangaro Co owns and operates a number of hotels. The company is preparing its financial statements for the year ended May 31, 2023 and has come across the following issues.

(a) One of the hotels owned by Kilimangaro Co is a complex which includes a theme park and a casino as well as a hotel. The theme park, casino and hotel were sold in the year ended May 31, 2023 to Manningtree Co, a public limited company, for ₦200 million but the sale agreement stated that Kilimangaro Co would continue to operate and manage the three businesses for their remaining useful life of 15 years. The residual interest in the business reverts back to Kilimangaro Co after the 15-year period. Kilimangaro Co would receive 75% of the net profit of the businesses as operator fees, and Manningtree would receive the remaining 25%. Kilimangaro Co has guaranteed to Manningtree that the net minimum profit paid to Manningtree would not be less than ₦15 million per year.

(b) Kilimangaro Co has recently started issuing vouchers to customers when they stay in its hotels. The vouchers entitle the customers to a ₦30 discount on a subsequent room booking within three months of their stay. Historical experience has shown that only one in five vouchers are redeemed by the customer. At the company's year end of May 31, 2023, it is estimated that there are vouchers worth ₦20 million which are eligible for discount. The income from room sales for the year is ₦300 million and Kilimangaro Co is unsure how to report the income from room sales in the financial statements.

Required:

Advise Kilimangaro Co on how the above accounting issues should be dealt with in its financial statements in accordance with IFRS 15, Revenue from Contracts with Customers

8.7.2 Suggested Solutions:

Solution 1 – Application of IFRS 15 to the "sale-and-repurchase" of the property

Key Fact	Assessment under IFRS 15	Reference
Benji Ltd has a call option — it can repurchase the property for ₦6 million after two years.	A forward or call option means the customer never obtains control if the entity is expected to, or can, reclaim the asset.	IFRS 15
Repurchase price (₦6 m) exceeds the original "sale" price (₦5 m).	When the call-option price is ≥ the original selling price, the contract is treated as a **financing arrangement**, not a sale.	IFRS 15
Benji continues to occupy the property.	Further evidence control has not passed; Jonta is essentially financing Benji's continued use.	—

Accounting Treatment

January 1, 2014 (initial entry)

Debit: Cash	5,000,000
Credit: Financing liability	5,000,000

No revenue is recognised and the property (carrying amount ₦4.5 million) remains on Benji's statement of financial position.

December 31, 2014 (Year-End Accrual)

The implicit interest rate that accretes ₦5 million to ₦6 million over two years is approximately **9.5 percent** per annum:

Interest 2014 = ₦5,000,000 × 9.5% = ₦475,000

Debit: Finance cost (Profit or Loss)	475,000
Credit: Financing liability	475,000

Closing Liability

₦5,000,000 + ₦475,000 = ₦5,475,000

Extracts for Benji Ltd –December 31, 2014

Statement of Financial Position	₦'000
Non-current assets – Property (carrying amount)	4,500
Non-current liabilities – Financing liability	5,475

Statement of Profit or Loss (2014)	₦'000
Finance cost (effective interest)	475
Revenue from the transaction	**nil**

Conclusion – Because the call option gives Benji Ltd the practical ability to reclaim the property and the repurchase price equals the "sale" price plus normal financing costs, the arrangement is accounted for as a **loan secured on the property**, not a revenue-generating sale. Control never transfers to the dealer, so IFRS 15 prohibits revenue recognition.

Solutions 2

(a) IFRS 15 – Conditions for revenue recognition

IFRS 15 sets out a **FIVE-STEP MODEL** that must be applied before revenue is recorded.

Step	Core Conditions That Must Be Satisfied
1. Identify a contract with a customer	• Agreement creates enforceable rights and obligations. • Probable that consideration will be collected.
2. Identify the performance obligations	Distinct goods or services promised to the customer.

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3. Determine the transaction price	Amount the entity expects to be entitled to in exchange for transferring the promised goods or services.
4. Allocate the transaction price	Split to each performance obligation on a relative stand-alone selling-price basis unless IFRS 15 permits a more targeted allocation.
5. Recognise revenue when (or as) control passes	Revenue is recognised **only when the customer obtains control** of the good or service; legal title *may* be an indicator but is **not conclusive**.

For a sale with a **repurchase option**:

If the entity has a **Call Option** to repurchase the asset and the exercise price equals or exceeds the original selling price (adjusted for normal financing), the arrangement is treated as a **Financing** – control never passes to the "customer"; no revenue is recognised.

For a put or call option whose economics mean the asset is "on consignment" or subject only to **custody**, the seller continues to recognise the asset until the customer (or a third-party purchaser) obtains control.

(b) Application to Lawali's consolidated financial statements for Y/EAugust 31, 2011

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Transaction 1 – Property Sold for ₦5 million with Call Option

Analysis	Conclusion	Accounting impact (Group)
• lawali retains a call option up to feb 28, 2016. • repurchase price = ₦5 m + ₦50,000 per month. 24 months × ₦50,000 = ₦1 m → strike price at feb 28, 2013 = ₦6 m. • present value of ₦6 m in two years at 9.5% ≈ ₦5 m. • therefore the option price ≈ original consideration (i.e. selling price + financing cost). • bank cannot force lawali to repurchase but lawali can do so at its discretion.	IFRS 15 treats a *call option* whose strike price ≥ original selling price as a **financing arrangement**. control of the property has **not** transferred.	**statement of financial position** • property (carrying amount ₦4.5 m) **remains ppe**. • record **financial liability** for ₦5 m proceeds. **profit/ loss** (20x0/20x1) • no revenue or gain. • accrue **finance cost** @9.5% from mar 1, 2011 to aug 31 2011 (six months) = ₦5,000,000 × 9.5% × 6/12 ≈ **₦237 500**. • liability at aug31, 20x1 ≈ ₦5,237,500.

Transaction 2 – Sale of Branch to Vehcole for ₦8 million, Lawali continues to control operations

Substance assessment

a. Vehcole is a newly-formed vehicle (SPV) with **no activities** other than holding the branch; it is financed 100% by a bank loan guaranteed by the parent bank.
b. Lawali manages and operates the branch, deciding its activities and earning or paying an annual "operating fee" equal to branch profit minus interest on Vehcole's loan.
c. If operating profit < interest, Lawali reimburses Vehcole.
d. Vehcole has neither practical ability nor relevant decision-making authority; it is a passive legal owner.

Implications

a. **Control of the branch** – Lawali still directs the **relevant activities** and is exposed to variable returns (positive or negative). Under **IFRS 10**, Lawali controls Vehcole; therefore Vehcole (and the branch) are *consolidated*.
b. **IFRS 15 scope** – The transfer is not a contract with a *customer* for goods/services; it is the sale of a business to a company that is, in substance, *still controlled* by Lawali. Consequently **no revenue** is recorded in the consolidated Profit/Loss.
c. **Consolidated financial statements** –
    - The branch's assets and liabilities remain in the group statement of financial position at their existing carrying amounts.

- The ₦8 million consideration and the corresponding net assets are eliminated on consolidation.
- The branch's operating profit (₦2 million) and interest expense (₦0.8 million or ₦800,000) are internal to the group and eliminated; only third-party items remain.

Consolidated impact	Statement of financial position	Statement of profit/loss (20X1)
Sale proceeds & gain	Eliminated on consolidation	No revenue, no gain
Branch assets & liabilities	Continue to appear (unchanged)	Branch profit/interest eliminated as intragroup
Operating-fee receivable/payable	Eliminated	—

Summary entries (Group) for year ended Aug 31, 20X1

Item	Debit (₦)	Credit (₦)
Transaction 1 – recognise financing	Debit: Cash ₦5,000,000	Credit: Financing liability ₦5,000,000
Finance cost to 31 Aug 20X1	Debit: Finance expense ₦237,500	Credit: Financing liability ₦237,500
Transaction 2 – consolidation elimination	Debit: Cash ₦8,000,000	Credit: Investment/Intercompany receivable ₦8,000,000
	Debit: Gain on disposal (individual records)	Credit: PPE/Branch net assets

The consolidated financial statements therefore show **no revenue** or disposal gain from either transaction; instead they show a **financing liability** of about ₦5.24 m and finance expense of ₦0.238 m related to the property arrangement.

Solutions 3

Issue (a) Sale of Hotel–Theme-Park–Casino complex with residual interest

Relevant guidance IFRS 15 (sales with a repurchase option) and (consignment-type and custodial arrangements). Although the transaction is a sale of an integrated business, the principles for repurchase rights are directly analogous.

Fact pattern	IFRS 15 assessment	Accounting consequence for Kilimangaro (Group) – Y/E May 31, 2023
• **Manningtree pays ₦200 million up-front.** • Kilimangaro will operate the three units for 15 years and keep 75% of net profit. • Residual interest reverts to Kilimangaro at the end of the term. • Kilimangaro guarantees Manningtree at least **₦15 million p.a.**	*Substance* – Kilimangaro has retained **control** of the asset-substance (it runs the businesses, absorbs most profit, and regains the asset). The up-front cash therefore represents **borrowed funds** secured on the property: a call option (residual return) at a price equal to the original consideration plus a finance return suggests a **financing**, not a sale: the customer (Manningtree) is providing finance to the vendor, not obtaining control.	**Statement of Financial Position** • Keep the complex in PPE at its carrying amount (re-tested for impairment). • Recognise a **financial liability** for the ₦200 million proceeds. • Accrete the liability using the effective-interest method so that, over 15 years, the liability unwinds to zero (or to the residual value guaranteed). • Record a separate provision if it is probable that future profits will be insufficient to cover the ₦15 million minimum payment. **Statement of profit or loss** • **No revenue/gain on "sale"** • Recognise: Operator-fee income = 75% of the current-year net profit. Financing cost (effective-interest expense) on the ₦200 million liability. If net profit for 2023 gives Manningtree < ₦15 million, recognise the top-up as an expense (or provision).

Issue (b) ₦30 vouchers issued with each hotel stay

Relevant guidance - IFRS 15 (customer options for additional goods/services = *material right*):

a. **Is the voucher a performance obligation?**
Yes. A ₦30 discount that can be redeemed within three months is a **material right** because the customer receives something valuable not available to other guests.

b. **Estimate the stand-alone selling price of the voucher**
Historical redemption rate = **20%** (1 in 5).
Expected cost to the entity per voucher = ₦30 × 20% = **₦6**.

c. **Split the consideration between:**
- the hotel room (already delivered) and
- the unexercised option (voucher).

Total vouchers still outstanding at year-end carry face value **₦20 million**.
Expected redemption cost = 20 m × 20% = **₦4 million**.

Unless the room tariff and voucher have very dissimilar relative prices, the practical approach is to defer the **₦4 million** as a **contract liability** and recognise **₦296 million** as revenue today:

Entry (May31, 2023)	Debit (₦ m)	Credit (₦ m)
Cash / receivables (room sales)	300	
Revenue – rooms		296
Contract liability – vouchers		4

d. Subsequent periods
- As vouchers are redeemed, recognise revenue and reduce the contract liability.
- Unredeemed vouchers that expire unused (expected breakage in line with IFRS 15 are recognised as revenue when the likelihood of redemption becomes remote.

Summary Presentation – Kilimangaro Co (consolidated) for Y/E May 31, 20X3

Statement of financial position	₦ million
PPE – hotel, theme park, casino	(carrying amount)
Contract liability – unredeemed vouchers	**4**
Financial liability – "sale" proceeds from Manningtree	**200** plus capitalised interest*
Statement of profit or loss	**₦ million**
Revenue – room sales	**296**
Operator-fee revenue (75% × net profit of complex)	recognised per management accounts
Finance expense – unwinding of ₦200 m liability	effective-interest amount
Provision/expense for minimum-profit guarantee	recognised if required

**Effective-interest expense increases the carrying amount of the financing liability and is presented in finance costs, not revenue.*

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Professional Level

Strategic Business Reporting

CHAPTER 9

NON-CURRENT ASSETS AND NON-FINANCIAL LIABILITIES

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9.6 Chapter Review

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9 Non-Current Assets and Non-Financial Liabilities

9.0: Learning objective

This chapter discusses treatment of non-current assets and non-financial liabilities in accordance with the relevant IASs and IFRS accounting standards.

Intellectual/Cognitive Levels Used

9.1 Learning outcomes

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

a. Explain the scope and definition of PPE and distinguish items within IAS 16 from those within IAS 40, IAS 38, IFRS 5, IAS 41 and other relevant standards;
b. Evaluate and apply the recognition criteria (probable future economic benefits; reliably measurable cost) and determine which expenditures are capitalisable (including directly attributable costs, dismantling & restoration, componentisation) versus expensed;
c. Apply initial measurement principles (purchased, self-constructed, deferred payment terms, asset exchanges, government grants interactions) and compute initial carrying amount;
d. Distinguish and apply the **cost** and **revaluation** models; record revaluation increases/decreases (OCI or profit/loss), revaluation surplus movements and subsequent depreciation; deal with revaluation frequency and class consistency; handle transfers on change in use;
e. Determine depreciable amount, useful life, residual value and depreciation method (including units of production, component depreciation); account for changes in estimates prospectively;
f. Account for subsequent expenditure (replacements, major inspections, overhauls) and derecognise replaced parts;
g. Present and disclose PPE classes, reconciliations of carrying amounts, revaluation reserve movements, capital commitments and restrictions; evaluate disclosure quality from an investor/stewardship perspective;
h. Define and identify investment property; distinguish it from owner-occupied property (IAS 16), inventory (IAS 2) and right-of-use assets (IFRS 16); analyse mixed-use/borderline cases;
i. Apply initial recognition and cost determination (including transaction costs; investment property interests held under leases);
j. Evaluate the accounting policy choice between the **fair value model** and the **cost model**; justify selection and ensure consistency across a portfolio (noting limited exceptions);
k. Measure fair value at each reporting date; recognise gains and losses in profit or loss under the fair value model; contrast with revaluation under IAS 16; disclose fair value when the cost model is used;

l. Account for transfers *to/from* investment property when, and only when, there is evidence of a **change in use** (e.g. commencement of owner-occupation; development for sale; end of construction for investment use); determine deemed cost or fair value on transfer and prepare journal entries;
m. Present and disclose required information (fair values, rental income, direct operating expenses, restrictions, valuation assumptions) and critique disclosure quality;
n. Define an intangible asset (identifiable, non-monetary, without physical substance) and outline scope exclusions; distinguish from PPE, inventory, financial assets and goodwill;
o. Evaluate the recognition criteria (probable future economic benefits; reliable measurement) including the identifiability test (separable or arising from contractual/legal rights);
p. Distinguish **research** and **development** phases; expense research; capitalise qualifying development costs when criteria are met; evaluate common borderline expenditures (brands, customer lists, start-up, training, advertising);
q. Apply initial measurement at cost for separately acquired, internally generated and business-combination-acquired intangibles; consider government grants and exchanges'
r. Choose and apply the **cost** versus **revaluation** model (active market requirement); account for revaluation surpluses/deficits and subsequent amortisation/impairment;
s. Determine useful life (finite vs indefinite); select and justify amortisation methods; assess residual value (normally nil); test for impairment (IAS 36) including for indefinite-life assets and assets not yet available for use;
t. Present and disclose classes of intangibles, R&D expense, capitalised development, indefinite-life assets, revaluation reserve movements; evaluate disclosure adequacy;
u. Explain scope and key definitions; distinguish provisions from accruals, payables and items within the scopes of other standards (e.g. IFRS 15, IFRS
v. Apply the three recognition tests: (i) present obligation (legal or constructive) from a past event; (ii) probable outflow; (iii) reliable estimate; use structured decision logic in scenario analysis;
w. Measure provisions at the **best estimate** required to settle or transfer the obligation at the reporting date; incorporate risk adjustments, future events, expected value vs most-likely-outcome approaches, and **discounting** where material (including unwinding);
x. Apply requirements to specific cases: onerous contracts (cost of fulfilling), restructuring programmes, decommissioning/environmental restoration, warranties, and litigation;
y. Distinguish and disclose **contingent liabilities** (possible or present obligations not recognised) and **contingent assets** (possible assets); evaluate probability thresholds (remote/possible/probable/virtually certain) and reassess at each reporting date;

z. Evaluate earnings-management risk ("big bath" provisioning) and discuss ethical, governance and audit implications; and

aa. Present and disclose movements, uncertainties and sensitivities; link to IAS 1/IFRS 18 presentation principles; appraise information usefulness to investors and other stakeholders.

9.2 IAS 16: Property, Plant and Equipment

9.2.1 Objective of Property, Plant and Equipment

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

9.2.2 Definition of Property, Plant and Equipment

Definition: Property, plant and equipment

Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

9.2.3 Initial recognition of property, plant and equipment

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.

Each part of an asset that has a cost that is significant in relation to the total cost of the item must be depreciated separately. This means that the cost of an asset might be split into several different assets and each depreciated separately.

This recognition principle is applied to all property, plant, and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.

9.2.4 Initial measurement of property, plant and equipment

Property, plant and equipment are initially recorded in the accounts of a business at their cost.

An item of property, plant and equipment should initially be recorded at cost. Cost includes all the costs necessary to bring the asset to working condition for its intended use. This would include not only its original purchase price but also costs of site preparation, delivery and handling, installation, related professional fees for architects and engineers, and the estimated cost of dismantling and removing the asset and restoring the site (see IAS 37 Provisions, Contingent Liabilities and Contingent Assets) and any cost that must be incurred before Property Plant and Equipment can be used.

Elements of cost

The cost of an item of property, plant and machinery consists of:

(a) its purchase price after any trade discount and rebates 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.

(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.

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.

Examples of directly attributable costs are:

(i) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

(ii) costs of site preparation;

(iii) initial delivery and handling costs;

(iv) installation and assembly costs;

(v) costs of testing whether the asset is functioning properly (i.e. assessing whether the technical and physical performance of the asset is such that it is capable of being used in the production or supply of goods or services, for rental to others, or for administrative purposes); and

(vi) professional fees.

Examples of costs that are not costs of an item of property, plant and equipment are:

(i) costs of opening a new facility;

(ii) costs of introducing a new product or service (including costs of advertising and promotional activities);

(iii) costs of conducting business in a new location or with a new class of customer

(including costs of staff training); and
(iv) administration and other general overhead costs.

Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.
(b) initial operating losses, such as those incurred while demand for the item's output builds up; and
(c) costs of relocating or reorganizing part or all of an entity's operations

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 known.

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.

How to determine if an exchange has commercial substance?

An exchange has **commercial substance** if:

(a) **Configuration of cash flows changes**: The asset received generates **cash flows** that are si(b)gtvcf5gnificantly different from the asset given up (e.g., different revenue streams, cost structures, or risk exposures).
(b) **Value of cash flows changes**: The **present value** of future cash flows associated with the asset received differs from that of the asset given up.

9.2.5 Subsequent expenditure

Expenditure relating to non-current assets, after their initial acquisition, should be capitalized if it meets the criteria for recognizing an asset.

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In practice, this means that expenditure is capitalized 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.

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.

9.2.6 Measurement 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.

Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

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

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.

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Definitions

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

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

The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:
(a) the period over which an asset is expected to be available for use by an entity; or
(b) the number of production or similar units expected to be obtained from the asset by an entity.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses. (net book value (NBV) is a term that is often used instead of carrying amount).

Depreciation
Depreciation of an asset begins when that asset is available for use. This means when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Depreciation ends at the earlier of when an asset is classified as held for sale in accordance with *IFRS 5: Non-current assets held for sale and discontinued operations* and when it is derecognised.

Depreciation does not cease when an asset becomes idle or is withdrawn or retired from active use.

Review of useful life

IAS 16 requires useful lives and residual values to be reviewed at each year-end. Any change is a change in accounting estimate in accordance with IAS 8 Basis of Preparation of financial statements. The carrying amount (cost minus accumulated depreciation) of the asset at the date of change is written off over the (revised) remaining useful life of the asset.

Residual value
The residual value of an item of property, plant and equipment must be reviewed at least at each financial year end and if expectations differ from previous estimates the depreciation rate for the current and future periods is adjusted.

A change in the asset's residual value is accounted for prospectively as an adjustment to future depreciation.

Review of depreciation method

The depreciation method applied to property, plant and equipment must be reviewed periodically and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method is changed to reflect the changed pattern.

Where there is a change in the depreciation method used, this is a change in accounting estimate. A change of accounting estimate is applied from the time of the change and is not applied retrospectively. The carrying amount (cost minus accumulated depreciation) of the asset at the date of the change is written off over the remaining useful life of the asset.

Revaluation

When a non-current asset is revalued, its 'carrying amount' in the statement of financial position is adjusted to its fair value at the date of the revaluation.

An increase in value is credited to other comprehensive income and accumulated in equity under the heading of revaluation surplus and debited to the asset. (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.

A decrease in value is recognised as a debit in profit or loss and credit to the asset. However, a decrease is recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus. After a non-current asset has been revalued, depreciation charges are based on the new valuation.

Realisation of the revaluation surplus

The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

9.2.7 Derecognition

The carrying amount of an item of property, plant and equipment shall be derecognised:
(a) on disposal; or
(b) when no future economic benefits are expected from its use or disposal.

The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless IFRS 16 Leases requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

9.2.8 Areas of judgement and estimate

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:
a. Which costs should be capitalised?
b. Whether subsequent expenditure is satisfying the recognition criteria or should be expensed;
c. Whether subsequent expenditure is satisfying the recognition criteria or should be expensed;
d. How to split assets into components for depreciation purposes?
e. Depreciation methods;
f. Estimates of useful lives and residual values;
g. Accounting policy (cost or revaluation); and
h. Allocation of assets into classes.

9.3 IAS 40: Investment Property

9.3.1 Objective of investment property

IAS 40: Investment Property defines and sets out the rules on accounting for investment properties.

9.3.2 Definition of investment property

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.

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9.3.3 Recognition 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.

A property held under a lease may be classified as an investment property. The initial cost of such a property is found by capitalising the lease in accordance with *IFRS 16: Leases*.

Measurement after recognition

After initial recognition an entity may choose as its accounting policy:
(a) the fair value model; or
(b) the cost model.

The chosen policy must be applied to all the investment property of the entity. IAS 40 states that a change from the fair value model to the cost model is unlikely to result in a more appropriate presentation. IAS 40 permit change from cost model to Fair value model.

Examples of investment property

The following are some examples (refer to IAS 40):
(a) Land held as an investment for long-term capital appreciation;
(b) Land held for future undetermined use (i.e. future purpose unknown);
(c) A building owned by an entity and leased out under one or more operating leases. This includes a building that is still vacant, but planned to be leased out; and
(d) Any property that is constructed or developed for future use as investment property.

Other classification issues

Property held under an operating lease. A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property provided that:
(a) the rest of the definition of investment property is met
(b) the lessee uses the fair value model set out in this Standard for the asset recognised

An entity may make the foregoing classification on a property-by-property basis.

(a) **Partial own use.** If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. Therefore, the part that is rented out is investment property. If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant.

(b) **Ancillary services.** If the entity provides ancillary services to the occupants of a property held by the entity, the appropriateness of classification as investment property is determined by the significance of the services provided. If those services are a relatively insignificant component of the arrangement (for instance, the building owner supplies security and maintenance services to the lessees), then the entity may treat the property as investment property. Where the services provided are more significant (such as in the case of an owner-managed hotel), the property should be classified as owner-occupied.

(c) **Intra-group or inter-company rentals.** Property rented to a parent, subsidiary, or fellow subsidiary is not investment property in consolidated financial statements that include both the lessor and the lessee, because the property is owner-occupied from the perspective of the group. However, such property could qualify as investment property in the separate financial statements of the lessor, if the definition of investment property is otherwise met.

Transfer/reclassification

An entity shall transfer a property to, or from, investment property when, and only when, there is a change in use. A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use. Examples of evidence of a change in use include:

(a) Commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;

(b) Commencement of development with a view to sale, for a transfer from investment property to inventories;

(c) End of owner-occupation, for a transfer from owner-occupied property to investment property; and

(d) Inception of an operating lease to another party, for a transfer from inventories to investment property.

For a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's deemed cost for subsequent accounting in accordance with IAS 16, IFRS 16 or IAS 2 shall be its fair value at the date of change in use.

(a) If an owner-occupied property becomes an investment property that will be carried at fair value, an entity shall apply IAS 16 for owned property and IFRS 16 for

property held by a lessee as a right-of-use asset up to the date of change in use. The entity shall treat any difference at that date between the carrying amount of the property in accordance with IAS 16 or IFRS 16 and its fair value in the same way as a revaluation in accordance with IAS 16.

(b) For a transfer from inventories to investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.

(c) When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.

Accounting treatment

Under the fair value model, the entity should:

(a) Revalue all its investment property to 'fair value' at the end of each financial year; and

(b) Recognise any resulting gain/loss in profit or loss for the period.

Note: The property would not be depreciated.

Cost model for investment property

The cost model follows the provisions of IAS 16. The property is measured at cost less accumulated depreciation and less impairment loss if any.

Disposals

An investment property shall be derecognised (eliminated from the statement of financial position) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss (unless IFRS 16 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.

Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.

9.3.4 Judgements – IAS 40

The basic accounting policy choice will affect the recognition of profits and losses, and could introduce extreme volatility to the statement of profit or loss. Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

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These include the following:
(a) Identification of investment property.
(b) Issues arise in respect of the assets that "come with" the property (consider a vineyard);
(c) Choosing the appropriate accounting policy.
(d) It is 'highly unlikely' that a change from fair value to the cost model would provide a more appropriate presentation; and
(e) Obtaining reliable measures of fair value.

9.4 IAS 38: Intangible Assets

9.4.1 Objective of intangible assets

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

9.4.2 Definition of intangible assets

Intangible asset: An identifiable, non-monetary asset without physical substance.
An asset: A resource controlled by the company as a result of past events and from which future economic benefits are expected to flow

Critical attributes of an intangible asset are:
(a) Identifiable
(b) Control (power to obtain benefits from the asset)
(c) Future economic benefits (such as revenues or reduced future costs)

An asset is identifiable if it either:
is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so arises from the contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations

Examples of intangible assets:
(a) patented technology, computer software, databases and trade secrets
(b) trademarks, trade dress, newspaper mastheads, internet domains
(c) video and audiovisual material (e.g. motion pictures, television programmes)
(d) customer lists
(e) mortgage servicing rights

(f) licensing, royalty and standstill agreements
(g) import quotas
(h) franchise agreements
(i) customer and supplier relationships (including customer lists)
(j) marketing rights

9.4.3 Recognition and initial measurement

An intangible asset must be measure at cost when first recognised. 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. An intangible asset must be recognised if (and only if):
    (i) it is probable that future economic benefits specifically attributable to the asset will flow to the company; and,
    (ii) the cost of the asset can be measured reliably.
    (iii) If it can be identified separately.
    (iv) If organisation currently control the Intangible Non-Current Asset

Subsequent Expenditure on Intangible Assets

Subsequent expenditure is only capitalised if it can be measured and attributed to an asset and enhances the value of the asset. This would rarely be the case:

Means of Acquiring Intangible Assets

A company might obtain control over an intangible resource in a number of ways. Intangible assets might be:
(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 acquired in a business combination;

IAS 38 provides extra guidance on how the recognition criteria are to be applied and/or how the asset is to be measured in each circumstance.

Recognition guidance for intangibles purchased separately

The probability recognition criterion is always satisfied for separately acquired intangible assets.

Also, the cost of a separately acquired intangible asset can usually be measured reliably, especially when the purchase consideration is in the form of cash or other monetary assets.

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Recognition guidance for intangibles acquired in exchange transactions

An intangible asset may be acquired in exchange or part exchange for another intangible asset or another asset.

The cost of such items is measured at fair value unless:
(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.

Recognition guidance for internally generated intangible assets
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.

Other internally generated intangibles

Assessment of whether an internally generated intangible asset meets the criteria for recognition requires a company to classify the generation of the asset into:
(a) a research phase; and
(b) a development phase

Definitions: Research

Research: Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development: The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production.

Accounting treatment of development costs
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).
(g) Only expenditure incurred after all the conditions have been met can be capitalised.
(h) Once such expenditure has been written off as an expense, it cannot subsequently be reinstated as an intangible asset.

9.4.4 Extra guidance for intangible assets acquired in a business combination

Any intangible asset identified in a business combination will be recognised as both recognition criteria are deemed to be recognised.

If an intangible asset is acquired in a business combination, its cost is the fair value at the acquisition date.

If cost cannot be measured reliably then the asset will be subsumed within goodwill.

In-process research and development

The acquiree might have a research and development project in process. Furthermore, it might not recognise an asset for the project because the recognition criteria for internally generated intangible assets have not been met.

However, the acquirer would recognise the in-process research and development as an asset in the consolidated financial statements as long as it:

(a) meets the definition of an asset; and
(b) is identifiable, i.e. is separable or arises from contractual or other legal rights.

In other words, expenditure incurred on an in-process research or development project acquired separately or in a business combination and recognised as an intangible asset is accounted for in the usual way by applying the IAS 38 recognition criteria.

Illustrative Example 1: In-process research and development

Company X buys 100% of Company Y. Company Y has spent ₦600,000 on a research and development project. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met. Company Y has known 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 because the recognition criteria have not been met.

From the Company X group viewpoint the in-process research and development is a purchased asset. Part of the consideration paid by Company X to buy Company Y was to buy the knowhow resulting from the project and it should be recognised in the consolidated financial statements at its fair value of ₦500,000.

Further expenditure on such a project would not be capitalised unless the criteria for the recognition of internally generated intangible assets were met.

Illustrative Example 2: Subsequent expenditure on acquired in-process R and D
Continuing the previous example. Company X owns 100% of Company Y and has recognised an intangible asset of ₦500,000 as a result of the acquisition of the company. Company Y has spent a further ₦150,000 on the research and development project since the date of acquisition. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met.

Analysis
The ₦150,000 expenditure is not recognised in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group viewpoint, further work on the in-process research and development project is research and the expenditure of ₦150,000 must be expensed.

9.4.5 Measurement after initial recognition

Intangible assets are recognised at cost when first acquired.

The two measurement models for intangible assets after acquisition are:
(a) cost model (i.e. cost less accumulated amortisation and any accumulated impairment losses; and
(b) revaluation model (i.e. revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. The same model should be applied to all assets in the same class.

Revaluation of an intangible asset is only allowed if the fair value can be determined by reference to an active market in that type of intangible asset.

Definition: Active market
An active market is a market in which all the following conditions exist:
(a) the items traded in the market are homogeneous;
(b) willing buyers and sellers can normally be found at any time; and
(c) prices are available to the public.

Active markets for intangible assets are rare. Very few companies revalue intangible assets in practice.

9.4.6 Amortisation of intangible assets

Useful life
An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life.

An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

The depreciable amount of an intangible asset with a finite useful life is allocated on a systematic basis over its useful life. Amortisation shall begin 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 shall cease at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date that the asset is derecognised. The amortisation charge for each period shall be recognised in profit or loss unless this or another Standard permits or requires it to be included in the carrying amount of another asset.

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 shall be accounted for in line with IAS 8 ‘Basis of Preparation of Financial Statements’ when an entity applies IFRS 18 ‘Presentation and Disclosure in Financial Statements’ (effective for annual periods beginning on or after 1 January 2027, with earlier application permitted).

9.4.7 Judgements – IAS 38

IAS 38: Areas of judgement and estimate
Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:
(a) Whether an internally generated asset meets the recognition criteria.
(b) Allocation of consideration in a business combination (i.e. the recognition of intangibles acquired).
(c) Future cash flows and discount rates for impairment tests.
(d) Amortisation periods.

9.5. IAS 37: Provisions, Contingent Liabilities and Contingent Assets

9.5.1 Objective of provisions, contingent liabilities and contingent assets

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

9.5.2 Definition of provisions, contingent liabilities and contingent assets

Provisions: Is a liability of uncertain timing or amount.

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

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 cash flows required to settle the liability.

Recognition criteria for provisions
A provision should be recognised when:
(a) a company has a present obligation (legal or constructive) as a result of a past event;
(b) it is probable that an outflow of economic benefits will be required to settle the obligation; and
(c) 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.

9.5.3 Measurement

The amount recognised as a provision must be the best estimate, as at the end of the reporting period, of the future expenditure required to settle the obligation. (This is amount that the company would have to pay a third party to take the obligation off its hands).

Where the effect of the time value of money is material, a provision is measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.

Each provision must be reviewed at the end of each reporting period. This might result in derecognition of a provision that no longer meets the recognition criteria or in the re-measurement of a provision. An increase in a provision would result in the recognition of a further expense or a reduction in expense as the previously recognised provision is reduced through a credit to profit or loss.

Reimbursements

An asset for an amount recoverable from a third party in respect of an obligation (e.g. insurance) is only recognised when receipt is virtually certain. Any such asset is recognised separately from the provision (no netting off) at an amount no greater than that of the provision.

Illustrative Example 1: Provision

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of 1 million would result. If major defects were detected in all products sold, repair costs of 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75 per cent of the goods sold will have no defects, 20 per cent of the goods sold will have minor defects and 5 per cent of the goods sold will have major defects. An entity assesses the probability of an outflow for the warranty obligations as a whole.

Analysis

The expected value of the cost of repairs is:

(75% of Nil) + (20% of ₦1 million) + (5% of ₦4 million) = ₦400,000

(a) **Risks and Uncertainties:**
The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

(b) **Present Value**
Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

(c) **Future events**
Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur

9.5.4 Using provisions

A provision is set up to recognise an expense (usually) that exists at the reporting date. (A provision for a liability to decommission an asset might be recognised as part of the cost of that asset).

A provision may be used only for expenditures for which the provision was originally recognise:

(a) 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.
(b) If the provision is insufficient to settle the liability an extra expense is recognised.

9.5.5 Guidance on specific provisions

Onerous contracts

Definition: An onerous contract is a contract where the unavoidable costs of fulfilling/completing the contract now exceed the benefits to be received (the contract revenue).

A provision should be made for the additional unavoidable costs of an onerous contract. (The 'additional unavoidable costs' are the amount by which costs that cannot be avoided are expected to exceed the benefits).

Future operating losses

Provisions cannot be made for future operating losses. This is because they arise from future events, not past events.

Restructuring [costs]

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:

(a) has a detailed formal plan for the restructuring (IAS 37 specifies certain minimum content); and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or

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(b) announcing its main features to those affected by it.

Future repairs and major overhauls
A provision cannot be recognised for the cost of future repairs or replacement parts unless the company has an obligation to incur the expenditure.

A company should capitalise expenditure incurred on replacement of an asset and depreciate this cost over its useful life.

Normal repair costs are expenses that should be included in profit or loss as incurred.

9.5.6 Contingent liabilities and contingent assets

Contingent liability

Definition:
A ***contingent liability*** is either of the following:

(a) 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
(b) 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

Definition: Contingent asset
A contingent asset is a possible asset that arises from past events whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Contingent liabilities and contingent assets **are not recognised** in the financial statements.

In some circumstances, information about the existence of a contingent asset or a contingent liability should be **disclosed** in the notes to the financial statements.

9.5.7 Summary

The following table provides a summary of the rules about whether items should be treated as provisions, contingent liabilities or contingent assets.

Question	Provision (Recognise)	Contingent liability (disclose only)	contingent asset (disclose only)
Is there a present obligation or asset created by a past event?	Yes	Yes (or a *possible* obligation)	No – only a *possible* asset exists
Is an outflow/inflow of economic benefits likely?	Outflow is **probable**	Outflow is *not* probable **or** cannot yet be measured **or** will depend on uncertain future events	Inflow will depend on uncertain future events
Can we measure the amount reliably?	Yes	No (or not yet)	-
What goes into the financial statements?	Put the amount on the balance sheet and charge the income statement – **recognise a provision**	Just describe it in the notes – **disclose as a contingent liability** (ignore if the chance of outflow is remote)	Only mention it in the notes **if** an inflow is *probable* (do nothing if merely possible)

How to use this in practice

a. **Start with the obligation or asset**

b. Did something in the past put the entity on the hook (or give it a right) today?
Yes → keep going.
No → nothing to record or disclose.

c. **Assess the likelihood of cash moving**
Probable outflow → book a **provision**.**Possible outflow** or **cannot estimate** → treat as a **contingent liability** and disclose.
Possible inflow → treat as a **contingent asset**; disclose only if the inflow is *probable*.

d. **Measure it if you can**
If you have both (a) a present obligation and (b) a reliable estimate, record the amount.
Otherwise, stick to narrative disclosure.

e. **Keep an eye on changes**
Circumstances evolve. Re-assess at each reporting date: provisions may be settled, contingencies may firm up, or items may become remote and drop out of the notes.

This pragmatic approach follows IAS 37 but is expressed in everyday language: recognise what is likely and measurable; otherwise, simply tell the reader about it, unless it is so remote that even disclosure would clutter the accounts.

9.5.8 Judgements – IAS 37

Areas of judgement and estimate
Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:
(a) Whether a present obligation exists as a result of a past event;
(b) Whether it is probable that an outflow of resources will be required to settle it;
(c) Whether a reliable estimate can be made of the amount of the obligation;
(d) Whether criteria have been satisfied to trigger the recognition of a restructuring provision;; and
(e) Whether a circumstance indicates future losses (no provision) or an onerous contract (provision)
(f) How to measure provisions.

Likelihood of the Cash Flow	Liability	Asset
Virtually certain – c. 100%	**Recognise a provision** (statement of financial position and profit-or-loss)	**Recognise the asset**
Probable – more than 50%	**Recognise a provision** (provided you can measure it reliably)	**Disclose as a contingent asset** in the notes
Possible but not probable	**Disclose as a contingent liability** in the notes	**Do nothing** (no entry, no note)
Remote	**Do nothing**	**Do nothing**

Quick Decision-Tree for Uncertain Items (IAS 37 Mindset)

How to use it
a. **Identify the event**: past obligating event for a liability, or past event that could give rise to an inflow for an asset.
b. **Estimate the probability** of an outflow or inflow.
c. **Apply the table** above.
d. **Update each reporting date**: probabilities shift, provisions may be settled, and remote items can be dropped entirely.

Put simply: book what's almost certain or probable, talk about what's merely possible, and ignore what's remote.

CHAPTER 10

IMPAIRMENT OF ASSETS (IAS 36)

Contents

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10 Impairment of Assets

10.0 Learning objective

This chapter equips readers to identify, measure, recognise, reverse and disclose impairment losses (and reversals) for individual assets and cash-generating units (CGUs), including goodwill, in accordance with IAS 36, applying professional judgement in data-limited, volatile and group-structured environments (e.g., Nigeria, wider Africa, and international practice), and to communicate the financial reporting and business implications to stakeholders.

10.1 Learning outcomes

IAS 16 – Property, Plant & Equipment (PPE)

By the end of this chapter (readers should be able to:

a. distinguish which assets fall within IAS 36 and which are excluded (e.g., inventories, deferred tax, FV-through-profit-or-loss instruments).
b. identify and evaluate internal and external indicators that an asset or CGU may be impaired.
c. define a CGU and allocate assets and goodwill to CGUs on a consistent basis that reflects independent cash inflows.
d. determine recoverable amount as the higher of fair value less costs of disposal and value in use using supportable cash flows and appropriate discount rates.
e. recognise an impairment loss when an individual asset's carrying amount exceeds its recoverable amount.
f. allocate the loss first to goodwill then pro-rata to other assets subject to carrying-amount limits,. when a CGU is impaired,
g. perform at least annual impairment tests for goodwill and indefinite-life intangibles and note that goodwill impairments are not reversed.
h. test corporate or shared assets through the CGUs that benefit from them and allocate any impairment appropriately.
i. assess at each reporting date whether prior impairment indicators have reversed and, where permitted, reverse earlier losses (excluding goodwill) and revise depreciation.
j. prepare required IAS 36 disclosures, including key assumptions, CGU descriptions, impairment and reversal amounts, and sensitivity where material.
k. explain how impairment charges affect profit, equity, EPS, ROCE, covenants and valuation ratios in performance analysis.
l. discuss practical challenges, forecast reliability, macro volatility, FX, commodity cycles, regulatory shocks, and evaluate the robustness of impairment models.

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m. apply IAS 36 principles in structured exam scenarios, performing calculations and articulating well-reasoned conclusions under time pressure.

10.2 Objective and scope of IAS 36

The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

Definition

An asset is said to be impaired when it carrying amount in the statement of financial position is above the recoverable amount of the asset or its cash generating unit.

From time to time an asset may have a carrying value that is greater than its fair value, but this is not necessarily an impairment as the situation might change in the future. Impairment means that the asset has suffered a permanent loss in value.

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) deferred tax assets (IAS 12);
(c) financial assets (IFRS 9);
(d) investment property held at fair value (IAS 40);
(e) non-current assets classified as held for sale (IFRS 5);
(f) agriculture (IAS 41) biological assets that are measured at fair value less cost to sell; and
(g) contracts within the scope of IFRS 17 Insurance Contracts that are assets

Recoverable amount of assets

Definition of terms

The ***recoverable amount*** of an asset is defined as the higher of its fair value less 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 (CGU) will be explained later.

Stages in accounting for an impairment loss

There are various stages in accounting for an impairment loss:

a. **Stage 1:** Establish whether there is an indication of impairment.
b. **Stage 2:** If so, assess the recoverable amount.
c. **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.

10.3 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.

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:

If there is an indication that an asset (or cash-generating unit) is impaired, then it is tested for impairment. This involves the calculating the recoverable amount of the item in question and comparing this to its carrying amount.

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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.

10.4 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); and
(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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Illustrative example 1: 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.

Impairment Test – Putting the Numbers to Work

	Calculation	Present value (₦)
Fair value less costs of disposal	240,000 − 5,000	**235,000**
Value-in-use (discounted cash flows)		
• **Year 1**	150,000 ÷ 1.10	136,364
• **Year 2**	100,000 ÷ 1.10^2	82,645
• **Year 3 (50,000 cash flow + 25,000 residual)**	75,000 ÷ 1.10^3	56,349
Total Value-in-Use		**275,358**

Recoverable amount
The recoverable amount is the higher of:
- **Fair value less costs to sell:** ₦235,000
- **Value-in-use:** ₦275,358

Hence **Recoverable amount = ₦275,358**

Next step:

Compare this figure with the carrying amount on the balance sheet:
- **If carrying amount > ₦275,358:** recognise an impairment loss equal to the excess.
- **If carrying amount ≤ ₦275,358:** no impairment – keep the asset at its current book value.

The above is the whole exercise, in a nutshell. Work out both yardsticks, pick the larger, and only write the asset down if its book value sits above that figure.

- 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.

10.5 Accounting for impairment

The impairment loss is normally recognised immediately in profit or loss.

Illustrative example 2: **Measurement of recoverable amount**
A company has a machine in its statement of financial position at a carrying amount of ₦300,000.

The machine has been tested for impairment and found to have recoverable amount of ₦275,358 meaning that the company must recognise an impairment loss of ₦24,642

	Debit	**Credit**
Statement of profit or loss	24,642	
Property, plant and equipment		24,642

Illustrative example 3:
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.

Required:
Calculate the:
(a) carrying amount of the machine on 31 December Year 3 (immediately before the impairment).
(b) impairment loss recognised in the year to 31 December Year 4.
(c) depreciation charge in the year to 31 December Year 4.

Suggested solution:
On 31 December Year 3 the machine was stated at the following amount"
(a) Carrying amount of the machine on 31 December Year 3

Cost	
	240,000
Accumulated depreciation (3 × (240,000 ÷ 20 years))	
	(36,000)
Carrying amount	
	204,000

(b) Impairment loss at the beginning of Year 4 of ₦104,000 (₦204,000 – ₦100,000). This is charged to profit or loss.

(c) Depreciation charge in Year 4 of ₦10,000 (= ₦100,000 ÷ 10). The depreciation charge is based on the recoverable amount of the asset

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.

Illustrative Example 4: Measurement of recoverable amount

A company has a machine in its statement of financial position at a carrying amount of ₦300,000 including a previously recognised surplus of ₦20,000.

The machine has been tested for impairment and found to have recoverable amount of ₦275,358 meaning that the company must recognise an impairment loss of ₦24,642.

This is accounted for as follows:

	Debit	**Credit**
Statement of profit or loss	4,642	
Other comprehensive income	20,000	
Property, plant and equipment		24,642

Following the recognition of the impairment, the future depreciation of the asset must be based on the revised carrying amount, minus the residual value, over the remaining useful life.

Illustrative example 5:

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.

Required:
Calculate the:

(a) The carrying amount of the machine on 31 December Year 2 and hence the revaluation surplus arising on 1 January Year 3.
(b) The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).
(c) The impairment loss recognised in the year to 31 December Year 4.

The depreciation charge in the year to 31 December Year 4.

Suggested Solutions:

(a) Carrying amount:

	₦
Cost	240,000
Accumulated depreciation at 1 January Year 3 (2 years × (240,000 ÷ 20 years))	(24,000)
Carrying Amount	**216,000**
Valuation at 1 January, Year 3 **(revalued amount)**	250,000
Revaluation Surplus (or, gain on revaluation)	**34,000**

(b)

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 ₦136,111 (₦236,111 – ₦100,000). *Impairment loss of:*

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).

10.6 Summary of 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.*
(c) 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.
(d) This impairment loss is recognised as a loss for the period.
(e) 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.

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(f) 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).

10.7 Cash generating units (CGUs)

It is not always possible to calculate the recoverable amount of individual assets. Value in use often has to be calculated for groups of assets, because assets may not generate cash flows in isolation from each other. An asset that is potentially impaired may be part of a larger group of assets which form a cash-generating unit.

IAS 36 defines a cash-generating unit (CGU) as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Goodwill
The existence of cash-generating units may be particularly relevant to goodwill acquired in a business combination. Purchased goodwill must be reviewed for impairment annually, and the value of goodwill cannot be estimated in isolation. Often, goodwill relates to a whole business.

It may be possible to allocate purchased goodwill across several cash-generating units. If allocation is not possible, the impairment review is carried out in two stages:

(a) Carry out an impairment review on each of the cash-generating units (excluding the goodwill) and recognise any impairment losses that have arisen.
(b) Then carry out an impairment review for the entity as a whole, including the goodwill.

This is explained in more detail in a later chapter.

10.8 Allocating an impairment loss to the assets of a cash generating unit

Allocating an impairment loss to the assets of a cash generating unit.
When an impairment loss arises on a cash-generating unit, the impairment loss is allocated across the assets of the cash-generating unit in the following order:

(a) In line with IAS 36 - Impairment, first to the goodwill allocated to the cash-generating unit;
(b) Derecognise any of the assets that caused the total loss or that are specifically impaired to the extent that it no longer meets the recognition criteria in line with IAS 16 - PPE (if there is any);

(c) Next, to the other assets in the cash-generating unit, on a pro-rata basis (i.e. in proportion to the carrying amount of the assets of the cash- generating unit).

NOTE: All monetary assets must not be impaired. However, the carrying amount of an asset cannot be reduced below the highest of:
(i) its fair value less costs of disposal (if determinable);
(ii) its value in use (if determinable); and
(iii) zero.

Illustrative Example 6: Allocation of impairment loss in cash-generating unit A cash-generating unit is made up of the following assets.

	₦' million
Property, plant and equipment	90
Goodwill	10
Other assets	60
	160

The recoverable amount of the cash-generating unit has been assessed as ₦140 million. The impairment loss would be allocated across the assets of the cash-generating unit as follows:

- There is a total impairment loss of ₦20 million (= ₦160 million – ₦140 million). Of this, ₦10 million is allocated to goodwill, to write down the goodwill to ₦0.
- The remaining ₦10 million is then allocated to the other assets pro-rata.

Therefore:
(i) ₦6 million (= ₦10 million × 90/150) of the impairment loss is allocated to property, plant and equipment, and
(ii) ₦4 million (= ₦10 million × 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)	0
Other assets	60	(4)	56
	160	**(20)**	**140**

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10.9 Reversal of an Impairment Loss

A company must make an assessment at the end of each reporting period as to whether a previously recognised impairment should be increased or may no longer exist. If the loss no longer exists it is reversed subject to the following guidance.

Any reversal:

(a) must be justifiable, by reference to an improvement in the indicators of impairment; and
(b) should not lead to a carrying amount in excess of what the carrying amount of the asset would have been without the recognition of the original impairment loss.

A reversal should be:

(a) recognised immediately in profit or loss; unless
(b) the original impairment was charged to the revaluation reserve, in which case the reversal should be credited to the revaluation reserve (and reported in the same way as a revaluation in 'other comprehensive income' for the period).

Depreciation charges for future periods should be adjusted to allocate the asset's revised carrying amount, minus any residual value, over its remaining useful life.

An impairment loss that has arisen on purchased goodwill **cannot** be reversed. This is because any reversal of an impairment loss to goodwill is likely to be caused by an increase in internally-generated goodwill rather than a reversal of the impairment of purchased goodwill. Internally-generated goodwill must not be reported as an asset.

10.10 IAS 36 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) Similar information about reversals of impairment losses recognised in profit or loss for the period.
(c) The amount of impairment losses on revalued assets that have been recognised (or reversed) in other comprehensive income for the period (and in the revaluation reserve).
    (i) If the recognition or reversal of an individual impairment loss is material to the financial statements, there should be additional disclosure of: the events that led to the recognition or reversal of the impairment loss;
    (ii) the amount of the impairment loss recognised or reversed;

(iii) the nature of the asset;
(iv) whether the recoverable amount is fair value less costs of disposal or value in use, and how the figure for the recoverable amount was calculated.

There are additional disclosures in aggregate for impairment losses (reversals) that are not individually material, and extensive disclosures for CGUs that include goodwill or intangible assets with an indefinite useful life, including estimated sensitivities for changes in assumptions used to derive a value in use or fair value less costs of disposal ("headroom" disclosures).

10.11 Judgements – IAS 36

Areas of Judgement and Estimate

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:

(a) Whether indicators suggest that an impairment review is required.
(b) The determination of fair value when there is no binding sale agreement or active market
(c) The input variables to a value in use estimation (expected future cash flows and discount rate)
(d) The identification of CGUs.
(e) How to allocate goodwill to CGUs.

10.12 Chapter review

Before moving to the next chapter, ensure that you can:

a. distinguish which assets fall within IAS 36 and which are excluded (e.g., inventories, deferred tax, FV-through-profit-or-loss instruments).
b. identify and evaluate internal and external indicators that an asset or CGU may be impaired.
c. define a CGU and allocate assets and goodwill to CGUs on a consistent basis that reflects independent cash inflows.
d. determine recoverable amount as the higher of fair value less costs of disposal and value in use using supportable cash flows and appropriate discount rates.
e. recognise an impairment loss when an individual asset's carrying amount exceeds its recoverable amount.
f. allocate the loss first to goodwill then pro-rata to other assets subject to carrying-amount limits,. when a CGU is impaired,
g. perform at least annual impairment tests for goodwill and indefinite-life intangibles and note that goodwill impairments are not reversed.

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h. test corporate or shared assets through the CGUs that benefit from them and allocate any impairment appropriately.
i. assess at each reporting date whether prior impairment indicators have reversed and, where permitted, reverse earlier losses (excluding goodwill) and revise depreciation.
j. prepare required IAS 36 disclosures, including key assumptions, CGU descriptions, impairment and reversal amounts, and sensitivity where material.
k. explain how impairment charges affect profit, equity, EPS, ROCE, covenants and valuation ratios in performance analysis.
l. discuss practical challenges, forecast reliability, macro volatility, FX, commodity cycles, regulatory shocks, and evaluate the robustness of impairment models.
m. apply IAS 36 principles in structured exam scenarios, performing calculations and articulating well-reasoned conclusions under time pressure.

Five Quick-fire MCQs

1. Which of the following is **not** an external impairment indicator?
   A. Adverse changes in technology
   B. Significant market decline
   C. Asset carrying amount > market cap
   D. Increase in interest rates.

2. A CGU's carrying amount (inc. goodwill) is ₦50 million, recoverable amount ₦42 million. Goodwill in the CGU is ₦6 million. Impairment loss allocated to non-goodwill assets is:
   A. ₦8 million
   B. ₦6 million
   C. ₦2 million
   D. ₦0 million.

3. Which **ONE** of the following future cash flows **must be excluded** from VIU?
   A. Tax payments
   B. Capital restructuring costs
   C. Working-capital movements
   D. Maintenance CAPEX.

4. When should reversals of impairment be recognised?
   A. Whenever recoverable amount rises
   B. Only when external indicators reverse
   C. When estimates used to measure loss have changed
   D. Never.

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5. Which disclosure is **not** required under IAS 36?
   A. The discount rate used
   B. Board approval date of budgets
   C. Description of CGUs containing goodwill
   D. Sensitivity analysis if reasonably possible changes could cause impairment.

Answers:

1. D
2. A
3. B
4. C
5. B

Mini Scenario (For discussion)

Zuma Oil identifies a 30 % fall in Brent prices and currency devaluation in Q4. Explain step-by-step how Zuma tests its upstream CGU (ROU assets + PP&E + goodwill) for impairment, including allocation and disclosure if recoverable amount is 20 % below carrying amount.

Examiner's pitfall list

- Forgetting to gross-up pre-tax cash flows with a **pre-tax** discount rate.
- Omitting working-capital cash flows or double-counting CAPEX.
- Reversing goodwill impairments (prohibited).
- Ignoring interaction between IFRS 5 classification and IAS 36 testing.

Memory Joggers

"I SEE DR GAP" – Indicators: **I**ndustrial decline, **S**ignificant loss, **E**conomic change, **E**vidence of obsolescence, **D**amages, **R**ate changes (discount), **G**oodwill in excess, **A**sset becoming idle, **P**lanned reorganisation.

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Professional Level

Strategic Business Reporting

CHAPTER 11

NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS (IFRS 5)

Contents

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11.5 Measurement of non-current assets (or disposal groups) as "held-for-sale"

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11.7 Discontinued operations

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11 Non-Current Assets Held For Sale And Discontinued Operations (Ifrs 5)

11.0 Learning objective

This chapter discusses situations when assets and disposal groups should be classified as held for sale or discontinued, measure and present them correctly, and their reporting impact.

11.1 Learning outcomes

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

a. Identify when a non-current asset or disposal group meets the criteria to be classified as held for sale under IFRS 5.

b. Measure assets classified as held for sale at the lower of carrying amount and fair value less costs to sell and cease depreciation.

c. Present assets and liabilities of disposal groups held for sale separately in the statement of financial position.

d. Determine when a component qualifies as a discontinued operation (major line of business, geographical area, or coordinated plan) and classify accordingly.

e. Present a single amount in profit or loss for discontinued operations with separate analysis of post-tax results and disposal gains or losses.

f. Present or disclose cash flows from discontinued operations separately to aid users' assessment of continuing cash-generating capacity.

g. Account for subsequent changes in a disposal plan, including reclassification out of held for sale, and adjust measurements where criteria are no longer met.

h. Apply impairment testing interactions between IFRS 5 and IAS 36, recognising impairment on classification and reversing as permitted when values recover.

i. Provide the required IFRS 5 disclosures that describe the asset/disposal group, facts and circumstances of the sale, and effects on financial performance.

j. Explain the analytical and ratio effects of held-for-sale and discontinued operations classifications on trend, EPS and valuation metrics.

11.2 Sale of Non-Current Assets

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.

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The gain or loss on the disposal is calculated as:

Step	Line item	FIgure (₦'000)	Comment
1	Cash received from buyer	X	Sale proceeds.
Less:	Direct selling costs (legal fees, agents' commission, removal costs, etc.)	(X)	Only the incremental costs to shift the asset.
	Net sale proceeds (i)	**X**	What actually comes in.
2	Original cost (or latest revalued amount)	X	Straight from the fixed-asset register.
Less:	Accumulated depreciation to date	(X)	Depreciation up to the disposal date.
	Carrying amount on disposal date	**X**	The book value you are removing from the ledger.
3	**Gain/(loss) on disposal [i – ii]**	**X**	Net proceeds **minus** carrying amount. Debit if negative (loss), credit if positive (gain).

Journal entries (typical)

1. **Remove the Asset and its Accumulated Depreciation**
   Debit: Accumulated depreciation X
   Debit: Cash/Bank (selling costs) X
   Credit: Asset cost/revaluation X

2. **Record the sale proceeds**
   Debit: Cash/Bank (sale price) X
   Credit: Gain on disposal (Profit or Loss) X (or Debit: if a loss)

Rule of Thumb:
Gain or Loss = what you pocket after selling costs – what the asset is worth on your books.
Post the difference straight to profit or loss in the period of disposal.

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:

(a) Non-current assets (and groups of non-current assets) that meet certain strict criteria are classified as being held for sale.

(b) Non-current assets that are held for sale are:
   (i) subject to an impairment test;
   (ii) presented on a separate category on the face of the statement of financial position; and
   (iii) 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.

11.3 Introduction to IFRS 5

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.

Disposal group

Definition: 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.

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 of an entity.

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 *IFRS 9: Financial Instruments*.
(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 17: Insurance Contracts*.

Comment on the scope of IFRS 5

The scope of IFRS 5 is a little complicated.

A non-current asset that is scoped out of IFRS 5 for measurement purposes may fall within the classification and presentation rules.

Such a non-current asset might be part of a disposal group. In this case the measurement rules of IFRS 5 apply to the disposal group as a whole but not to the scoped out assets within the group which are measured individually according to the rules set out in their own standards.

Abandonment of non-current assets

Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be:

(a) used to the end of their economic life; or

(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

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.

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);

(b) 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;

(c) 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).

Illustrative example 1: Classification of asset as held for sale

Entity R had the following asset at March 31, Year 4. A property that it offered for sale for ₦5 million during June Year 3. The market for this type of property has deteriorated and at March 31, 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 March 31, Year 4) the entity received an offer of ₦4 million and the property was eventually sold for ₦3.5 million during May Year 4, before the financial statements were authorised for issue.

Analysis as at March 31, Year 4

a) The property cannot be classified as 'held for sale'.
b) 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.
c) 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.

Illustrative example 2: Classification of asset as held for sale

Entity R had the following asset at March 31, 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 March 31, Year 4** The plant cannot be classified as 'held for sale'.

At the year-end management had not made a firm commitment to sell the plant. Even though the plant was sold just after the year-end, IFRS 5 prohibits the classification of non-current assets as 'held for sale' if the criteria are met after the end of the reporting period and before the financial statements are signed.

Sale expected in over 1 year

Sometimes circumstances might extend the period to complete the sale beyond a year. This does not preclude an asset (or disposal group) from being classified as held for sale as long as:

(a) the delay is caused by events or circumstances beyond the entity's control; and
(b) there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group).

IFRS 5 sets out detailed guidance on when this is deemed to be the case.

11.5 Measurement of non-current assets (or disposal groups) classified as held for sale

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 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.

Illustrative example 3: Impact of classification as held for sale

An asset is reclassified as 'held for sale', when its carrying amount is ₦20 million. Its fair value less estimated costs to sell is ₦17 million. The asset should be revalued at ₦17 million and a loss of ₦3 million should be reported in the period.

If the carrying amount is less than the fair value less costs to sell there is no impairment. In this case there is no adjustment to the carrying amount of the asset. (A gain is not recognised on reclassification as held for sale).

Illustrative example 4: Impact of classification as held for sale
An asset is reclassified as 'held for sale', when its carrying amount is ₦20 million. Its fair value less estimated costs to sell is ₦24 million.

The asset 'held for sale' should not be remeasured and should continue to be carried at ₦20 million.

A gain on disposal will be included in profit for the period when the disposal actually occurs.

Illustrative example 5: Accounting on reclassification and subsequent disposal
A machine was purchased on January 1, Year 1 for ₦80,000. It had a useful life of 8 years and no residual value.

On December 31, Year 4 the machine was classified as held for sale. On this date the machine's fair value was estimated at ₦50,000 and the costs to sell were estimated at ₦1,000
The machine was sold for ₦48,000 on 30 June Year 5.

The machine would be accounted for in Year 4 and Year 5 are as follows:

Turning the numbers into a clear narrative (IFRS 5 approach)

Year 4 – Reclassifying the machine as "held for sale"

Detail	Calculation	₦'000
Original cost		80,000
Accumulated depreciation (4 years used ÷ 8-year life)	80,000 × 4/8	(40,000)
Carrying amount on the transfer date		**40,000**

*Under IFRS 5, once an asset is classified as held for sale you stop depreciating it and measure it at the **lower** of:*

(a) **Carrying amount** – ₦40,000, and
(b) **Fair value less costs to sell** – *assumed to be no lower than ₦40,000 here.*

So, the machine stays on the statement of financial position at **₦40,000** and is shown in the current-assets section as "assets held for sale".

Year 5 – Disposal of the Machine

	₦'000
Cash proceeds	48,000
Less: Carrying amount (brought forward)	(40,000)
Gain on disposal (P&L credit)	**8,000**

Journal Entry on Sale

Debit:	Bank/Cash	48,000	
Credit:	Asset held for sale		40,000
Credit:	Gain on disposal (profit or loss)		8,000

Key Practical Points to Remember

a. **Stop depreciation immediately** once the asset meets the held-for-sale criteria.
b. **Measure at the lower of** carrying amount and fair value less costs to sell at the reclassification date.
c. **Present separately** on the face of the balance sheet.
d. **Record the disposal gain or loss** straight to profit or loss when the sale completes.

Illustrative example 6: **Accounting on reclassification and subsequent disposal**
A machine was purchased on January 1, Year 1 for ₦80,000. It had a useful life of 8 years and no residual value.

On December31, 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 June 30, Year 5.

The entries in the statement of profit or loss for Year 4 and Year 5 are as follows:

Putting the figures into everyday words (IFRS 5, IAS 36)

Year 4 – First Hit: Impairment on Classification as Held For Sale

	Calculation	₦'000
Carrying amount on reclassification date	Cost 80,000 − Dep'n (80,000 × 4/8)	**40,000**
Fair value less costs to sell	41,000 − 2,000	**39,000**
Impairment loss (lower of the two amounts)	40,000 − 39,000	**1,000**

Accounting Entry:
Debit: Impairment loss (Profit or Loss) 1,000
Credit: Asset held for sale 1,000

The machine now sits in "assets held for sale" at **₦39,000** and **no further depreciation** is charged.

Year 5 – Second Hit: Loss on Disposal When the Sale Actually Happens

	₦'000
Proceeds received	37,500
Less: carrying amount (b/fwd)	(39,000)
Loss on disposal (Profit or Loss)	**1,500**

Accounting Entry:
Debit: Bank/Cash 37,500
Debit: Loss on disposal (Profit or Loss) 1,500
Credit: Asset held for sale 39,000

The story in one paragraph

When the machine was moved to "held for sale" it failed the *lower-of-cost-or-fair-value* test, so it was written down by ₦1 million. Twelve months later it fetched less than that reduced book value, triggering a further ₦1.5 million loss on sale. In total the profit and loss account absorbs **₦2.5 million** across the two years – exactly the gap between the original ₦40 million carrying amount and the ₦37.5 million cash actually realised.

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

Illustrative Example 7: Allocation of Impairment Loss in a Disposal Group

An entity has decided to dispose of a group of its assets.

The carrying amount of the assets immediately before the classification as held to sale were as follows:

Goodwill	20,000
Property, plant and equipment (carried at re-valued amounts)	52,000
Property, plant and equipment (carried at cost)	80,000
Inventory	21,000
Financial assets	17,000
Total	190,000

Allocation of the Impairment Loss:

a) The first ₦20,000 of the impairment loss reduces the goodwill to zero.

b) This impairment loss of ₦30,000 will be included in the reported profit or loss from discontinued operations.

	Carrying Amount Before Allocation	Impairment Loss	Carrying Amount After Allocation
	₦	₦	₦
Goodwill	20,000	20,000	**0**
Property, plant and equipment (carried at re-valued amounts)	52,000	3,939	**48,061**
Property, plant and equipment (carried at cost)	80,000	6,061	**73,939**
Inventory	21,000	0	**21,000**
Financial assets	17,000	0	**17,000**
Total	**190,000**	**30,000**	**160,000**

Subsequent Remeasurement

Subsequent remeasurement 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.

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:

(a) 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

(b) its recoverable amount at the date of the subsequent decision not to sell.

Any necessary adjustment to the carrying amount is recognised in income from continuing operations, in the same statement of profit or loss caption used to present a gain or loss on assets held for sale.

11.6 Presentation and Disclosure

Assets (or Disposal Groups) Held for Sale

Statement of financial position presentation

(a) Non-current assets classified as held for sale are presented separately from other assets in the statement of financial position.

(b) 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.

(c) 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.

(d) This disclosure is not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

(e) Comparatives are not restated to reflect the classification in the statement of financial position for the latest period presented.

Gains or losses

(a) Any gain or loss on the remeasurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation is included in profit or loss from continuing operations.

(b) The gain or loss recognised on measuring or remeasuring a non-current asset (or disposal group) classified as held for sale is disclosed. If it is not presented separately on the face of the statement of profit or loss, the caption that includes that gain or loss must also be disclosed.

Other disclosures

The following information must be disclosed in the notes in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

(a) a description of the non-current asset (or disposal group);

(b) 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;

(c) if applicable, the segment in which the non-current asset (or disposal group) is presented in accordance with ***IFRS 8 Operating Segments***.

Changes to a plan of sale

When this occurs the following must be disclosed:

(a) a description of the facts and circumstances leading to the decision; and

(b) the effect of the decision on the results of operations for the period and any prior periods presented.

11.7 Discontinued operations

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.

Definition of discontinued operations
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 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.

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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:

(i) the post-tax profit or loss of discontinued operations; and

(ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

(b) 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.

(c) 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).

(d) The analysis is not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

(e) The net cash flows attributable to the operating, investing and financing activities of discontinued operations.

These disclosures may be presented in the notes or on the face of the financial statements.

These disclosures are not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

Comparatives

Comparatives must be restated for these disclosures so that the disclosures relate to all operations that have been discontinued by the reporting date for the latest period presented.

Illustrative Example 8: Presentation of discontinued operations in the statement of profit or loss

Information relating to discontinued operations might be presented as follows.

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X Limited: Statement of profit or loss for the year ended December 31, 2019

	2019	2018
	₦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)
Profit before financing and income taxes	**1,200**	**1,500**
Finance costs	(300)	(300)
Profit before income taxes	**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	**850**	**980**

Note

1. 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.
2. *Presentation in the statement of financial position*
3. Non-current assets classified as held for sale must be disclosed separately from other assets in the statement of financial position.
4. 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.
5. This also applies to the assets and liabilities of a discontinued operation.

Illustrative Example 9: **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)

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Information relating to discontinued operations might be presented as follows.

How the balance sheet looks once a disposal group is "held for sale" (IFRS 5 layout)

Statement of financial position – End of Year 4	**₦'000**
Assets:	
Non-current assets	2,000
Current assets (ordinary trading items)	720
Non-current assets classified as held for sale	*900
Total Assets	**3,620**
Equity:	
Share capital	1,000
Reserves	1,950
Total Equity	**2,950**
Liabilities:	
Non-current liabilities	400
Current liabilities (ordinary trading items)	200
Liabilities directly linked to the assets held for sale	*70
Total liabilities	**670**
Total equity and liabilities	**3,620**

What this presentation tells the reader

a. **Held-for-sale items are broken out**
Both the **asset group (₦900,000)** and the **related liabilities (₦70,000)** sit in their own lines, making it clear that these balances are expected to be settled through a sale rather than through continuing operations.

b. **They sit with the current section**
IFRS 5 requires assets and liabilities held for sale to be shown as **current**, regardless of their previous classification, because management intends to realise them within twelve months.

c. **No double-counting**
The usual non-current/current headings still appear for everything else; the held-for-sale lines are simply added underneath each heading so users can see the disposal group separately without losing the bigger picture.

d. **Totals still balance**
Equity plus liabilities (₦2,950,000 + ₦670,000k = ₦3,620,000) equals total assets – the fundamental accounting equation is untouched.

e. **Next period disclosure**
In the following year the lines will disappear once the sale completes, replaced by cash received and any gain or loss in profit or loss.

In practice: when an asset (or group of assets) is earmarked for sale and meets the IFRS 5 criteria, stop depreciation/amortisation, measure at the lower of carrying amount and fair value less costs to sell, and carve the balances out as above until disposal.

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Further note:
In this summarised statement of financial position, the non-current assets classified as 'held for sale' are the sum of the non-current assets of disposal groups 1 and 2 (₦600,000 + ₦300,000).

Similarly the 'liabilities directly associated with non-current assets classified as held for sale' are the sum of the liabilities for disposal groups 1 and 2.

In the statement of financial position, the comparative figures for the previous year are not restated. The amount for discontinued operations in the previous year does not include discontinued items for the current year. The presentation in the statement of financial position therefore differs from the presentation in the statement of profit or loss.

Other disclosures

Adjustments to Carrying Amounts of Discontinued Operations
Sometimes there is a need to adjust amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period. For example, circumstances in which these adjustments may arise include the resolution of uncertainties relating to:

(a) the disposal (e.g. purchase price adjustments; or
(b) obligations retained by the seller (e.g. environmental and product warranty obligations).

Such adjustments are classified separately in discontinued operations and the nature and amount of the adjustments are disclosed.

Note on Discontinued Operations and the Statement of Cash Flows
IFRS 5 states that in the **statement of cash flows**, there should be separate disclosure of the net cash flows in the period attributable to operating activities, investing activities and financing activities of the discontinued operations.

These disclosures may be presented either on the face of the statement of cash flows or in the notes to the financial statements.

Additional disclosures
Additional disclosures about discontinued operations must be included in the notes to the financial statements. These include:

(a) a description of the non-current asset or disposal group;
(b) a description of the facts and circumstances of the sale in the case of operations and non-current assets 'held for sale', a description of the facts and circumstances leading to the expected disposal and the expected manner and timing of the disposal.

11.8 Judgements – IFRS 5

IFRS 5: Areas of judgement and estimate
Disclosure about assets held for sale and discontinued operations, is intended to help users understand the implications for future results and cash flows. The classification is based on actions taken by management at or before the reporting date and expectation that a sale will be achieved. Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements. These include the following:

(a) Whether the held for sale criteria are satisfied (several judgements).
(b) Whether a disposal is a discontinued operation.

11.9 Chapter review

Before moving to the next chapter, ensure that you can:

a. Identify when a non-current asset or disposal group meets the criteria to be classified as held for sale under IFRS 5.

b. Measure assets classified as held for sale at the lower of carrying amount and fair value less costs to sell and cease depreciation.

c. Present assets and liabilities of disposal groups held for sale separately in the statement of financial position.

d. Determine when a component qualifies as a discontinued operation (major line of business, geographical area, or coordinated plan) and classify accordingly.

e. Present a single amount in profit or loss for discontinued operations with separate analysis of post-tax results and disposal gains or losses.

f. Present or disclose cash flows from discontinued operations separately to aid users' assessment of continuing cash-generating capacity.

g. Account for subsequent changes in a disposal plan, including reclassification out of held for sale, and adjust measurements where criteria are no longer met.

h. Apply impairment testing interactions between IFRS 5 and IAS 36, recognising impairment on classification and reversing as permitted when values recover.

i. Provide the required IFRS 5 disclosures that describe the asset/disposal group, facts and circumstances of the sale, and effects on financial performance.

j. Explain the analytical and ratio effects of held-for-sale and discontinued operations classifications on trend, EPS and valuation metrics.

Five quick-Fire MCQs *(Answers Footnoted)*

1. Which criterion is **not** required for held-for-sale classification?
   A. Sale highly probable
   B. Buyer's deposit received
   C. Active marketing at reasonable price
   D. Expected completion within a year.

2. On classification, an item of PPE's carrying amount is ₦10 million and FV-CTS is ₦9 million; its accumulated depreciation is ₦4 m. Impairment to recognise is:
   A. ₦1 million
   B. ₦5 million
   C. ₦4 million
   D. ₦0 million.

3. Depreciation on held-for-sale assets:
   A. Continues until disposal
   B. Continues if asset rented out
   C. Ceases from classification date
   D. Ceases only once buyer identified.

4. Cash flows of discontinued operations are disclosed:
   A. In aggregate investing and financing
   B. Separately in the notes
   C. Not required
   D. Within continuing operations.

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5. If criteria cease to be met, the asset is reclassified back to PPE at:
   A. Original carrying amount + depreciation
   B. Fair value only
   C. Lower of carrying amount before classification (adjusted) and recoverable amount
   D. Lower of carrying amount and fair value

Answers:

1 B
2 A
3 C
4 B
5 C

Mini Scenario (Discussion)

Naija Foods plans to spin off its East-African segment; management expects listing in nine months. Draft the journal entries on classification, outline SOFP and P&L presentation, and discuss how the move affects EBITDA trend analysis.

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Professional Level

Strategic Business Reporting

CHAPTER 12

LEASES (IFRS 16)

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12 LEASES (IFRS 16)

12.0 Learning objective

Equip candidates to identify, measure, recognise, remeasure and disclose leases (lessee and lessor) under IFRS 16 and interpret the financial analysis consequences.

12.1 Learning outcomes

By the end of this chapter (and related question practice) candidates should be able to:

a. Identify whether a contract contains a lease, including separating lease and non-lease components, by assessing the right to control an identified asset for a period.
b. For lessees, recognise a right-of-use asset and lease liability at commencement, measuring the liability at the present value of lease payments.
c. Subsequently measure the lease liability by accruing interest and reducing for payments, and depreciate the right-of-use asset subject to impairment.
d. Reassess and remeasure the lease liability when lease terms, indices, rates or estimates of residual guarantees change and adjust the right-of-use asset.
e. Apply short-term and low-value asset exemptions when elected, expensing qualifying lease payments instead of recognising a right-of-use assets.
f. Distinguish between fixed, in-substance fixed, index-linked and usage-based variable lease payments and account for each appropriately.
g. Account for lease modifications as separate leases or remeasurements of the existing lease depending on scope and consideration changes.
h. Evaluate and account for sale-and-leaseback transactions by determining whether a sale occurs under IFRS 15 and recognising any resulting gain or loss appropriately.
i. Classify lessor leases as finance or operating and apply the respective recognition, income, and derecognition requirements.
j. Present and disclose lease information—including right-of-use assets, lease liabilities maturity analysis, expenses and cash flows—to enable users to assess leasing activities.
k. Apply transition methods and practical expedients pragmatically on first-time adoption, explaining effects on reported metrics and comparatives.
l. Analyse how bringing leases on balance sheet affects leverage, EBITDA, ROCE, covenants and valuation ratios in performance analysis.

12.2 Introduction and definitions - Leases

IFRS 16 prescribes the accounting treatment of leased assets in the financial statements of lessees and lessors.

Definition: 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 right for 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.

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.

Operating leases gave lessees the right to use assets and impose obligations on the lessee to pay for his right in the same way as finance leases. The rights and obligations under operating leases often satisfied the definitions of assets and liabilities set out in the conceptual framework yet these were not recognised on the statement of financial position.

Consequently, a lessee's statement of financial position provided a misleading picture about leverage and the assets that the lessee uses in its operations.

The 2013 World Leasing Yearbook reported that new leases entered into worldwide in 2011 amounted to almost ₦800 billion but under the previous rules the majority of those leases were not reported on a lessee's statement of financial position.

Illustrative example 1:
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.

Guidance note and 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.

Scope of IFRS 16
IFRS 16 applies to all leases except for:

(a) leases to explore for or use minerals, oil etc.;
(b) leases of biological assets (IAS 41);
(c) service concession arrangements (IFRIC 12);
(d) licences of intellectual property granted by a lessor (within the scope of IFRS 15); and
(e) rights held under licensing agreements within the scope of IAS 38 e.g. patents and copyrights (a lessee can, but is not required to, apply IFRS 16 to leases of other intangible assets).

IFRS 16 specifies the accounting for an individual lease. However, as a practical expedient the rules can be applied to a portfolio of leases with similar characteristics as long as there is a reasonable expectation that the effects on the financial statements would not differ materially from applying the rules to the individual leases of the portfolio.

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A lease might cover the use of several assets. Such a lease might be split into separate lease components. The right to use an asset is a separate lease component if both:

(a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to it; and

(b) the asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

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.

Identifying a lease
It is usually straightforward to identify a leasing contract. However, some contracts might not have the legal form of a lease but still might convey a right to use an asset in return for a payment or series of payments. Such contracts (either in whole or in part) are subject to the rules in IFRS 16.

Examples of such contracts might include:

(i) certain outsourcing arrangements; and

(ii) arrangements in the telecommunications industry where suppliers of network capacity sell rights to capacity

Illustrative example 2: **Identifying a lease**
X Plc manufactures cement and employs drivers who own their own vehicles to transport the cement.

The issue that IFRS 16 would address in this circumstance is whether X Plc is paying the drivers for a delivery service or was leasing the lorries and paying the owners to drive them.

Y Plc pays another company to store chemicals in a refrigerated facility.

The issue that IFRS 16 would address in this circumstance is whether Y Plc is paying for a storage service or is leasing the warehouse in which the chemicals are stored.

The issues addressed by IFRS 16 are as follows:

(a) how to determine whether an arrangement is (or contains) a lease as defined; and

(b) if an arrangement is (or contains) a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Existence of a lease

A contract that gives the lessee the right to control the use of an identified asset for a period of time in exchange for consideration is (or contains) a lease.

A period of time may be described in terms of usage. For example, a contract might allow for the use of a vehicle for 20,000 km.

A contract conveys the ***right to control*** the use of an ***identified asset*** when a customer has both of the following:

(a) the right to obtain substantially all of the economic benefits from use of the identified asset; and
(b) the right to direct the use of the identified asset.

This assessment of whether the contract is (or contains a lease is made at the made at the inception of the contract and this is only reassessed if the terms and conditions of the contract are changed.

Identified Asset

The determination of whether a contract is (or contains) a lease is based on the substance of the arrangement. This requires an assessment of whether:

(a) fulfilment of the contract depends on the use of a specific asset(s); and
(b) whether the supplier could use another asset to fulfil his obligation the arrangement does not contain a lease

An asset might be specified explicitly in a contract or specified implicitly at the time that it is made available for use by the customer.

If a supplier has a substantive right to substitute the asset throughout the period of use, the customer does not have the right to use an identified asset.

Such a right is substantive when the supplier:

(a) has the practical ability to substitute alternative assets throughout the period of use; and
(b) would benefit economically from the exercise this right.

The evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract. The evaluation must exclude consideration of future events are not considered likely to occur.

A right to substitute an asset after a particular event or date is not a substantive right as the lessee would have the use of an identified asset up until that event or date.

If a contract allows the supplier to provide a substitute asset in the event of the original asset needing to be repaired, the supplier does not have a substantive right of substitution.

Illustrative example 3: Existence of a lease

X Plc is a catering company. It enters into a contract with a railway operator (Y Plc) to use a space in a major railway station to provide a catering outlet for a five-year period.

The contract specifies the amount of space and that the space may be located at any one of several platforms in the station.

Y Plc has the right to change the location of the space allocated to X Plc at any time during the period of use.

There would be minimal costs to Y Plc associated with changing the space for the X Plc and there are many areas in the station that could meet the specifications for the space in the contract.

Analysis

a) Is there an identified asset?
b) ***NO***. The contract specifies the amount of space but the location of the outlet can be changed at Y Plc's discretion.

Conclusion: The contract does not contain a lease

Right to control

The right to control the use of an identified asset means that the customer has both the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset.

The right to obtain substantially all of the economic benefits from use of an asset must be assessed within the defined scope of a customer's right to use the asset. For example, if a contract for the use of an airplane prohibits the use of the pane for transporting passengers the customer shall consider only the economic benefits from use of the airplane for transporting cargo. The restriction does not affect the ability of the customer to obtain all of the economic benefits from use of an asset.

The right to direct the use of an identified asset throughout the period of use implies that the customer can either:

(a) direct how and for what purpose the asset is used throughout the period of use; or
(b) the relevant decisions about how and for what purpose the asset is used are predetermined and cannot be changed by the supplier.

Illustrative example 4: Existence of a lease

X Plc has a contract for the use of 5 articulated lorries for 10 years provided by Y Plc. X Plc can use the lorries to transport most sort of goods to destinations of its choice and is allowed to split the cabs from the trailers and could put either to alternate use.

If a particular lorry needs to be serviced or repaired the Y Plc must provide a substitute lorry.

Analysis

a) Is there an identified asset?
b) ***YES***. The contract has identified 5 lorries. (These could either be explicitly specified in the contract or implicity identified when Y Plc delivered 5 lorries to X Plc)

Right to obtain right to obtain substantially all of the economic benefits from use of assets?

a) ***YES***.
b) X Plc has exclusive use of the lorries over the period of the contract
c) X Plc can direct the use of the lorries over the period of the contract.

Conclusion: The contract is a lease

Separating payments – Lessee

Lease components in a contract are accounted for separately from non-lease components (unless the allowed practical expedient is used – see later). This involves separating payments under the contract into those that relate to the lease and those that relate to other elements.

A lessee must allocate the consideration to the components of a contract on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

The relative stand-alone prices are determined on the basis of the price that a supplier would charge for a similar component.

If an observable stand-alone price is not readily available, one is estimated maximising the use of observable information.

Practical expedient

A lessee can elect (by class of asset) not to separate non-lease components from lease components, in which case the entire contract is accounted for as a lease.

Separating Payments – Lessor

A lessor must apply the rules in IFRS 15 when allocating consideration to different components of a contract.

Lease term
IFRS 16 refers to different periods when describing its rules

Definition: Lease term
The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

A lease may be split into a primary period followed by an option to extend the lease for a further period (a secondary period).

In some cases, the lessee might be able to exercise such an option with a small rental or even for no rental at all. If such an option exists and it is reasonably certain that the lessee will exercise the option, the second period is part of the lease term.

A lease may allow a lessee to terminate the lease before its end. The period covered by the termination option is included in lease term if it is reasonably certain that the lessee will not exercise that option.

Illustrative example 5: Lease term
X plc signed a contract for the lease of an asset terms include:
Non-cancellable term = 5 years at an annual rental of ₦100,000 Option to extend for a further 5 years at an annual rental of ₦1

Analysis
X plc is likely to exercise the option lease term = 10 years

Illustrative example 6: Lease term

X plc signed a contract for the lease of an asset terms include:
Non-cancellable term = 5 years at an annual rental of ₦100,000 Option to extend for a further 5 years at an annual rental of ₦200,000

Analysis
X plc is unlikely to exercise the option lease term = 5 years

Lease payments
In essence, the term ***lease payments*** refer to the payments that a lessee expects to make over a lease term or to the receipts that a lessor expects over the economic life of the asset.

In a 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:

(a) fixed payments (including in-substance fixed payments), less any lease incentives;
(b) variable lease payments that depend on an index or a rate;
(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.

Lease payments as defined are included in the accounting treatment for leases described later in this chapter.

Variable lease payments that do not depend on an index or a rate are not lease payments as defined. For example, a lease term that required the payment of a percentage of lessee's sales revenue to the lessor is not a lease payment. Such amounts would be recognised in profit or loss and would be part of lease accounting.

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 shortfall.

On the other hand, the residual value might not be guaranteed.

Definition: Residual value guarantee and unguaranteed residual value

Residual value guarantee: A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

Unguaranteed residual value: That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

The guaranteed and unguaranteed residual values might influence the lessor's classification of a lease and therefore how it is accounted for.

Interest rate implicit in the lease

Definition:
The rate of interest that causes:

(a) the present value of the lease payments and the unguaranteed residual value; to equal
(b) the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

The interest rate implicit in the lease is the IRR of the cash flows from the lessor's viewpoint. It is the rate that equates the future cash inflows for the lessor to the amount that the lessor invested in the asset.

Illustrative example 7: 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:

Net present value @ two discount rates

Year	Cash flow (₦'000)	Present value at 7%	Present value at 9%
0 (i)	**(426,494)**	**(426,494)**	**(426,494)**
1-5	100,000 each year	100,000 × 4.100 = 410,000	100,000 × 3.890 = 389,000
5 (Residual)	40,000	40,000 × 0.713 = 28,520	40,000 × 0.650 = 26,000
Total PV of inflows (ii)		**438,520**	**415,000**
NPV (i – ii)		**+12,026**	**(11,494)**

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Year	Cash flow	Discount factor @ 7%	Present value @ 7%	Discount factor @ 9%	Present value @ 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)**

Key points:

- **Positive at 7%** – the project adds about **₦12 m** of value if your cost of capital is 7%.
- **Negative at 9%** – it *destroys* about **₦11 m** of value if the hurdle rate rises to 9%.

What's the Break-Even Discount Rate (IRR)?

Because the NPV flips sign between 7% and 9%, the internal rate of return sits in that interval**. A straight-line interpolation gives:**

$$\text{IRR} \approx 7\% + \frac{12{,}026}{12{,}026 - (11{,}494)} \times (9\% - 7\%) \approx \mathbf{8\%}$$

Shortcut for Finding the Internal Rate of Return (IRR) by Linear Interpolation

When you have **one positive NPV and one negative NPV** that straddle the true IRR, you can estimate the IRR with a quick proportion:

$$\text{IRR} = A\% + \frac{NPV_A}{NPV_A - NPV_B} \times (B - A)\%$$

Where:

- **A%** = the lower discount rate (NPV_A is still **positive**)
- **B%** = the higher discount rate (NPV_B has turned **negative**)

It is unlikely that you will have to calculate the interest rate implicit in the lease in an exam question. The working has been provided here to illustrate the definition.

The impact of rentals paid in advance on the interest rate implicit in the lease
If two leases are identical except that the rentals are in arrears for one (as above) and in advance for the other, the interest rates implicit in each will be different.

The lease for which the payments are in advance will be higher than the lease for which the payments are in arrears. This is because, although the total cash flows to and from the lessor will be the same, if payment is in advance, they will be received by the lessor (paid by the lessee) over a shorter period. Thus, although the total interest is the same it is recognised more quickly in the lease for which the payments are in advance.

Illustrative example 8: 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.

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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:

	Discount factor @ 10%		Present value @ 10%	Discount factor @ 13%	Present value @ 13%
Year	**Cash flow**	**DF**	**PV**	**DF**	**PV**
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)**

IRR ≈ $10\% + \frac{17,826}{17,826 - (4,574)} \times (13\% - 10\%)$ ≈ **12.4%**

Initial direct costs

The definition of interest rate implicit in the lease makes reference to incremental initial direct costs.

Definition:

Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

Both the lessor and the lessee might incur initial direct costs. The calculation of the interest rate implicit in the lease is from the lessor's viewpoint. Therefore, the initial direct costs that feature in this calculation are those of the lessor.

The accounting treatment for initial direct costs will be explained later

12.3 Lessee accounting

Initial recognition

A lease is capitalised at the commencement of the lease term. This involves the recognition of the asset that is subject to the lease (the underlying asset or right- of-use asset) and a liability for the future lease payments.

The initial double entry is based on the lease liability, but the asset might also contain other components in its initial measurement.

Illustration: Double entry (in part) on initial recognition of a lease

	Debit	Credit
Asset	X	
Lease liability		X

Initial measurement of the lease liability
The lease liability is measured at the commencement date as the present value of the lease payments not yet paid at that date.

The lease payments are discounted using the interest rate implicit in the lease or, if that rate cannot be readily determined, the lessee's incremental borrowing rate is used.

Definition:

Lessee's incremental borrowing rate
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.

Illustrative example 9: 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	Present value @ 8%
1 – 5	100,000	399,271
5	40,000	27,223
		426,494

The initial measurement of the lease liability is ₦426,494. (***Note**: This has been measured without rounding the discount factors*).

The amount paid before the commencement date and the initial direct costs are not included in the measurement of the liability.

Initial measurement of the right-of-use asset
The right-of-use asset is measured at the commencement date as follows:

Template: Initial measurement of the ROU asset (Lessee)

Line item	Notes/What to include	Amount (₦)
Initial measurement of the lease liability	Present value of lease payments not yet paid (discounted at lease discount rate).	X
+ Lease payments made at or before the commencement date	Prepayments; **deduct** any lease incentives received.	X
+ Initial direct costs incurred (by the lessee)	Incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, legal fees).	X

Line item	Notes/What to include	Amount (₦)
+ Estimate of dismantling, removal & site restoration costs	Present value of costs to dismantle/remove the underlying asset and restore the site (recognise related provision under IAS 37 where an obligation exists).	X
= Initial carrying amount of ROU asset	Sum of the above.	**X**

Illustrative example 10: 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:

	Debit	Credit
On initial recognition		
Right-of-use asset	426,494	
Lease liability		426,494
Right-of-use asset	5,000	
Cash		5,000

The right-of-use asset is measured as follows on initial recognition:

	₦
Initial measurement of the lease liability	426,494
Initial direct costs (lessee's)	5,000
	431,494

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.

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Notes:

a. The ROU asset is **depreciated** over the shorter of the **lease term** and **useful life of the asset** (unless ownership transfers).
b. Remeasurements of the lease liability (e.g., from a change in lease term or future payments) result in **corresponding adjustments** to the ROU asset unless it is fully written down.
c. Any excess decrease (i.e., if the ROU asset is already at zero) goes to profit or loss.

The asset is measured as follows using the cost model:

Carrying amount of a right-of-use asset (Lessee)

Line item	Description	Amount (₦)
Non-current asset at cost	Initial measurement of the ROU asset (includes lease liability, initial direct costs, prepayments, dismantling provision).	X
Less: Accumulated depreciation and impairment loss	Depreciation from commencement to reporting date; plus any impairment loss under IAS 36.	(X)
± Adjustments on remeasurement of lease liability	Increase or decrease arising from lease modifications or reassessment (e.g., index-linked payment changes, reassessed options).	X/(X)
= Carrying Amount	Net book value of the ROU asset as at the reporting date.	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.
(c) In other cases the asset is depreciated from the commencement date to the earlier of:
  (i) the end of its useful life; or
  (ii) the end of the lease term

Illustrative Example 11: Subsequent measurement of the asset

X Plc enters into a 5 year lease of a machine on January 1, Year 1. The lease liability at the commencement of the lease was ₦426,494 and X Plc incurred initial direct costs of ₦5,000 when arranging the lease. X Plc has guaranteed the residual value of the asset at the end of the lease term at ₦40,000. The estimated useful life of the asset is 5 years.

The accounting policy for similar owned machines is to depreciate them over their useful life on a straight-line basis.

Annual Depreciation Charge

Initial cost:	₦
Lease liability on initial measurement	426,494
Initial direct costs	5,000
	431,494
Residual value	(40,000)
Depreciable amount (i)	**391,494**

Useful life (shorter of the lease term and the useful life) (ii)	5 years
Annual depreciation charge (i/ii)	**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.

Journal entry: Lease payment (IFRS 16 – Lessee)

Description	Debit (₦)	Credit (₦)
Lease liability	X	
Cash/Bank		X

**This entry reflects the reduction of the lease liability as payments are made.*

A lease liability is measured as follows at each reporting date

Subsequent measurement of lease liability

Component	Description	Amount (₦)
Opening lease liability	Amount recognised at the start of the lease	X
+ Interest accrued	Finance charge using the lease discount rate	X
– Lease payments made	Total cash outflows including both interest and principal	(X)
– Repayment of principal	Portion of payment reducing liability	(X)
± Remeasurement adjustment	Due to changes in lease term, payments, options, etc.	±X
= Closing lease liability	Amount owed at reporting date	**X**

Quick notes:

a. **Interest** is recognised separately in profit or loss (finance cost).
b. **Principal** repayments reduce the liability.
c. **Remeasurements** adjust both the liability and the right-of-use asset (unless the asset is already zero).
d. This model reflects the **actuarial method**, similar to amortised cost accounting under IFRS 9.

In effect, each lease payment consists of two elements:

(a) a finance charge (interest charge) on the liability; and
(b) a partial repayment of the liability.

The finance charge is treated as a finance cost in profit or loss for the period. The partial repayment of the lease obligation reduces the amount of the liability that remains unpaid.

Finance charge

The total rental payments over the life of the lease will be more than the amount initially recognised as a liability. The difference is finance charge.

The total finance charge that arises over the life term is the difference between the amount initially recognised as the lease liability and the sum of the lease payments from the standpoint of the lessee.

Total finance charge calculation

Description	Amount (₦)
Total lease payments by lessee	X
Less: Present value of lease liability at commencement	(X)
= Total finance charge (interest over lease term)	**X**

**This reconciles total payments with the time value-adjusted liability recognised initially.*

Illustrative example 12: 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

Lease payments:	₦
Annual rentals (5×100,000)	500,000
Guaranteed residual value	40,000
	540,000
Amount on initial recognition	(426,494)*
Total finance charge (interest)	**113,506**

**This is the amount of the liability, The asset is recognised at ₦431,494.*

The finance charge (interest) is recognised over the life of the lease by adding a periodic charge to the lease liability with the other side of the entry as an expense in profit or loss for the year.

Journal Entry – Interest Expense Recognition

Description	Debit (₦)	Credit (₦)
Statement of Profit or Loss: Interest Expense	X	
Lease Liability		X

*This records the **finance cost** element of the lease payment, calculated using the effective interest method.

Allocating the finance charge (Interest)

The total finance charge for a leased asset is allocated "so as to provide a constant rate of charge on the outstanding obligation".

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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.

Illustrative example 13: Allocation of the finance charge

X Plc enters into a 5-year lease of a machine on January 1, Year 1. The lease liability at the commencement of the lease was ₦426,494 and X Plc incurred initial direct costs of ₦5,000 when arranging the lease. X Plc has guaranteed the residual value of the asset at the end of the lease term at ₦40,000.

The interest rate implicit in the lease is 8%.

Lease Liability: Year	Opening liability	Interest (@ 8%)	Lease payments	Closing liability
1	426,494	34,120	(100,000)	**360,614**
2	360,614	28,849	(100,000)	**289,463**
3	289,463	23,157	(100,000)	**212,620**
4	212,620	17,010	(100,000)	**129,630**
5	129,630	10,370	(140,000)	**0**
		113,506		

the interest expense is calculated by multiplying the opening liability by 8% in each year (so as to provide a constant rate of charge on the outstanding obligation).

the lease liability consists of the capital balance outstanding. this can be shown as follows:

amortisation schedule: example of lease liability at 8% interest

year	opening balance	lease payment (₦)	interest (₦)	capital repayment (₦)	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 interest is computed on the **opening balance each year at 8%. lease payments reduce both interest and principal.*

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:

Final Payment – Guaranteed Residual Value

Journal Entry (Illustrative Example 14)

Description	Debit (₦)	Credit (₦)
Lease Liability	40,000	
Right-of-Use Asset		40,000

This reflects the settlement of a **guaranteed residual value component at lease end. No cash movement occurs; it's a book adjustment.*

a. In other words, the ₦40,000 parts of the final year payment to the lessor of ₦140,000
b. Is not cash but the transfer of the asset.
c. If the asset is worth less than ₦40,000 the lessee must make good any shortfall. In this case the asset is written down to its value at the date of the transfer (as agreed between the lessee and the lessor) and the lessee will pay cash to the lessor to compensate for any difference.

(a) Asset write-down due to impairment or residual value loss

Description	Debit (₦)	Credit (₦)
Statement of profit or loss	5,000	
Asset under lease (write-down)		5,000

(b) Payment of guaranteed residual value to lessor

Description	Debit (₦)	Credit (₦)
Lease liability	40,000	
Asset held under lease		35,000
Cash/Bank		5,000

**Illustrates a final settlement where the right-of-use asset is derecognised and a payment is made to the lessor.*

Current and non-current elements of the lease liability

The total liability must be divided between:

(a) the current liability (amount payable within the next 12 months), and
(b) 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.

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Illustrative Example 16: Split of current and Non-Current Liability at the End of Year 1

Year	Opening Balance	Lease Payments	Interest	Capital Repayments	Closing Balance
1	426,494	(100,000)	34,120	(65,880)	**360,614**
2	360,614	(100,000)	28,849	***(71,151)**	****289,463**
				**This is the current liability*	****This is the non-current liability***
Liability:				**₦**	
Current liability				71,151	
Non-current liability				289,463	
Total liability (*as a Proof*)				**360,614**	

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.

Illustrative example 17: 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 @ 12.37%	Present Value
1 – 4	100,000	3.014	301,404
4	40,000	0.627	25,090
			326,494

Double Entry on Initial Recognition	**Debit**	**Credit**
Right-of-use asset (*as before*)	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 (as seen before) ₦
Annual rentals (4 □ 100,000)	400,000	
Annual rentals (5 □ 100,000)		500,000
Guaranteed residual value	40,000	40,000
	440,000	**540,000**
Amount on initial recognition	(326,494)	(426,494)
Total finance charge (interest)	**113,506**	**113,506**

When the lease payments are made at the start of each period instead of the end of the period and payments are discounted using the interest rate implicit in the lease, the total finance charge is the same but the interest rate used is different. (This is not the case if the lease payments are discounted using the lessee's incremental borrowing rate but this will be explained later).

Illustrative Example 18: 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**	**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

Illustrative example 19: Current and non-current liability
If payments are made annually in advance, the next payment is a current liability. Therefore in the above example the ₦100,000 paid on 1 January Year 2 is a current liability and the balance (₦266,881) is a non-current liability.

Year	Opening Liability	Lease Payment	Liability After Day 1 Payment	Interest (@ 12.37%)	Closing liability
1	326,494	0	326,494	40,387	**366,881**
2	366,881	(100,000)	266,881		
			↑	↑	↑

Notes:

a) **Current liability** reflects lease payments due within **the next 12 months**.
b) **Non-current liability** represents payments due **after 12 months**.
c) This split aligns with **IAS 1** presentation requirements on liabilities in the statement of financial position.

Lease liability classification

Component	Amount (₦)
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:
(a) the interest recognised in year 1 but unpaid at the year-end (₦40,387);
(b) 'the current element of the capital owed on the lease (₦59,613); and
(c) the non-current element of the capital owed on the lease (₦266,881).

Illustrative example 20: Current and non-current liability

Year	Opening liability	Lease payment	Liability after day 1 payment	Interest (@ 12.37%)	Closing liability
1	326,494	0	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 (*as a Proof*)	**366,881**

Illustrative example 21: The fair value of an asset, leased under a lease commencing on January 1, Year 1 is ₦10,000. The lease is for three years with payments of ₦4,021 annually on January 1, Year 1, Year 2 and Year 3.The interest rate implicit in the lease is 22.25%.

Required:
Complete the lease payment table for all three years 1 to 3, and calculate the current liability and the non-current liability at December 31, Year 1 under the actuarial method.

Suggested solutions:

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.

Other issues

Recognition exemption

A company can elect not to apply the lessee accounting rules to short-term leases (lease with a lease term of 12 months or less) and leases for assets of low value (e.g. lap-tops and mobile phones).

The election must be made by class of short term leases but may be made on an asset-by-asset basis for low value assets.

If such an election is made, the rental costs of the assets are recognised in profit or loss on a straight-line basis or some other systematic basis if that gives a better reflection of the benefit arising from the asset.

Portfolio application

The rules in IFRS 16 set out the accounting rules for individual leases. However, the rules may be applied to a portfolio of leases similar characteristics. In other words, and entity can account for a number of separate leases as a single lease.

This is only allowed if there is a reasonable expectation that this would not cause the financial

statements to differ materially from applying the rules to the individual leases within that portfolio.

Presentation and disclosure

Statement of financial position: Presentation

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: Presentation

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: Presentation

Cash payments for the principal portion of the lease liability must be classified within financing activities.

Cash payments for the interest portion of the lease liability are classified by applying the requirements in *IAS 7: Statement of Cash Flows* for interest paid.

Short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability are classified within operating activities.

Disclosure

Information is provided that, together with the information provided in main financial statements gives users a basis to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

Information is disclosed in a single note (or separate section of the financial statements). However, information already presented elsewhere in the financial statements, does not need to be duplicated as long as the information is incorporated by cross-reference in the single note or separate section about leases.

The following must be disclosed:

(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; additions to right-of-use assets;
(f) gains or losses arising from sale and leaseback transactions; and
(g) the carrying amount of right-of-use assets at the end of the reporting period by class of

underlying asset.

These disclosures should be given in a tabular format, unless another format is more appropriate. Amounts disclosed must include costs that are included in the carrying amount of another asset during the reporting period.

The IAS 40: Investment property disclosures apply to right-of-use assets that meet the definition of investment property.

Disclosure requirements of IAS 16: Property, plant and equipment apply to right- of-use assets at revalued in accordance with that standard

IFRS 7; Financial Instruments: Disclosures requires a maturity analysis for non- derivative financial liabilities. The requirement is to provide information on the contracted undiscounted future cash. A similar disclosure must be provided for lease liabilities separately from the maturity analyses of other financial liabilities. As this is a disclosure of undiscounted cash flows it will not agree with the balance of the liabilities in the statement of financial position which represent discounted amounts. However, the two can be reconciled be deducting future finance charges from the undiscounted amount.

Illustrative example 22: Lease liability maturity analysis
Using the example used earlier to show the disclosures as at the end of the first year.

Lease payment reconciliation & PV of lease liability

	Gross ₦
Due no later than 1 year	100,000
Due later than 1 year, not later than 5	340,000
Total lease payments (undiscounted)	**440,000**
Less: Finance charge relating to future	(79,386)
Present Value of Lease Liability	**360,614**

**The finance charge (₦79,386) is the difference between undiscounted cash flows and their present value.*

12.4 Lessee accounting: Reassessment and modification

Remeasuring the lease liability

Lease liabilities must be remeasured to reflect changes in circumstances. Circumstances might change over the life of the lease leading to a change in the lease payments. This could be because the lease term changes, perhaps due to a reassessment of whether an option to extend or terminate a lease is made.

Other changes might occur due to a rent review. A review of rentals would be provided in the contract but any revision to the rentals following the review might not have been anticipated in the original forecast of rentals.

A lease liability is remeasured by discounting the revised lease payments:

(a) using a revised discount rate when there is a change in the lease term or in the assessment of an option to purchase the underlying asset; or ‘

(b) by discounting the revised lease payments at the original rate when there is a change in the amounts expected to be payable under a residual value guarantee or in future lease

payments resulting from a change in an index or a rate used to determine those payments (e.g. following a market rent review).

Illustrative example 23: Remeasuring the lease liability (change in lease term)
X Plc enters into a 5 year lease of a machine on January 1, Year 1. The lease liability at the commencement of the lease was ₦426,494. X Plc incurred initial direct costs of ₦5,000 when arranging the lease.

X Plc recognised a right-of-use asset at the commencement of the lease in the amount of ₦431,494 (₦426,494 + ₦5,000). X Plc has guaranteed the residual value of the asset at the end of the lease term at ₦40,000.

Further Information:

(i) X Plc has an option to extend the lease term for a further three years at an annual rental of ₦110,000.

(ii) At the commencement date, X Plc concluded that it was not reasonably certain to exercise the option so the lease term was determined to be 5 years.

(iii) X Plc would not have to guarantee a residual value if it were to exercise the option to extend the lease term.

End of Year 4
X plc's circumstances have changed and it is now reasonably certain that it will exercise the option to extend the lease (meeting the conditions in IFRS 16). X Plc is unable to determine a revised interest rate implicit in the lease but its incremental borrowing rate is 9%.

Suggested Guidance: *Remeasuring the lease liability*
The balances in X Plc's at the end of year 4 before the remeasurement of the liability are as follows:

Lease liability at Year 4

Year	Opening liability	Interest (@ 8%)	Lease payments	Closing liability
1	426,494	34,120	(100,000)	**360,614**
2	360,614	28,849	(100,000)	**289,463**
3	289,463	23,157	(100,000)	**212,620**
4	**212,620**	**17,010**	**(100,000)**	**129,630**

Right-of-use asset (RoU) at Year 4

Component	**Amount (₦)**
Balance on initial recognition	431,494
Less: 4 years depreciation	(313,195)
Carrying amount at end of Year 4	**118,299**

Depreciation calculation:

Depreciation = 4 × (₦431,494 − ₦40,000/5 years) = 4 × ₦78,298.8 = **₦313,195**

- *The deduction of ₦40,000 represents a **guaranteed residual value** (not depreciated).*
- *The asset is depreciated on a **straight-line basis** over the **lease term of 5 years**, excluding the residual value.*

The lease liability is re-measured as follows:

Years (from the end of Year 4)	Narrative	Cash flow	Discount factor @ 9%	Present value
1	Year 5 rental on the original lease term	100,000	0.917	**91,743**
2	Year 2 of the extension of the lease	110,000	0.842	**92,585**
3	Year 3 of the extension of the lease	110,000	0.772	**84,940**
4	Year 4 of the extension of the lease	110,000	0.708	**77,927**
				347,195

Remeasurement at end of year 4:	**₦**
Remeasured liability	347,195
Liability before adjustment	(129,630)
Remeasurement adjustment	**217,565**

Illustrative example 24 (Continued): Remeasuring the lease liability
This is achieved with the following double entry:

	Debit	Credit
Right-of-use asset	217,565	
Lease liability		217,565

The right-of-use asset after this adjustment is as follows:

	₦
Carrying amount before adjustment	118,299
Adjustment	217,565
Carrying amount after adjustment	335,864

X plc would account for the lease over the next four years (the last year of the original term plus the three years of the extension) as follows:

Lease liability over next 4 years

Year	Opening liability	Interest (@ 9%)	Lease payments	Closing liability
1 (5)	347,195	31,248	(100,000)	**278,443**
2 (6)	278,443	25,060	(110,000)	**193,502**
3 (7)	193,502	17,415	(110,000)	**100,918**
4 (8)	**100,918**	**9,083**	**(110,000)**	**0**

Right-of-use asset depreciation: Years 5 to 8

Component	Amount (₦)
Carrying amount after adjustment (Year 4)	335,864
Less: Depreciation over Years 5 to 8	(335,864)
Carrying amount at end of Year 8	**Nil**

Depreciation calculation:

Annual depreciation = ₦335,864/4 years = **₦83,966**

Total depreciation over 4 years = 4 × ₦83,966 = **₦335,864**

a) This illustrates **straight-line depreciation** over the **remaining 4-year lease period**.

b) The carrying amount becomes **nil** at the end of Year 8, indicating **full depreciation** of the remeasured right-of-use asset.

Lease modification

Definition: A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

Lease modification is different from the situations addressed by the previous section. A lease modification involves changes to the lease that were not part of the original terms and conditions of a lease.

Illustrative example 25: Lease modification

X Plc leases a building for an initial period of five years with an option to extend the lease for a further three years. At the commencement date, X Plc concluded that it was not reasonably certain to exercise the option so the lease term was determined to be 5 years.

At the end of the fourth year of the lease X plc's circumstances have changed and it is now reasonably certain that it will exercise the option to extend the lease (meeting the conditions in IFRS 16).

X Plc must remeasure the lease liability but this is **not a lease modification** as it is a change that was part of the original terms and conditions of the lease.

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Illustrative example 26: Lease modification
Y Plc leases a building for five years. At the end of the fourth year of the lease X plc's circumstances have changed and it has contracted with the lessor to extend the lease for a further three years beyond the original lease term.

This is a lease modification as it is a change that was **not** part of the original terms and conditions of the lease.

Accounting for lease modifications
A lease modification might be accounted for as a new lease depending on circumstances.

A lease modification is accounted for as a new lease if the modification changes the scope of the lease by adding the right to use one or more underlying assets and charges a consideration which is commensurate with the stand-alone selling price of the additional right-of-use and reflects the circumstances of the contract.

Illustrative example 27: Lease modification – new lease
X Plc enters into a 6 year lease for 3 floors of an office block.
At the end of Year 4, X Plc and the lessor agree to amend the original lease for the remaining 2 years to include an additional floor in the same block.

The increase in the lease payments is commensurate with the current market rate for the extra floor as adjusted for a discount to reflect costs saved by the lessor in renting to X Plc. (*For example, the lessor would save the marketing costs of finding a new tenant).*

Analysis
The modification grants X Plc an additional right to use an underlying asset (an extra floor in the building) and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract.

Conclusion
The modification is a separate lease from the original 6 year lease.

Accounting consequences
X Plc must recognise a right-of-use asset and a lease liability relating to the lease of the additional floor.
There are no adjustments in respect of the original lease of 3 floors as a result of this modification.

If a modification is not accounted for as a separate lease, the lease liability is remeasured by discounting the modified future cash flows using a revised discount rate.

(a) The lease liability would be reduced by a modification that reduces the scope of the original lease. In that case, right-of-use asset is reduced by the proportionate reduction of the asset with any balance (gain or loss recognised in profit or loss.
(b) The change in the lease liability for other lease modifications simply results in an adjustment to the right-of-use asset.

Illustrative example 28*: Lease modification – Reduction in scope (no separate lease)*

X Plc enters into a 6-year lease for 3 floors of an office block at ₦100,000 per floor per annum payable in arrears.

The interest rate implicit in the lease could not be readily determined. X Plc's incremental borrowing rate at the commencement date was 5% per annum.

The asset is written off on a straight-line basis over the life of the lease.

At the end of Year 4, X Plc and the lessor agree to amend the original lease for the remaining 2 years to reduce the space to 2 floors only.

X Plc's incremental borrowing rate at the date of the modification is 6% per annum.

Analysis

The modification does not result in a new lease as it does not the right to use one or more underlying assets.

Accounting c

The accounting treatment is as follows.

The lease liability was measured initially as follows:

Year	Cash Flow	Discount factor @ 5%	Present value
1 – 6	300,000	5.076	1,522,800

At end of Year 4

The lease liability and right-of-use asset were measured as follows before the adjustment for the modification

Carrying amount of ROU asset vs lease liability (initial recognition)

(a) ROU asset

Description	Value (₦)
Carrying amount of the asset (cost amortised) [₦1,522,800 x 2/6 years]	507,600

(b) Lease Liability (present value at 5%)

Year	Cash flow	Discount factor (5%)	Present value
1–2	300,000	1.859	557,600

**A mismatch between asset and liability may arise due to differences in amortisation, upfront costs, or remeasurements.*

Remeasurement: fall in rentals and asset value

Year	Cash flow	Discount factor (@ 6%)	Present value
1–2	200,000	1.833	366,600

**This shows remeasurement of lease liability following a downward revision in expected rentals and economic assumptions.*

The double entry is as follows:

	Debit	Credit
Lease liability 557,600 - 366,600)	191,000	
Right-of-use asset (1/3 x 507,600)		169,200
Profit or loss (balance)		21,800

Summary - takeaways:

a. Lease liabilities are **initially measured** as the present value of future lease payments and adjusted over time for payments, interest, and remeasurements.
b. The **ROU asset** may differ from the liability due to capitalised costs or impairment write-downs.
c. Lease modifications, changes in payments, or changes in discount rates trigger **remeasurement**.
d. **Guaranteed residual values** must be settled if applicable, and result in derecognition and final payments.

12.5 Lessors: Lease classification

Lessors
Companies might be lessors as a result of a variety of business models.

Finance companies (often banks and their subsidiaries)

Finance companies provide finance for the purchase of assets. In addition, they might finance the use of assets through leases.

Finance companies are often associated with finance leases, but they also fund large operating leases. Many airlines have use of aircraft through operating leases through finance companies.

Hire companies

These companies own a stock of capital assets which they will lease out for varying periods.

They include:
(i) tool hire companies;
(ii) plant hire companies; and
(iii) car hire companies

Hire companies are usually involved in operating leases.

Manufacturer/dealer lessors
Some companies make or buy assets to sell. They may offer to lease the asset out as an alternative to outright sale.

Many motor vehicle manufacturers and dealers do this. Such leases would usually be finance leases (but not necessarily).

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Property companies

Many companies own properties which they lease out to others. These companies might apply *IAS 40: Investment Properties* to these assets.

Finance leases and operating leases

All lessors must classify a lease as either:

(a) a finance lease; or
(b) an operating lease

Definitions

Finance lease: A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating lease: A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Risks may be represented by the possibility of losses from:

(a) idle capacity;
(b) technological obsolescence;
(c) variations in return caused by changes in economic conditions. Rewards may be represented by the expectation of;
(d) profitable use of the asset over its economic life;
(e) gains from increases in value or profits on disposal.

Substance over form

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

The legal form of a finance lease is that the lessor is the legal owner of the leased asset.

The economic substance of a finance lease is that the lessee has all the benefits and costs associated with ownership of the asset. The finance lessee is in the same position as it would have been if it had borrowed money to buy the asset itself. That is why such leases are called finance leases; they provide finance for the use of an asset.

Identifying a finance lease

The following situations (individually or in combination) would normally lead to a lease being classified as a finance lease:

(a) At the end of the term of the lease, the legal ownership of the asset will be transferred from the lessor to the lessee, under the terms of the lease agreement;

(b) The lessee has the option, at a future date, to purchase the asset from the lessor, and the agreed purchase price is substantially lower than the expected fair value of the asset at the date the option to buy can be exercised. (In this situation, it is therefore probable that the lessee will exercise the option to buy the asset);

(c) The term of the lease is for a major part of the expected economic life of the asset;

(d) At the inception of the lease, the present value of all the future lease payments amounts to substantially all of the fair value of the leased asset, or more;

(e) The leased asset is of such a specialised nature that it can only be used by the lessee (without the need for a major modification);

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(f) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(g) Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(h) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

In all these situations, it can normally be concluded that substantially all the risks and rewards incidental to ownership are transferred to the lessee.

These indicators are not always conclusive. Classification should always be based on the substance of the agreement taking account of all information.

Leases are classified at the inception of the lease. Sometimes a lessee and lessor agree to change the provisions of a lease and the changes might be of a sort that would have changed the lease classification if the new terms had been in effect at the inception of the lease. In these cases the revised agreement is regarded as a new agreement over its term.

However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

Commentary on finance lease indicators

(a) It is not always obvious why the above circumstances indicate that a lease is a finance lease. This section provides an explanation on some of these.

(b) To understand these it is useful to think of the terms from the lessor's viewpoint.

Bargain purchase option

If a lease includes a term whereby the lessee can buy the leased asset at a bargain price at the end of the lease that lease is a finance lease.

If the lessor includes this term in the lease the lessor would expect the lessee to take advantage of it. Therefore, the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals and final sale price are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

(a) The lessee would only do this if it had access to the risks and benefits of ownership.

(b)]In substance, this is just like borrowing the cash and buying the asset. Therefore, the lease is a finance lease.

Lease is for a major part of the expected economic life of the asset.

If the lessor includes this term in the lease the lessor knows that when the asset is given back to it at the end of the lease, the asset will only have a small value.

Therefore, the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

(a) The lessee would only do this if it had access to the risks and benefits of ownership.
(b) In substance, this is just like borrowing the cash and buying the asset. Therefore, the lease is a finance lease.

Specialised nature of the asset

If the lessor includes this term in the lease the lessor knows that when the lease comes to an end it will be unable to lease the asset on to another party.

Therefore, the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

(a) The lessee would only do this if it had access to the risks and benefits of ownership.
(b) In substance, this is just like borrowing the cash and buying the asset. Therefore, the lease is a finance lease.

PV of future lease payments amounts to substantially all of the fair value of the leased asset

A lease is a finance lease if at the inception of the lease, the present value of all the future lease payments amounts to substantially all of the fair value of the leased asset, or more. (The discount rate to be used in calculating the present value of the lease payments is the interest rate implicit in the lease).
In this case the lessee is paying the full cash price of the asset together with related finance expense over the lease term.

Illustrative example 29: Present value (PV) of future lease payments

A finance company has purchased an asset to lease out to a manufacturing company. The asset cost for ₦500,000 and has an economic life of 10 years. The lease is for 9 years at an annual rental (in arrears) of ₦87,000 per annum. The interest rate implicit in the lease is 10%

Analysis: Lessor's view

Time	Narrative	Cash Flows	Discount Factor (@ 10%)	Present Value
1 to 9	Lessor's lease payments	87,000	5.759	501,033

This is more than the fair value of the asset. This lease is a finance lease (also note that the lease is for the major part of the expected economic life of the asset which is another finance lease indicator).

Illustrative example 30: Present value (PV) of future lease payments

A finance company has purchased an asset for ₦50,000 and will lease it out in a series of leases as follows: The first lease is to Company A for a period of 4 years at an annual rental of ₦10,000. After the end of the lease to Company A the asset will be leased to Company B for 3 years at a rental of ₦10,000. Company B is not related to Company A. At the end of this lease the asset is expected to have an unguaranteed residual value of ₦2,573. The Interest rate implicit in the lease is 10%.

Analysis: Lessor's view

Time	Narrative	Cash flows	Discount factor (@ 10%)	Present value
1 to 7	Lessor's lease payments	10,000	4.868	48,680

This is 97.4% ($^{48,680}/_{50,000}$ x 100) of the fair value of the asset which most would agree that this was substantially all of the fair value of the asset (though IFRS 16 does not give a numerical benchmark).
This lease is a finance lease.

Illustrative example 31:

X Plc has leased a cement lorry. The cash price of the lorry would be ₦3,000,000. The lease is for 6 years at an annual rental (in arrears) of ₦600,000. The asset is believed to have an economic life of 7 years. The interest rate implicit in the lease is 7%. X Plc is responsible for maintaining and insuring the asset.

Required:
State with reasons the kind of lease X Plc has entered into.

Type of Lease: Finance Lease (IFRS 16)

Reasons:

1. **Substantial lease term**: The lease term (6 years) covers most (approximately 86%) of the asset's economic life (7 years), indicating that X Plc is likely to consume the majority of the asset's benefits.
2. **Present value of lease payments ≈ Fair value**:
   a. PV of lease payments = ₦600,000 × 4.766 (PV annuity @ 7% for 6 years) = ₦2,859,600,
   b. This amount is approximately 95% of the asset's fair value (₦3,000,000), showing that the lessor is substantially recovering the fair value of the asset through the lease.
3. **Maintenance responsibility**: X Plc is responsible for maintaining and insuring the asset, indicative of control and risks/rewards of ownership.

Under **IFRS 16**, this indicates a **Finance Lease** as the lease transfers substantially all the risks and rewards incidental to ownership of the asset to X Plc.

Leases of land and buildings

A property lease usually includes both land and buildings. Each element should be classified separately. In other words, a property lease is viewed as a lease of land and a different lease of the building.

Leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets.

Land element

An important consideration is that land normally has an indefinite economic life. This means that the lease term will not normally be for a major part of the life of the asset and the asset will have a significant value at the end of the lease. This implies that the land element of the lease will usually be an operating lease.

This is not always the case. In some parts of the world a property lease might be very long (say 999 years). In a case like this the unguaranteed residual value might be very large but in present value terms is negligible, leading the present value of the lease payments to be substantially all of the fair value of the asset at the inception of the lease. Such a lease could be a finance lease.

Building element

The building is classified as a finance lease or as an operating lease according to the guidance set out and explained in sections 2.2 and 2.3 above.

Splitting the payments
It is necessary to split the rental payments for the land and building into the rental for the land and the rental for the building.

The lease payments are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease.

The relative fair value of the leasehold interests is from the point of view of the lessee. This means that the relative fair value of the leasehold interests is not the same as the relative fair value of the land and the building.

Illustrative example 32: Land and buildings
A company leases a property for ₦450,000 per annum (in arrears). The lease is for 10 years, and the useful life of the building is 5 years.

	Land (₦)	Building (₦)
Fair value	2,000,000	500,000
Fair value of leasehold interest	1,000,000	500,000

Rental allocation between land and buildings

Basis	Ratio	Total rent		Allocated rent (₦)
Land	2/3	450,000	300,000	
Building	1/3	450,000	150,000	

**Land and buildings often need separate accounting under IFRS 16 because land is not depreciated unless ownership transfers.*

If this cannot be done the entire lease must be classified as a finance lease unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

If the land element is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification. In such a case, the economic life of the building is regarded as the economic life of the entire leased asset.

12.6 Lessor accounting

Finance lease accounting

The lessor does not record the leased asset in his own financial statements because he has transferred the risks and rewards of ownership of the leased asset to the lessee. Instead, he records the amount due to him under the terms of the finance lease as a receivable.

The receivable is described as the net investment in the lease.

Definitions: Net and gross investment in the lease

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Gross investment in the lease is the aggregate of:

(a) the lease payments receivable by the lessor under a finance lease, and
(b) any unguaranteed residual value accruing to the lessor.

An earlier section explained that the interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes:

(a) the aggregate present value of the lease payments and the unguaranteed residual value; to be equal to
(b) the sum of the fair value of the leased asset and any initial direct costs of the lessor.

Therefore, the net investment in the lease is the sum of the fair value of the asset plus the initial direct costs.

Initial recognition

The lessor records a receivable for the capital amount owed by the lessee. This should be stated at the amount of the 'net investment in the lease.

Initial recognition (Finance Lease – Lessor)

Journal entry:

	Debit (₦)	Credit (₦)
Net investment in the lease	X	
Cash/Bank		X

**The lessor recognises a "net investment in the lease" equal to the present value of lease payments receivable.*

For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable thus reducing the amount of income recognised over the lease term to below what it would have been had the costs not been treated in this way. The result of this is that the initial direct costs are recognised over the lease term as part of the income recognition process.

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Initial direct costs of manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease.

The treatment of similar costs incurred by manufacturers and dealers is explained later.

Subsequent measurement of the receivable
During each year, the lessor receives payments from the lessor. Each receipt is recorded in the ledger account as follows.

Lease receipts by lessor

Journal entry:

	Debit (₦)	Credit (₦)
Cash/Bank	X	
Net investment in the lease		X

**As payments are received, the net investment in lease reduces and cash increases accordingly.*

A finance lease receivable (net investment in the lease) is measured in the same way as any other financial asset. The balance at any point in time is as follows:

Subsequent measurement of net investment in lease

Description	Amount (₦)
Amount loaned at start (initial recognition)	X
+ Interest accrued	X
– Lease payments received	(X)
– Principal repayments	(X)
= Net investment now (amount owed)	**X**

This reflects the **actuarial amortisation model, where interest income is earned and repayments reduce principal.*

In effect, each lease receipt consists of two elements:

(a) finance income on the receivable; and
(b) a partial repayment of the receivable (net investment in the lease).

The finance charge is recognised as income in profit or loss for the period. The partial repayment of the lease receivable reduces the amount owed to the lessor.

Finance income
The total rental receipts over the life of the lease will be more than the amount initially recognised as a receivable. The difference is finance income.

The total finance income that arises over the life of the lease is the difference between the amount invested in the lease (the amount loaned plus the initial direct costs) and the sum of all receipts.

Total finance income (lessor's earnings over lease term)

Description	Amount (₦)
Lessor's lease payments (receivable)	X
+ Initial direct costs incurred	X
– Amount recognised initially	(X)
= Total finance income	**X**

**Total finance income is the cumulative interest earned over the life of the lease, including compensation for initial costs.*

Illustrative Example 33: *Total Finance Income*

Ready Finance Plc agreed to lease a machine to X Plc commencing on 1 January Year 1. The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of ₦18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was ₦80,000 and Ready Finance incurred initial direct costs of ₦2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is ₦10,000. The lessee has guaranteed an amount of ₦8,000.

The interest rate implicit in the lease is 10.798%.

Total Finance Income

Lessor's lease payments:	₦
Annual rentals (6 x 18,000)	108,000
Guaranteed residual value	8,000
Unguaranteed residual value	2,000
	118,000
Amount on initial recognition	(80,000)
Initial direct costs	(2,000)
	(82,000)
Total finance income	**36,000**

The finance income is recognised over the life of the lease by adding a periodic return to the net investment in the lease with the other side of the entry as income in profit or loss for the year.

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Recognition of finance income – Lessor

Journal entry (periodic recognition):

	Debit (₦)	Credit (₦)
Net investment in the lease	X	
Statement of profit or loss: finance income		X

This entry reflects the **recognition of interest income over the lease term using the effective interest method.*

Calculating and Allocating Finance Income

Finance income is recognised so as to give a constant periodic rate of return on the lessor's net investment in the finance lease.

Illustrative example 34: ***Calculating and allocating finance income***

Ready Finance Plc agreed to lease a machine to X Plc commencing on January 1, Year 1. The lease was a 6 year finance lease of a machine on January 1, Year 1 with annual lease payments of ₦18,000, payable in arrears. The fair value of the machine at the commencement of the lease was ₦80,000 and Ready Finance Plc incurred initial direct costs of ₦2,000 when arranging the lease. The estimated residual value of the asset at the end of the lease is ₦10,000. The lessee has guaranteed an amount of ₦8,000.

The interest rate implicit in the lease is 10.798%. **Proof that interest rate implicit in the lease is:**

Proof of interest rate implicit in the lease (10.798%)

Year	Description	Cash Flow (₦)	Discount Factor (@ 10.798%)	Present Value (₦)
1–6	Annual rentals	18,000	4.2553	76,595
6	Guaranteed residual value	8,000	0.54052	4,324
6	Unguaranteed residual value	2,000	0.54052	1,081
	Total Present Value			**82,000**

Matched against:

(a) **Fair value of asset**: ₦80,000
(b) **Initial direct costs**: ₦2,000
(c) **Total investment**: ₦82,000
(d) Confirming interest rate implicit in lease.

Summary overview (Lessor under IFRS 16 – Finance Lease):

- **Initial recognition:** Recognise a receivable (net investment).
- **Subsequent measurement:** Allocate each payment between finance income (interest) and reduction in receivable.

- **Income recognition:** Finance income recognised in profit or loss using the effective interest rate.
- **Lease components:** Split payments between land and building components if necessary.

Illustrative example 35: ***Calculating and allocating finance income***
Ready Finance Plc agreed to lease a machine to X Plc commencing on January 1, Year 1. The lease was a 6 year finance lease of a machine on January 1, Year 1 with annual lease payments of ₦18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was ₦80,000 and Ready Finance Plc incurred initial direct costs of ₦2,000 when arranging the lease. The estimated residual value of the asset at the end of the lease is ₦ 10,000 and the lessee has guaranteed ₦8,000 of this amount. The interest rate implicit in the lease is 10.798%.

Net Investment in the Lease

Year	Opening Net Investment	Interest (@ 10.798%)	Lease Receipts	Closing Net Investment
1	82,000	8,854	(18,000)	**72,854**
2	72,854	7,867	(18,000)	**62,721**
3	62,721	6,773	(18,000)	**51,494**
4	51,494	5,560	(18,000)	**39,054**
5	39,054	4,217	(18,000)	**25,271**
6	25,271	2,729	(26,000)	**2,000**
		36,000		

The interest income is calculated by multiplying the opening receivable by 10.798% in each year (so as to provide a constant rate of return on the net investment in the lease). The final balance on the account is the unguaranteed residual value

Manufacturer/Dealer leases

Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) finance income over the lease term.

Revenue

The sales revenue recognised at the commencement of the lease term is the lower of:

(a) the fair value of the asset; and

(b) the present value of the lessor's lease payments at a market rate of interest.

Cost of sale

The cost of sale recognised at the commencement of the lease term is the carrying amount of the leased asset less the present value of the unguaranteed residual value.

The deduction of the present value of the unguaranteed residual value recognises that this part of the asset is not being sold. This amount is transferred to the lease receivable.

The balance on the lease receivable is then the present value of the amounts which the lessor will collect off the lessee plus the present value of the unguaranteed residual value. This is the net investment in the lease as defined earlier.

Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease must be recognised as an expense when the selling profit is recognised.

Profit or loss on the sale

The difference between the sales revenue and the cost of sale is the selling profit or loss. Profit or loss on these transactions is recognised in accordance with the policy followed for recognising profit on outright sales.

The manufacturer or dealer might offer artificially low rates of interest on the finance transaction. In such cases the selling profit is restricted to that which would apply if a market rate of interest were charged.

Illustrative example 36: Manufacturer or dealer leases

Best Cars Plc is a car dealer. It sells expensive cars and offers a certain model for sale by lease. The following information is relevant:

Price of the car in a cash sale	₦200,000
Cost of the car	₦150,000
Finance option: Annual rental	₦80,423
Lease term	3 years
Interest rate	10%
Estimated residual value	nil
Lessor's cost of setting up the lease	₦2,000

IFRS 15 & IFRS 16 – Revenue from lease (Lessor, Sale-Type/Finance lease)

Working: Revenue Recognition – Use the lower of:

Description	Amount (₦)
Fair value of the asset	200,000
Present value of the lease payments	80,423 × 2.487 = 200,000
Recognised Revenue (lower of above)	**200,000**

Explanation:

a. **Revenue at commencement of a sale-type lease** is recognised at the **lower of**:
The **fair value** of the underlying asset, and
The **present value of lease payments**, including any guaranteed residual value.
The multiplier **2.487** reflects the **present value factor** or the **annuity multiplier** used to estimate PV of future lease receipts based on periodic payments.

Note: *In this case, both values are equal, so ₦200,000 is recognised as revenue.*

Initial Double Entry:

	Debit	Credit
Revenue:		
Lease receivable (Net investment in the lease)	200,000	
Statement of profit or loss		200,000
Cost of sale:		
Statement of profit or loss Asset (Inventory)	150,000	
Cost of setting up the lease:		150,000
Statement of profit or loss	2,000	
Cash/bank		2,000

Illustrative Example 37: Manufacturer or Dealer Lease (Continued)

Net Investment in the Lease (Over its Life): **Net Investment in the Lease (Version 1)**

Year	Opening Net Investment (₦)	Interest @10% (₦)	Lease Receipts (₦)	Closing Net Investment (₦)
1	200,000	20,000	(80,423)	139,577
2	139,577	13,958	(80,423)	73,112
3	73,112	7,311	(80,423)	0

**Each year's lease receipts include both principal and interest. The net investment amortises to nil at lease end.*

The interest income is calculated by multiplying the opening receivable by 10% in each year (so as to provide a constant rate of return on the net investment in the lease).

Summary of double entry in Year 1:

	Bank	Inventory	the lease	Profit or loss
B/fwd		150,000Dr		
Revenue			200,000Dr	200,000Cr
Cost of sales		(150,000)Cr		(150,000)Dr
Set up cost	(2,000)Cr			(2,000)Dr
Profit on sale				**48,000Cr**
Finance income				
			20,000Dr	20,000Cr
Lease rental	80,423Dr		(80,423)Cr	
			139,577Dr	**68,000Cr**

Illustrative Example 38: Manufacturer or Dealer Leases with Unguaranteed Residual Value

The following information is relevant:

Price of the car in a cash sale	₦200,000
Cost of the car	₦150,000
Finance option:	
Annual rental	₦76,402
Lease term	3 years
Interest rate	10%
Estimated residual value	₦13,310
Lessor's cost of setting up the lease	₦2,000

Discount Factors (at 10%)

Period	Factor
t3 @ 10%	0.7513148 → written as 0.751
t1 to t3 @ 10%	2.486852 → written as 2.487

Workings	₦
	200,000
W1: Revenue – lower of:	
Fair value of the asset	
Present value of the lease payments	
76,402 x 2.487	190,000
W2: Present value of the unguaranteed residual value	₦
Present value of the lease payments	
13,310 x 0.751	10,000

Initial Double Entry:

Revenue:	**Debit**	**Credit**
Lease receivable (Net investment in the lease)	190,000	
Statement of profit or loss		190,000
Cost of sale:		
Statement of profit or loss	140,000	
Asset (Inventory)		140,000
Transfer:		
Lease receivable (Net investment in the lease) Asset (Inventory)	10,000	10,000
Cost of setting up the Lease:		
Statement of profit or loss	2,000	
Cash/bank		2,000

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Illustrative Example 39: Manufacturer or Dealer Lease (Continued)

Net investment in the lease (over its life): Lease Schedule (Effective Interest Method)

Year	Opening Net Investment	Interest (@ 10%)	Lease Receipts	Closing Net Investment
1	200,000 (190,000 + 10,000)	20,000	(76,402)	143,598
2	143,598	14,360	(76,402)	81,556
3	81,556	8,156	(76,402)	13,310

The interest income is calculated by multiplying the opening receivable by 10% in each year (so as to provide a constant rate of return on the net investment in the lease).

The balance on the account at the end of the lease term is the unguranteed residual value.

Summary of Double Entry in Year 1:

	Bank	Inventory	Net Investment in the Lease	Profit or Loss
B/fwd		150,000Dr		
Revenue			190,000Dr	190,000Cr
Cost of sales		(140,000)Cr		(140,000)Dr
Set up cost	(2,000)Cr			(2,000)Dr
Profit on sale				**48,000Cr**
Transfer		**(10,000)Cr**	10,000Dr	
Finance income			20,000Dr	20,000Cr
Lease rental	76,402Dr		(76,402)Cr	
			143,598Dr	**68,000Cr**

Operating lease accounting

The lessor has **not** transferred the risks and rewards of ownership of the physical asset to the lessee. Therefore, the lessor shows the leased asset as a non- current asset in its statement of financial position.

It will be shown in an appropriate category of **property, plant and equipment as an investment property** at its carrying value (cost/valuation minus accumulated depreciation). In respect of the leased asset, the lessor's annual statement of profit or loss will include:

(a) depreciation on the asset as an expense, and

(b) rental income (as for the lessee, this is usually calculated on a straight-line basis).

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Lease income from operating leases is recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

The depreciation policy for depreciable leased assets must be consistent with the lessor's normal depreciation policy for similar assets, and calculated in accordance with IAS 16 and IAS 38.

Manufacturer/dealer leases
A manufacturer or dealer lessor must not recognise any selling profit on entering into an operating lease. It is not the equivalent of a sale as the risks and benefits of ownership do not pass.

Operating lease incentives
Lessors often give incentives to induce a potential lessee to sign up for a lease. Incentives include:
(a) rent-free periods;
(b) up-front cash payments; or
(c) contributions to the lessee's relocation costs

Lease incentives (for new or renewed operating lease) are an integral part of the net consideration and should be recognised on a straight-line basis unless another systematic basis is more appropriate.

Illustrative example 40: Operating lease incentives

X Limited signed a contract to lease an asset to a customer on January 1, 2016. The lease was for 20 years. The first year is rent free with rentals of ₦30,000 per annum payable in arrears thereafter.

Analysis
The lease incentive must be recognised as an expense over 20 years. This means that the total rentals for 20 years are 19 payments of ₦30,000).

Therefore, the annual income net of the lease incentive given would be:
=19/20 years x ₦30,000 = **₦28,500**

The double entries would be as follows

Year 1	**Debit**	**Credit**
Lease incentive	₦28,500	
Statement of profit or loss		₦28,500

The deferred debit represents an amount “paid” by the lessor in order to receive future rentals over the lease term.

This asset is written off to profit or loss over the lease term. This means that even though the future annual cash receipts will be ₦30,000 the company will only recognise income of ₦28,500.

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Years 2 to 20	Debit	Credit
Cash	₦30,000	
Statement of profit or loss		₦28,500
Deferred credit		₦1,500

Disclosure

Information is provided that, together with the information provided in main financial statements gives users a basis to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

Information is disclosed in a single note (or separate section of the financial statements). However, information already presented elsewhere in the financial statements, does not need to be duplicated as long as the information is incorporated by cross-reference in the single note or separate section about leases.

Finance Lease Disclosures

A lessor must disclose the following amounts for the period:

(a) finance income on the net investment in the lease;

(b) selling profit or loss (if any); and

(c) income relating to variable lease payments not included in the measurement of the net investment in the lease.

Significant changes in the carrying amount of the net investment in finance leases must be explained (in both qualitative and quantitative terms).

A lessor must provide a maturity analysis showing undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. The sum of the undiscounted lease payments must be reconciled to the net investment in the lease by deducting unearned finance income from the total.

Definitions: Unearned Finance Income

Unearned finance income is the difference between:

(a) the gross investment in the lease, and

(b) the net investment in the lease.

Operating leases

A lessor must disclose the lease income (separately disclosing income relating to variable lease payments that do not depend on an index or a rate).

IAS 16 disclosure requirements apply to items of property, plant and equipment subject to an operating lease. Each class of property, plant and equipment must be disaggregated into assets subject to operating leases and assets not subject to operating leases. Therefore, the IAS 16 disclosures are given separately for assets subject to an operating lease (by class of underlying asset) and other assets.

The disclosure requirements in IAS 36, IAS 38, IAS 40 and IAS 41 for assets subject to operating leases are applied as appropriate.

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A lessor must provide a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

A lessor must disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective of IFRS 16. This additional information includes, but is not limited to, information that helps users of financial statements to assess:

(a) the nature of the lessor's leasing activities; and
(b) how the lessor manages the risk associated with any rights it retains in underlying assets.

12.7 Sale and leaseback transactions

Sale and leaseback transactions involve one entity (seller/lessee) transferring an to another entity (the buyer/lessor) and then immediately leasing it back.

The buyer/lessor is normally a bank or finance company. The purpose of the transaction is to allow the seller/lessee to raise cash whilst retaining use of the asset.

Illustrative Example 41: Sale and Leaseback Transactions

X Plc owns an office building that it uses for its administrative operations.
It may decide to sell and lease back the building, to raise cash. By selling the building, it raises cash. By leasing back the building, it retains the use of the building for its operational activities.

The accounting treatment for such a transaction depends on whether the initial transfer of the asset from the seller/lessee to the buyer/lessor is a sale or not. This in turn depends on whether the transfer involves the seller/lessee incurs and satisfies a performance obligation in accordance with rules in IFRS 15.

Seller/Lessee Accounting for Transfers that are a Sale

The seller/lessee must account for the sale of the asset and the subsequent leaseback of the asset.

Accounting for the sale involves:

(a) recognising the sale proceeds; and
(b) derecognising the original asset. Accounting for the lease involves recognising a lease liability; and
(c) recognising a right-of-use asset.

These different amounts interact and result in a change in net assets. This results in the recognition of a gain/(loss) on the rights to the asset that have been transferred by the seller/lessee.

Another way of thinking about the gain/(loss) is that although the seller/lessee has sold an asset, it has also retained a right to continue using it. Any gain or loss should relate only to the rights sold and not those retained.

The gain of loss is easily calculated as a balancing figure as follows:

Double Entry Illustration: Sale and Leaseback

Accounts:	**Debit (Dr)**	**Credit (Cr)**
Sale proceeds	X	
Original asset (carrying amt.)		X
Right-of-use asset	X	
Lease liability		X
Gain on transfer (balancing figure)		X

Lease liability

The lease liability at the inception of the lease is measured in the usual way as the present value of the lease payments discounted at the interest rate inherent in the lease (if available) or the lessee's incremental borrowing rate.

Right-of-use (RoU) asset

The seller/lessee has sold an asset but retained a right to use it. The right-of-use asset is a portion of the asset that has been sold.

The fair value of the asset is a measure of all rights inherent in the asset. The lease liability is a measure of the fair value of those rights reacquired through the lease. Therefore, the relationship between the two figures can be used to show the proportion of the rights retained.

This proportion is applied to the original carrying amount as follows to arrive at the right-of-use asset.

Right-of-use asset measurement formula

Right-of-Use Asset = Carrying amount of the asset × (Lease liability/Fair value of the asset)

Note that the right-of-use asset is not measured at its fair value but as a proportion of its original carrying amount.

Illustrative example 42: Sale and leaseback (at fair value)
X plc sells an asset and leases it back. The transfer qualifies as a sale according to IFRS 15 criteria. Details of the asset: Carrying amount = ₦1,000,000 Sale proceeds = ₦1,300,000 Fair value = ₦1,300,000

Terms of thelLease:
20 annual payments of ₦83,951.48 Interest rate implicit in the lease = 5% (The 20 period, 5% annuity factor is 12.16). The transaction is accounted for as follows:

Step 1: Measure the lease liability as the present value of the lease payments.

Years	Cash Flow	Discount Factor	Present Value
1 to 20	83,951.48	12.4622	1,046,221

Step 2: Calculation of Right-of-Use Asset

- Carrying Amount = ₦1,000,000
- Lease Liability = ₦1,046,221
- Fair Value = ₦1,300,000

Right-of-use asset = 1,000,000 × (1,046,221/1,300,000) = **₦804,785**

Step 3: Complete the double entry identifying the gain/(loss) on disposal as a balancing figure

	Debit	**Credit**
	₦	**₦**
Cash	1,300,000	
Asset		1,000,000
Lease liability		1,046,221
Right-of-use asset	804,785	
Gain on disposal (balance)		58,564
	2,104,785	**2,104,785**

Seller/Lessee Accounting for Transfers that are a Sale at Above Market Terms

A sale and leaseback transaction may be at above market terms. This is where either:

(a) the fair value of the consideration for the sale of the asset is greater than its fair value; or

(b) the lease payments are above market rates (implying that they do more than simply pay for the right-of-use asset).

In such cases an adjustment is made to recognise additional financing. In effect, the sale proceeds received are treated as being made up of two amounts (being actual sale proceeds plus a loan). The lease payments pay for the right-of-use asset and the loan. Therefore, the present value of the lease payments is a total made up of the lease liability proper plus the loan.

The adjustment for additional finance is made on the basis of the more readily determinable of:

(a) he difference between the fair value of the consideration for the sale and the fair value of the asset; and

(b) he difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates

Illustrative example 43: Sale (Not at Fair Value) and Leaseback

X plc sells an asset and leases it back. The transfer qualifies as a sale according to IFRS 15 criteria. Details of the asset:

(a) Carrying amount of = ₦1,000,000 Sale proceeds = ₦1,500,000
(b) Fair value = ₦1,300,000 Terms of the lease:
(c) 20 annual payments of ₦100,000 Interest rate implicit in the lease = 5%

(The 20 period, 5% annuity factor is 12.4622)

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Notes: The sale proceeds of ₦1,500,000 comprise ₦1,300,000 for the asset and additional finance of ₦200,000.

The present value of the annual payments discounted at the interest rate implicit results in a total liability which is made up of the lease liability proper plus this additional finance. The lease liability proper is calculated by subtracting the additional finance from the total liability.

Illustrative example 44 (continued): Sale (not at fair value) and leaseback
The transaction is accounted for as follows

Step 1: Measure the total liability as the present value of the annual payments.

Years	Cash flow	Discount factor	Present value
1 to 20	100,000	12.4622	1,246,220
Step 2: Identify the lease liability			
Extra finance			₦ 200,000
Lease liability			1,046,220
PV of payments (12.4622 x 100,000)			**1,246,220**
Step 3: Measure the Right-of-Use Asset "RoU" (as before)			
Right-of-Use Asset =		**1,000,000**	**1,046,221**
			1,300,000
Right-of-Use Asset =		**804,785**	

Step 4: Complete the double entry
The double entry can be completed as follows

Journal Entries

Account	Debit (₦)	Credit (₦)
Cash	1,500,000	
Asset		1,000,000
Right-of-use asset	804,785	
Liability (extra finance)		200,000
Lease liability		1,046,221
Net gain		58,564
Totals	**2,304,785**	**2,304,785**

Tutorial Notes:

a. The existence of the extra finance component does not affect the other aspects of the transaction.

b. The difference between the solution in this example and the previous example is a simple double entry of ₦200,000 between cash and a liability for the extra finance.

c. The payments in this example are higher than those in the previous example in order to pay off the extra ₦200,000.

d. It is not needed to solve the above example but the annual payments of ₦100,000 can be prorated between the two components of the liability as follows:

Lease Liability Breakdown (Additional ₦100,000 financing)

- Extra finance = ₦100,000 × (200,000/1,246,221) = **₦16,049**
- Lease liability = ₦100,000 × (1,046,221/1,246,221) = **₦83,951**

Seller/lessee accounting for transfers that are a sale at below market terms

A sale and leaseback transaction may be at below market terms. This is where either:

(a) the fair value of the consideration for the sale of the asset is less than its fair value; or

(b) the lease payments are lower than market rates.

In such cases an adjustment is made to recognise that the seller/lessee made a prepayment of lease rentals. In effect, the sale proceeds received is not the only asset arising as a result of the initial sale; there is a prepayment to recognise also.

The present value of the lease payments is made up of the lease payment proper less the prepayment made. Therefore, in order to calculate the lease liability proper, the prepayment must be added to the present value of the lease rentals.

This is a little tricky to think of but it is exactly the same as recognising additional finance for transactions at above market terms but using a negative figure instead.

Illustrative Example 45: Sale (not at Fair Value) and Leaseback

X plc sells an asset and leases it back. The transfer qualifies as a sale according to IFRS 15 criteria.
Details of the asset: Carrying amount of = ₦1,000,000

Sale proceeds = ₦1,200,000 (₦100,000 less than fair value) Fair value = ₦1,300,000
Terms of the Lease:

a) 20 annual payments of ₦75,927 Interest rate implicit in the lease = 5%
b) (The 20 period, 5% annuity factor is 12.4622)
c) The present value of lease payments is ₦946,221

Notes: The sale proceeds of ₦1,200,000 are ₦100,000 less than the fair value of the asset. In effect, this is an extra amount being paid by X Plc in addition to the annual payments in order to obtain the right-of-use asset. The lease liability proper is made up of the present value of the lease payments plus the shortfall.

Illustrative Example 46 Example (Continued): Sale (not at Fair Value) and Leaseback
The transaction is accounted for as follows:

Step 1: Measure the total liability as the present value of the annual payments.

Years	Cash Flow	Discount Factor	Present Value
1 to 20	75,927	12.4622	**946,221**
Step 2: Identify the Lease Liability.			
Lease liability (balancing figure)			₦ 1,046,220
Lease prepayment			(100,000)
PV of payments (as above)			**946,221**
Step 3: Measure the right-of-use asset (as before)			**1,046,221**
Right-of-use asset = 1,000,000			
			1,300,000
Right-of-use asset = 804,785			

The double entry is as follows:

	₦	₦
Cash Asset	1,200,000	
Right-of-use asset	804,785	1,000,000
Lease prepayment	100,000	
Lease liability		1,046,221
PV of the lease payments		946,221
Net gain		58,564
	2.004.785	**2.004.785**

Tutorial Notes:

1. The existence of the lease prepayment does not affect the other aspects of the transaction. The difference between the solution in this example and the example at market terms is a simple double entry of ₦100,000 between cash and a a lease prepayment.
2. The payments in this example are lower than those in the first example as ₦100,000 has already been repaid.
   Buyer/Lessor accounting for transfers that are a sale
   The lessor must account for the purchase of the asset by applying applicable accounting standards.

   The lease back is accounted for using lessor accounting as previously described.
   Accounting for transfers that are not a sale

   This is accounted for using loan accounting by both parties. IFRS 9 applies to the financial liability recognised by the seller and the financial asset recognised by the buyer.

12.8 Chapter Review

Before moving to the next chapter, ensure that you can"

a. Identify contracts that contain a lease.
b. Distinguish between finance and operating leases (Legacy vs IFRS 16 Treatment).
c. Apply lessee accounting model – Right-of-Use Asset and Lease Liability.
d. Apply lessor accounting – finance lease vs operating lease treatment.
e. Understand sale and leaseback transactions.
f. Perform calculations for present value of lease liabilities.
g. Apply disclosure requirements under IFRS 16.

12.9 End of chapter questions

Questions

Section A: Conceptual questions

a) Define a lease under IFRS 16. What key elements must be present in a lease contract?
b) Explain the difference between a finance lease and an operating lease under previous IAS 17. How has IFRS 16 changed this treatment for lessees?
c) What are the initial and subsequent measurement requirements for a lease liability?
d) When can a lessee elect to apply lease exemptions under IFRS 16? Give examples.
e) Explain how sale and leaseback transactions are accounted for under IFRS 16.
f) State the key disclosures a lessee is required to make under IFRS 16.

Section B: Computational questions

Question 1: Lessee accounting

ABC Ltd enters into a 5-year lease of machinery with annual payments of ₦2,000,000 payable at the end of each year. The interest rate implicit in the lease is 8%.

Required:
Calculate:

a. The initial lease liability.
b. The amortisation schedule for the first three years.
c. The journal entries at inception and end of year 1.

Question 2: Right-of-use asset measurement

A company leases a building. Lease term is 10 years, annual payments of ₦5 million, payable in advance. Discount rate is 6%. Initial direct costs: ₦1 million. Restoration obligation: ₦500,000 (PV).

Calculate: The initial measurement of the right-of-use asset.

Question 3: Sale and leaseback

XYZ Plc sells equipment with a carrying amount of ₦10 million for ₦13 million and leases it back for 4 years with annual payments of ₦1.5 million. The fair value of the asset is ₦12 million. The interest rate implicit is 6%:

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Required:

a. Determine whether a sale has occurred.
b. Calculate the gain to be recognised.
c. Show appropriate double entries.

Section C: True or False

a) IFRS 16 requires all leases to be capitalised by lessees, with few exemptions.
b) Short-term leases (less than 12 months) and low-value asset leases can be exempted from recognition.
c) Under IFRS 16, lease liabilities are initially measured at fair value.
d) Lessors are no longer required to distinguish between operating and finance leases.
e) The right-of-use asset is measured at the present value of future lease payments only.

Exam tips

Memorise the formula:

a. **Lease Liability = PV of lease payments using interest rate implicit in lease (or incremental borrowing rate)**
b. **Right-of-use Asset = Initial lease liability + initial direct costs + dismantling costs – lease incentives**
c. Use discounting tables (or PV formulas) correctly – time value of money is tested often!
d. In **sale and leaseback**, only recognise gain relating to rights transferred.
e. **Disclosures** are crucial for both lessee and lessor: always remember qualitative + quantitative.

Summary flashcards

Term	Definition/Explanation
Right-of-use Asset	An asset that represents a lessee's right to use an underlying leased asset
Lease Liability	Present value of unpaid lease payments discounted at the appropriate rate
Short-term Lease	A lease term of 12 months or less, exemption available
Low-value Asset Lease	Lease of an asset with value typically below $5,000
Sale and Leaseback	Requires transfer of control for sale; gain recognition limited to rights transferred
Initial Measurement	Includes PV of lease payments + initial direct costs + provision for restoration etc.

Practical scenarios and real-world relevance

(a) **Airlines** lease aircraft – huge impact of IFRS 16 on balance sheets.
(b) **Retail chains** (e.g. Shoprite, Spar) – leases of premises recognised on balance sheet.
(c) **Tech companies** leasing servers or IT infrastructure.
(d) **Energy firms** leasing land or heavy equipment under long-term contracts.

Professional Level

Strategic Business Reporting

CHAPTER 13

IAS12: INCOMETAXES

Contents

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13 IAS 12: Income Taxes

13.0 Learning objective

This chapter is to enable candidates to develop a comprehensive, practical, and analytical understanding of the accounting treatments for current tax and deferred tax under IAS 12. Candidates will learn how to recognise, measure, present, and disclose income taxes in financial statements, and apply these principles to complex real-world scenarios, including business combinations and the implications of recent amendments to the standard.

13.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. Explain the nature and accounting treatment of **current tax** and **deferred tax**.

b. Define **temporary differences** and distinguish between **taxable temporary differences** and **deductible temporary differences**.

c. Identify transactions and events that give rise to the recognition of **deferred tax liabilities** and **deferred tax assets**.

d. Apply the **basic recognition and measurement rules** of IAS 12 for deferred tax.

e. Determine the amount of deferred tax to be recognised and appropriately account for:

   i. Revaluations of assets
   ii. Business combinations
   iii. Tax losses and tax credits

f. Evaluate the recent **amendments to IAS 12** regarding deferred tax arising from **single transactions** and the impact of the **Pillar Two Model Rules**.

g. Prepare and present the **disclosure** requirements for income taxes in accordance with IAS 12.

h. Apply professional judgment and strategic thinking to practical issues and examination scenarios involving complex taxation matters.

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13.2 Accounting for Taxation

13.2.1 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; and

  (ii) income recognised in the financial statements but which is exempted from company income tax.

The tax rate is applied to the taxable profit to calculate how much a company owes in tax for the period. IFRS describes this as ***current tax***.

An exam question might require you to perform a basic taxation computation from information given in the question.

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Computation of Current Taxes for 2025 Year of Assessment

(Financial Year Ended 31 December 2024)

	₦'000	₦'000
Accounting Profit (Profit Before Tax)		**100,000**
Tax Adjustments:		
Add-back: Non-Allowable Expenses		
Expenses not incurred wholly, exclusively, necessarily	2,000	
Depreciation and disqualifying capital expenditure	12,000	
Loss on disposal of assets	800	
		14,800
Deduct: Non-Taxable Income		
Income wholly exempted from tax	(500)	
Income liable under a different tax regime (e.g., disposal under Capital Gains Tax)	(1,200)	
Franked Investment Income (final withholding tax deducted)	(2,000)	
Income earned but not yet received in cash, but of which is ONLY subject to TAX on a CASH BASIS	100	
		(3,800)
Deduct: 'Omitted' Allowable Deductions		
Expenses not recognised for accounting purposes but allowable for tax purposes (e.g. Intangible Drilling Costs; development cost)	(10,000)	
Accrued expense not allowed in the year it is incurred but allowed in the current year it is paid	(700)	
		(10,700)
Add: 'Omitted' Taxable Income (Income Taxable on Cash Basis)		
Income earned in prior year but cash received in current and which is subject to TAX on a CASH BASIS	1,580	**1,580**
Profit adjusted for tax purposes/Assessable Profit/Adjusted Profit		**101,880**
LOSS RELIEF:		
Loss Brought Forward	(20,000)	
Loss Relieved for the year	20,000	**(20,000)**
Loss Carried Forward	**0**	

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	₦'000	₦'000
Accounting Profit (Profit Before Tax)		**100,000**
Tax Adjustments:		
Add-back: Non-Allowable Expenses		
		81,880
Capital allowance:		
Balance brought forward	10,000	
Additions for the year	35,000	
Total capital allowance	**45,000**	
Less: Capital allowance absorbed for the year (66⅔% or 2/3 of Assessable Profit "Where Applicable")	(45,000)	**(45,000)**
Balance Carried Forward	**0**	
Taxable (or Total) Profit for tax purposes		**36,880**

Computation of Taxable (or Total) Profit:	**₦'000**
Adjusted Profit (after tax adjustments)	101,880
Less: Loss Relief for the fiscal year	(20,000)
Less: Capital Allowances Absorbed for the fiscal year	(45,000)
Taxable (or Total) Profit for tax purposes	**36,880**

Estimated Current Tax Liabilities

Tax regimes for Corporate in Nigeria:	**Rate**	**₦'000**
Company Income Tax (CIT)	30% of ₦36.88m	11,064
Tertiary Education Tax (TET)	3% of ₦101.88m	3,056
Information Technology Development Levy (NITDA Levy)	1% of ₦100m	1,000
NASENI Levy	0.25% of ₦100m	250
NPF Levy	0.005% of ₦100m	5
Capital Gains Tax (CGT)	10% of ₦4m	400
Total Estimated Taxes		**15,775**

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Computation of chargeable gains

(For 2024 Year of Assessment)

	₦'000
Sales proceeds (or rateable value) from chargeable asset	20,000
Less: Cost of acquisition	(15,000)
Less: Other allowable incidental costs	(1,000)
Chargeable/Capital Gain	**4,000**

Summary of tax returns

	₦'000
Company Income Tax Payable	11,064
Less: Withholding Tax Credits (utilised) [Given there were Withholding "WHT" CREDIT NOTES]	(5,428)
Net Company Income Tax Payable	**5,636**
Tertiary Education Tax Payable	3,056
Information Technology Development Levy Payable	1,000
NASENI Levy Payable	250
NPF Levy Payable	5
Capital Gains Tax Payable	400
Total corporate taxes payable to FIRS	**10,347**

Illustrative example: Current tax computation

Enugu Traders had an accounting profit of ₦789 million for the year ended 31 December 2024. The accounting profit was after depreciation of ₦70 million and included a profit on disposal (capital gain) of ₦97 million

The company had incurred borrowing costs of ₦70 million in the year of which ₦10 million had been capitalised in accordance with IAS 23. The company holds right-of-use assets (IFRS 16). During the year the lease finance charge was ₦15 million and rentals paid were ₦80 million. At 1 January 2024 the tax written down value of machinery was ₦120 million and for buildings was ₦600 million.

Current tax regime provisions:

(i) All borrowing costs are deductible for tax purposes.
(ii) Capital gains are not taxable.
(iii) Fines are not tax deductible.

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(iv) Lease rentals are deductible in full for tax purposes.
(v) Accounting depreciation is not allowable for tax purposes.
(vi) Capital allowances are claimable at 10% per annum for buildings and 15% per annum for machinery applied to tax written down value at the start of the year.
(vii) Corporate Tax is paid at 30%, Tertiary Education Tax is 3% of Assessable/Adjusted Profit, Information Technology Development Levy (NITDA Levy) of 1% on Accounting Profit, NASENI Levy of 0.25% on Accounting Profit, and NPF Levy of 0.005% of accounting profit.

The tax computation is as follows:

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Computation of Current Taxes for 2025 Year of Assessment
(Financial Year Ended 31 December 2024)

	₦'000	₦'000
Accounting profit (Profit before tax)		**789,000**
Tax Adjustments:		
Add-back: Non-allowable expenses		
Accounting depreciation	70,000	
Fine paid	125,000	
Lease finance charge	15,000	
		210,000
Deduct: Non-taxable income		
Profit on disposal is liable under a different tax regime (e.g., disposal under Capital Gains Tax)	(97,000)	
		(97,000)
Deduct: 'Omitted' allowable deductions		
Lease payment	(80,000)	
Borrowing cost capitalised	(10,000)	
		(90,000)
Add: 'Omitted' taxable income (income taxable on cash basis)	Nil	**Nil**
Nil		
Profit adjusted for tax purposes/Assessable profit/Adjusted profit		**812,000**
LOSS RELIEF: *(Not applicable)*		*Nil*

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	₦'000	₦'000
Accounting profit (Profit before tax)		**789,000**
Tax Adjustments:		
Add-back: Non-allowable expenses		
		812,000
Capital Allowance:		
Balance brought forward	0	
Additions for the year (15% x ₦120,000 + 10% x ₦600,000)	78,000	
Total Capital Allowance	**78,000**	
Less: Capital allowance absorbed for the year (66⅔% or 2/3 of Assessable Profit "*Where Applicable*")	(78,000)	**(78,000)**
Balance carried forward	**0**	
Taxable (or Total) Profit for tax purposes		**734,000**

Estimated current tax liabilities

TAX REGIMES for Corporate in Nigeria:	**Rate**	**₦'000**
Company Income Tax (CIT)	30% of ₦734.00m	220,200.00
Tertiary Education Tax (TET)	3% of ₦812.00m	24,360.00
Information Technology Development Levy (NITDA Levy)	1% of ₦789m	7,890.00
NASENI Levy	0.25% of ₦789m	1,972.50
NPF Levy	0.005% of ₦789m	39.45
Total Estimated Taxes		**254,461.95**

Key Concept: Tax Base (Reminder):

(i) The tax base of an asset refers to the value of the asset according to tax laws — typically, original cost less cumulative capital allowances.

(ii) It is fundamental to identifying temporary differences when accounting for deferred taxes under IAS 12.

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13.2.2 Tax base

The above example referred to the tax written down value of the machinery and buildings. This is the tax authority's view of the carrying amount of the asset measured as cost less capital allowances calculated according to the tax legislation.

IFRS uses the term tax base to refer to an asset or liability measured according to the tax rules.

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

The tax base of an asset is the amount that the tax authorities will allow as a deduction in the future.

13.2.3 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.

13.2.4 Components of Income Taxes

Income taxes, under IAS 12, consist of two key components:

a) Current taxes
b) Deferred taxes

Understanding the two components

Current tax accounting is ordinarily straightforward. It involves the amount of income tax payable (or recoverable) based on the taxable profit for the current accounting period, in accordance with tax laws.

However, complexities arise when considering the **future tax consequences** of events and transactions already recognised in the financial statements.
These future effects are captured under **deferred tax accounting** — an essential aspect of financial reporting that ensures the tax effects are matched to the periods in which the related transactions occur.

Thus, total income tax expense in a financial statement is the combination of:

- The **current tax expense** (or credit), and
- The **deferred tax charge** (or credit).

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Illustration: Income tax expense analysis

Income tax expense/ (credit):	**2019 (₦'000)**	**2020 (₦'000)**
Current tax expense/charge	845	1,083
Deferred tax charge/(credit)	105	(103)
Total income tax expense	**950**	**980**

The **total tax charge** reported in the statement of profit or loss each year consists of both the current tax due for the year and any adjustment for deferred tax movements.

Current tax payable reconciliation

Current tax payable:	**2019 (₦'000)**	**2020 (₦'000)**
Balance at January 1	610	845
Current tax charge for the year	845	1,083
Less: Payments made during the year	(610)	(845)
Balance at December 31	**845**	**1,083**

The balance on **current tax payable** represents the amount outstanding to the tax authority at the reporting date after adjusting for payments made during the year.

Deferred tax liability reconciliation

Deferred tax liability:	**2019 (₦'000)**	**2020 (₦'000)**
Balance at 1 January	325	430
Deferred Tax Charge/(Credit) for the Year	105	(103)
Balance at December 31	**430**	**327**

The movement on the **deferred tax liability** account reflects changes in temporary differences between accounting carrying amounts and tax bases.

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Key points for Strategic Business Reporting candidates

- **Current tax** focuses on the amount payable based on current taxable profits.
- **Deferred tax** addresses timing differences, ensuring that the tax effects are reported in the same periods as the accounting income and expenses they relate to.
- Proper reconciliation of both **current tax** and **deferred tax** is critical for financial statement accuracy and compliance with IFRS requirements.

13.2.5 over-estimate or under-estimate of tax from the previous year

Current tax for current and prior periods must be recognised as a liability until paid. If the amount already paid exceeds the amount due the excess must be recognised as an asset.

When the financial statements are prepared, the tax charge on the profits for the year is likely to be an estimate. The figure for tax on profits in the statement of comprehensive income is therefore not the amount of tax that will eventually be payable, because it is only an estimate. The actual tax charge, agreed with the tax authorities some time later, is likely to be different.

In these circumstances, the tax charge for the year is adjusted for any under- estimate or over-estimate of tax in the previous year.

(a) an under-estimate of tax on the previous year's profits is added to the tax charge for the current year;

(b) an over-estimate of tax on the previous year's profits is deducted from the tax charge for the current year.

Uncertain tax position and its accounting

Current tax

Illustration

In the 2020 financial year, **ABC Limited** reported **taxable profits** of **₦100,000**. In the previous year (2019), the company had initially estimated its tax liability on 2019 profits at **₦20,000**.
Tax rate: 30%

Additional information

Subsequently, the tax authority agreed the final tax liability for 2019 as either:

a) **₦25,000**, or
b) **₦15,000**.

Important note:
Any underpayment or overpayment of tax relating to the previous year is recognised and settled along with the current year's tax charge.

Required

Calculate:

a) The **current tax payable** for 2020, and
b) The **total income tax expense** to be reported in the 2020 financial statements **for both** final settlement scenarios.

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Suggested solution

Scenario (a): Final Agreed 2019 Tax = ₦25,000:	**₦**
Current Tax for 2020 (₦100,000 × 30%)	30,000
Add: Underpayment relating to 2019 (₦25,000 – ₦20,000)	5,000
Total Income tax expense for 2020	**35,000**

Scenario (b): Final agreed 2019 tax = ₦15,000:	**₦**
Current Tax for 2020 (₦100,000 × 30%)	30,000
Less: Overpayment relating to 2019 (₦20,000 – ₦15,000)	(5,000)
Total income tax expense for 2020	**25,000**

Key examiner insight:

a. Any **adjustment** for **overpayment** or **underpayment** of tax is **reflected as an adjustment** to the **current year's tax expense** when final assessments are agreed.
b. Such adjustments are important because they ensure the financial statements present a fair and accurate tax charge in line with accrual accounting principles.

13.2.6 Presentation of income taxes in the statement of financial position

Recognition of current tax in financial statements

The **taxation charge for the year** represents the amount of tax that a company expects to pay to the tax authorities based on its taxable profits for the period.

The **timing of tax payments** differs across jurisdictions and is determined by the **relevant tax laws** and **regulatory frameworks** in each country.
In some countries, companies may be required to make advance tax payments or provisional tax installments, while in others, payment is made after filing the final tax returns.

Regardless of the timing, the **current tax liability** recognised in the **statement of financial position** is based on the **actual amount of tax** that remains **payable at the reporting date**. This amount is typically presented as a **current liability** under the heading "**Current Tax Payable**" or "**Income Tax Payable**."

Thus, the **current tax payable** reflects:

a) The income tax expense for the year, as adjusted for:
b) Advance payments made,
c) Underpayments,
d) Overpayments, and
e) Any settlements agreed with the tax authorities.

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It ensures that the company's financial statements fairly present its outstanding obligations for income taxes as at the year-end.

Example: Taxation in the financial statements

Scenario
Fresh Company prepares its financial statements with a financial year ending on 31 December.
The following tax information applies:

- At **December 31, 2017**, Fresh Company had a liability for income tax amounting to **₦77,000**.
- The **current year's tax charge** on profits for the year ended **December31, 2018** was **₦114,000**.
- The tax charge for the prior year (**2017**) had been **over-estimated** by **₦6,000**.
- During the year ended **December 31, 2018**, the company made **tax payments totalling ₦123,000**.

Accounting treatment

1. Tax charge in the statement of comprehensive income

	₦
Current tax expense on 20X8 profits	114,000
Adjustment for over-estimate of prior year tax	(6,000)
Total Taxation Charge for the Year	**108,000**

Note: The adjustment for the prior year's over-estimate reduces the tax expense for 2018.

2. Tax liability in the statement of financial position

	₦
Opening tax payable balance (as at 1 January 20X8)	77,000
Add: Taxation charge for the year (from above)	108,000
Subtotal	**185,000**
Less: Tax payments made during 20X8	(123,000)
Closing tax payable balance (as at 31 December 20X8)	**62,000**

Key Interpretation for SBR candidates

a) The **opening balance** represents taxes owed from previous periods.
b) The **current year's tax expense** is adjusted for any prior year over- or under-estimations.
c) **Payments made** during the year reduce the liability.

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d) The **closing balance** is reported as a **current liability** under **current tax payable** in the statement of financial position.

This ensures that financial statements accurately reflect both the tax expense for the year and any outstanding tax obligations at the reporting date.

13.3 Deferred tax: Introduction

13.3.1 Deferred taxation — The underlying problem

In most jurisdictions, the **rules for recognising and measuring assets, liabilities, income, and expenses for tax purposes** differ significantly from those prescribed under **International Financial Reporting Standards (IFRSs)**.

As a result, two distinct sets of "accounts" effectively exist:

(a) **IFRS-based accounts** — Prepared in accordance with IFRS recognition and measurement principles, reflecting the economic substance of transactions.
(b) **Tax-based accounts** — Prepared for tax purposes, following local tax legislation and rules, often with different treatments and timings for the same transactions.

These differences lead to **discrepancies** between:

a) The figures presented in the financial statements, and
b) The figures used in the entity's tax computations and filings.

Impact on the profit-tax relationship

Because of these differences:

(a) The **tax charge** reported in the financial statements is **not simply** the application of the **statutory tax rate** to the **accounting profit before tax**.
(b) Instead, **adjustments** are required to bridge the gap between accounting profit and taxable profit, leading to the recognition of **deferred tax assets** or **deferred tax liabilities**.

Thus, the **effective tax rate** (i.e., tax expense divided by accounting profit before tax) often differs from the **statutory corporate tax rate**.

This "breakdown" highlights the necessity of accounting for **deferred taxes** to ensure financial statements fairly reflect all current and future tax consequences.

Example: Difference between accounting profit and taxable profit

The following table illustrates how differences between accounting depreciation and tax capital allowances create **temporary differences**, leading to differences between **accounting profit** and **taxable profit**, and subsequently affect the **current tax charge**:

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	2021	2022	2023
	(₦)	(₦)	(₦)
Accounting profit (after depreciation) [A]	**50,000**	**50,000**	**50,000**
Add back: Depreciation (non-tax deductible)	3,000	3,000	3,000
Deduct: Capital allowances (tax deductible)	(4,500)	(2,500)	(2,000)
Adjustment for tax purposes [B]	**(1,500)**	**500**	**1,000**
Taxable profit [C = A – B]	**48,500**	**50,500**	**51,000**
Tax at 30% [D = 30% x C]	**14,550**	**15,150**	**15,300**

Key insights for SBR candidates

- **Accounting profit** starts after deducting depreciation, which is **not allowable** for tax purposes.
- Instead, **capital allowances** are deducted when calculating **taxable profit** under tax rules.
- This creates **temporary differences** between accounting carrying amounts and tax bases, necessitating deferred tax adjustments.
- As a result, **taxable profit** differs from **accounting profit**, and the **tax charge** is not simply accounting profit × statutory tax rate.

This reinforces the strategic need for **deferred tax accounting** under IAS 12 to correctly match tax effects to the periods in which the underlying transactions occur.

Example (continued): Deferred taxation — Understanding the underlying problem

In the **absence of recognising deferred tax**, the reporting of tax expense would appear as follows:

X Limited — Statement of Comprehensive Income for the Years Ended 20X1 to 20X3

	2021	2022	2023	Total
	(₦)	(₦)	(₦)	(₦)
Profit before tax	50,000	50,000	50,000	150,000
Income tax @ 30% (based on taxable profits)	(14,550)	(15,150)	(15,300)	(45,000)
Profit after tax	**35,450**	**34,850**	**34,700**	**105,000**

Key observations

a) **Over the three-year period**, the total **accounting profit** (₦150,000) and the **total tax charge** (₦45,000) align when applying the **statutory tax rate** of 30%:

b) = ₦150,000 × 30% = ₦45,000

c) However, this relationship **does not hold on a year-by-year basis** because:

i. The **current tax charge** each year is **not directly** 30% of the **accounting profit before tax**.

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ii. Instead, the tax is calculated on an **adjusted taxable profit**, factoring in differences such as:

a) Depreciation for accounting purposes, and
b) Capital allowances for tax purposes.

Why the difference occurs

a) The **same item of plant** (e.g., machinery) is expensed over different periods for:
b) **Accounting purposes** (via depreciation), and
c) **Tax purposes** (via capital allowances).
d) These **timing differences** are **temporary**:

(a) Over the full three-year period, the **total expense** recognised for the plant is **identical** under both accounting and tax rules.
(b) However, the **amount expensed each year** differs between the financial statements and the tax computation.

Thus, **deferred tax accounting** is necessary to:

a) Match the tax effects to the periods in which the related accounting transactions occur.
b) Accurately reflect the economic reality of the company's tax position.

Strategic Business Reporting Insight

Deferred tax ensures that financial statements show the correct **matching of tax effects** to the timing of income and expenses, smoothing out temporary mismatches that would otherwise distort annual results.

Without deferred tax, users could be misled about the effective tax rate and the future tax implications of the company's financial position.

The concept of deferred tax recognition

In many instances, **transactions recognised in the financial statements** during one reporting period may have their **tax consequences** deferred to a **different period** (or, less commonly, accelerated to an earlier period).

This timing difference means that the **tax expense** is **not automatically matched** with the **underlying transaction** that created it.

Illustration from previous example

In the earlier illustration involving depreciation:

a) **The accounting expense (depreciation)** is recognised over a defined period based on IFRS principles.
b) **However, the tax deduction (capital allowances)** is based on local tax rules and occurs at a different rate and timing.

Thus, although the same plant is eventually fully written off for both accounting and tax purposes, **the periods of recognition differ**, creating a **temporary difference**.

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The objective of deferred tax accounting

Deferred tax accounting addresses this mismatch by ensuring that:

a) **The tax consequence of a transaction** is **recognised in the same period** as the **transaction itself** in the financial statements.

b) This preserves the integrity of the **matching principle** — matching tax expenses (or credits) to

the underlying revenues and expenses to which they relate.

To achieve this, the **effect of the timing differences** between the IFRS-based carrying amounts and the tax-based carrying amounts must be **recognised as deferred tax** in the financial statements.

13.3.2 Accounting mechanic: Deferred tax double entry

To recognise deferred tax:

a. A **deferred tax asset** or **deferred tax liability** is recorded in the **statement of financial position**, depending on the nature of the timing difference.

b. A corresponding **deferred tax charge or credit** is recorded in the **statement of comprehensive income**.

Thus, the **overall tax expense** reported each period comprises two components:

a. **Current Tax** — based on the taxable profit for the period, using current tax laws and rates.
b. **Deferred Tax** — arising from changes in temporary differences between accounting and tax treatments.

Note:

While more complex deferred tax adjustments (e.g., relating to items recognised directly in other comprehensive income or equity) exist, these are **beyond the immediate scope** of this syllabus at the SBR level.

Strategic summary for SBR candidates

Deferred tax ensures **faithful representation** of an entity's financial position and performance by properly matching tax effects to underlying transactions.

Without deferred tax accounting, financial statements would **misstate** profit trends and **distort** users' understanding of the entity's future tax obligations or benefits.

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.

Identifying deferred tax balances

In financial reporting, the differences between the **accounting treatment under IFRS** and the **tax treatment under tax legislation** inevitably produce **different numbers** for:

a) **Income and expenses**, and

b) **Assets and liabilities**.

These differences form the basis for recognising **deferred tax assets** or **deferred tax liabilities**.

13.3.3 Two analytical perspectives

Deferred tax differences can be identified from **two distinct perspectives**:

a. Statement of comprehensive income perspective (income and expenses view)

a. Differences are identified **period-by-period** by comparing:
a) Income and expenses recognised under **IFRS**, with
b) Income and expenses treated as **taxable** or **allowable** under **tax legislation**.

b. This method focuses on identifying the **deferred tax charge or credit** that should be recognised in the **statement of comprehensive income** for the period.

c. The **corresponding entry** will be made to a **deferred tax liability or asset** in the **statement of financial position**.

Key outcome: Recognises deferred tax effects by analysing *current period* differences in reported income and expenses.

Statement of financial position perspective (assets and liabilities view)

a. Differences are identified on a **cumulative basis** by comparing:
- The **carrying amounts** of assets and liabilities as per **IFRS**, with
- Their **tax bases** according to tax legislation.

b. This approach focuses on calculating the **total deferred tax liability** or **deferred tax asset** to be reported in the **statement of financial position** at the reporting date.

- The **movement** (increase or decrease) in the deferred tax balance from the prior period to the current period is then recognised as a **deferred tax expense or credit** in the **statement of comprehensive income**.

Key outcome: Recognises deferred tax balances by assessing *cumulative differences* at a specific reporting date.

IAS 12 preferred approach

Under IAS 12, the **statement of financial position perspective** is the **required approach**.
However, for a deeper conceptual understanding — and to strengthen candidates' examination performance — **both perspectives** are explained and illustrated within this Study Text.

Example: Deferred tax — Two perspectives (assets vs income)
The following table shows how differences arise between the **accounting treatment** and the **tax treatment** of an item of plant, analysed from both:

a. The **assets and liabilities perspective** (balance sheet view), and
b. The **Income and expenses perspective** (income statement view).

Summary table

	Carrying Amount (₦)	Tax Base (₦)	Difference — Assets and Liabilities (₦)	Difference — Income and Expenses (₦)
Cost at 01/01/X1	9,000	9,000		
Charge for the year (depreciation vs capital allowance)	(3,000)	(4,500)		(1,500)
Cost/Value at 31/12/X1	6,000	4,500	1,500	
Charge for the year (depreciation vs capital allowance)	(3,000)	(2,500)		500
Cost/Value at 31/12/X2	3,000	2,000	1,000	
Charge for the year (depreciation vs capital allowance)	(3,000)	(2,000)		1,000
Cost/Value at 31/12/X3	—	—	0	

Interpretation

a. **Assets and liabilities perspective**:
   a. Focuses on the **cumulative difference** between the **carrying amount** and the **tax base** of the asset at each reporting date.
   b. These differences create either **deferred tax liabilities** (if carrying amount > tax base) or **deferred tax assets** (if tax base > carrying amount).

c. **Income and expenses perspective**:
   i. Focuses on the **differences arising each year** between:
   ii. Accounting depreciation charged to profit or loss, and
   iii. Capital allowances claimed for tax purposes.

These annual differences give rise to **deferred tax expenses** or **credits** in the income statement.

Statement of comprehensive income perspective

Example: Deferred taxation and the statement of comprehensive income perspective

2021 Analysis

a. **₦3,000** of accounting depreciation is **disallowed**.
b. **₦4,500** of capital allowance is **allowed** instead.
c. As a result:
   - Taxable expenses are **₦1,500 greater** than accounting expenses.
   - Taxable profit is **₦1,500 less** than accounting profit.
d. **Current tax** is **reduced** by 30% of ₦1,500 = **₦450**.
e. To balance, a **deferred tax expense** of **₦450** must be recognised:
   i. **Debit**: Tax expense
   ii. **Credit**: Deferred tax liability.

2022 Analysis

a. **₦3,000** of accounting depreciation is **disallowed**.
b. **₦2,500** of capital allowance is **allowed** instead.

As a result:

i. Taxable expenses are **₦500 less** than accounting expenses.
ii. Taxable profit is **₦500 more** than accounting profit.
iii.

c. **Current tax** is **increased** by 30% of ₦500 = **₦150**.
d. A **deferred tax credit** of **₦150** must be recognised:
   i. **Debit**: Deferred tax liability
   ii. **Credit**: Tax expense.

2023 Analysis

a. **₦3,000** of accounting depreciation is **disallowed**.
b. **₦2,000** of capital allowance is **allowed** instead.
c. As a result:
   i. Taxable expenses are **₦1,000 less** than accounting expenses.
   ii. Taxable profit is **₦1,000 more** than accounting profit.
d. **Current tax** is **increased** by 30% of ₦1,000 = **₦300**.
e. A **deferred tax credit** of **₦300** must be recognised:
   i. **Debit**: Deferred tax liability
   ii. **Credit**: Tax expense.

Summarised financial statements

Statement of comprehensive income

	20X1 (₦)	20X2 (₦)	20X3 (₦)
Profit before tax	50,000	50,000	50,000
Income tax @ 30%	(14,550)	(15,150)	(15,300)
Deferred tax	(450)	150	300
Total tax charge	(15,000)	(15,000)	(15,000)
Profit after tax	35,000	35,000	35,000

Statement of financial position (deferred tax liability)

	20X1 (₦)	20X2 (₦)	20X3 (₦)
Opening balance	Nil	450	300
Movement for the year	450	(150)	(300)
Closing balance	450	300	Nil

Strategic Insight for SBR Candidates

The **statement of comprehensive income perspective** clearly tracks the **year-on-year movements** of deferred tax, tying each movement to specific timing differences in income and expenses.

Ultimately, deferred tax accounting **smooths the tax charge** over the life of the asset, ensuring a faithful matching of tax effects to accounting treatments.

Statement of financial position perspective
Concept overview

This approach compares the **carrying amounts** of assets and liabilities in the financial statements to their **tax bases**, in order to identify **cumulative temporary differences** at each reporting date.
Temporary differences arise when:

The accounting carrying amount ≠ the tax base of assets or liabilities.
A **deferred tax liability** (or asset) is recognised based on the tax effect of these differences.

Practical -illustration: Temporary differences and deferred tax

Reporting Date	Carrying Amount (₦)	Tax Base (₦)	Temporary Difference (₦)	Tax @ 30% (₦)
31/12/X1	6,000	4,500	1,500	450
31/12/X2	3,000	2,000	1,000	300
31/12/X3	Nil	Nil	Nil	Nil

Journal entries for deferred tax recognition:

By end of 2021

a. The asset's carrying amount is **₦1,500 higher** than its tax base.
b. Deferred tax liability of **₦450** must be recognised.

	Debit	Credit
Tax Expense	₦450	
Deferred Tax Liability		₦450

By end of 2022

a. The asset's carrying amount is **₦1,000 higher** than its tax base.
b. Deferred tax liability must be **₦300** (but existing balance is ₦450).
c. Hence, a **reduction** of **₦150** is needed.

	Debit	Credit
Deferred Tax Liability	₦150	
Tax Expense		₦150

By end of 2023

- The carrying amount and tax base are equal (nil difference).
- Deferred tax liability should now be **nil** (existing balance ₦300).
- The **remaining ₦300** must be reversed.

	Debit	Credit
Deferred Tax Liability	₦300	
Tax Expense		₦300

Key outcome

The recognition of deferred tax ensures that the **total tax charge** (current + deferred) aligns with **30%** of **profit before tax** in each year (i.e., ₦50,000 × 30% = ₦15,000).

This restores consistency between **accounting profit** and **total tax charge** over time.

Important terminology

a. **Origination**:
When a temporary difference **arises or grows**, it is said to "originate".
b. **Reversal**:
When a temporary difference **reduces or eliminates**, it is said to "reverse".

Example:
i. In 2021, a temporary difference of **₦1,500 originated**.
ii. In 2022 and 2023, the difference **reversed** progressively.

Examiner's strategic warning

Be Careful:
Origination does **not always** automatically mean the creation of a deferred **liability** and an expense.

a. Sometimes, origination can result in a **deferred asset** and a **credit** to tax expense.
b. The direction of the deferred tax adjustment depends on **the nature of the underlying temporary difference**.

This concept is explored further in **Section 3 of this chapter**.

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13.3.4 IAS 12 approach to deferred tax

IAS 12: *Income Taxes* mandates that entities adopt a **statement of financial position approach** when accounting for deferred tax.

At each reporting date, businesses are required to:

- Identify whether a **deferred tax liability** or a **deferred tax asset** should be recognised.

This is achieved by:

- Comparing the **carrying amounts** of assets and liabilities in the financial statements (prepared under IFRS) with their corresponding **tax bases** (as determined under the tax laws).

The **differences** between the carrying amount and the tax base are known as **temporary differences**.

Recognition process

Once temporary differences are identified:

The deferred tax balance (liability or asset) is measured by **applying the appropriate enacted or substantively enacted tax rate** to the amount of the temporary difference.

Deferred tax ensures that the **future tax consequences** of today's accounting transactions are **faithfully represented** in the financial statements, maintaining consistency with the matching principle.

13.4 Recognition of deferred tax: Basic approach

13.4.1 Identifying the temporary difference

Definition: Temporary difference

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences may be either:

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

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

Accounting for deferred tax is based on the identification of the temporary differences.

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefit that will flow to an entity when it recovers the carrying amount of the asset.

Definition: Tax base

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

13.4.2 Taxable and deductible temporary differences

Temporary differences may be either taxable temporary differences or deductible temporary differences.

Taxable temporary differences

A taxable temporary difference is caused by a debit in the carrying amount of an asset or liability in the financial statements compared to the tax base of that item.

Taxable temporary differences lead to the recognition of deferred tax liabilities.

Example: Taxable temporary differences

Each of the following is a taxable temporary difference leading to the recognition of a deferred tax liability.

Assets & Liabilities:	Carrying amount	Tax base	Temporary difference	Deferred tax liability (30%)
Non-current asset	1,000	800	200	**60**
Inventory	650	600	50	**15**
Receivable	800	500	300	**90**
Receivable (note 1)	500	nil	500	**150**
Payable (note 2)	**(1,000)**	**(1,200)**	**200**	**60**

Note 1:
This implies that an item accounted for using the accruals basis in the financial statements is being taxed on a cash bases.
If an item is taxed on cash basis the tax base would be zero as no receivable would be recognised under the tax rules.

Note 2:

The credit balance in the financial statements is ₦1,000 and the tax base is a credit of ₦1,200. Therefore, the financial statements show a debit balance of 200 compared to the tax base. This leads to a deferred tax liability.

IAS 12 rationalises the approach as follows (using the non-current assets figures to illustrate)

Inherent in the recognition of an asset is that the carrying amount (₦1,000) will be recovered in the form of economic benefits that will flow to the entity in future periods.

When the carrying amount exceeds the tax base (as it does in this case at ₦800) the amount of taxable economic benefit will exceed the amount that will be allowed as a deduction for tax purposes.

This difference is a taxable temporary difference and the obligation to pay the resulting income tax in the future periods is a liability that exists at the reporting date.

The company will only be able to expense ₦800 in the tax computations against the recovery of ₦1,000.

The ₦200 that is not covered will be taxed and that tax should be recognised for now.

Definition: Deferred tax asset

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:
(a) deductible temporary differences;
(b) the carry forward of unused tax losses; and
(c) the carry forward of unused tax credits.
(The deferred tax assets arising from the carry forward of unused tax losses and the carry forward of unused tax credits are not in your syllabus).

13.4.3 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).

Balance sheet (statement of financial position) computation of deferred tax

Recall: **Deferred tax** refers to the **future tax consequences** of recovering or settling the **carrying amount** of an asset or liability.

IAS 12 requires that entities adopt a structured and principles-based approach to compute deferred tax balances at each reporting date.

Step-by-step calculation process

Step 1: Determine the tax base
(a) Calculate the **tax base** of each **asset and liability** as defined by local tax legislation.
(b) The tax base represents the amount that will be deductible (asset) or taxable (liability) for tax purposes in the future.

Step 2: Identify the Temporary Differences
(a) Compute the **temporary difference** between the **carrying amount** in the financial statements and the **tax base**.
(b) This difference may be:
  (i) **Taxable** (leading to deferred tax liabilities), or
  (ii) **Deductible** (leading to deferred tax assets).

Step 3: Apply Recognition Criteria and Exceptions
(a) Determine which temporary differences should result in recognition of deferred taxes based on **IAS 12 recognition rules**.
(b) Apply **exceptions**, such as:

(i) Initial recognition of goodwill.
(ii) Initial recognition of an asset/liability in a transaction that is not a business combination and affects neither accounting nor taxable profit.

Step 4: Apply the Appropriate Tax Rate

(a) Multiply the temporary differences by the **enacted or substantively enacted tax rate** applicable to the future period in which the difference will reverse.
(b) This yields the **deferred tax asset or liability**.

Step 5: Recognise the Net Movement

(a) Recognise the **net movement** in deferred tax balances in the financial statements:
  (i) In the **statement of financial position** (as a deferred tax asset or liability).
  (ii) In the **statement of profit or loss**, **other comprehensive income**, **equity**, or as part of a **business combination**, depending on the nature of the underlying transaction.

(*This structured five-step approach ensures **compliance with IAS 12** and enhances the accuracy of financial reporting for tax-related items.*)

Example: Accounting for Deferred Tax

X plc has non-current assets with a carrying value of ₦200,000 and a tax base of

₦140,000.

It has recognised a receivable of ₦10,000. This relates to income which is taxed on a cash basis.

It has also accrued for an expense in the amount of ₦20,000. Tax relief is only given on this expense when it is paid.

At the start of the year X plc had a deferred tax liability of ₦12,000.

Required

Show the movement on the deferred tax account and construct the journal to record this movement.

In order to answer a question like this you need to complete the following proforma:

	₦
Deferred taxation balance at the start of the year	12,000
Transfer to the income statement (as a balancing figure)	?
Deferred taxation balance at the end of the year **(working)**	?

In order to complete this you need to work to identify the temporary differences.

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Guidance to Solving the Problem: Accounting for deferred tax – X Plc

Step 1: Identify temporary differences

We calculate the difference between the **carrying amounts** and **tax bases** of relevant assets and liabilities:

Assets & Liabilities:	Carrying Amount (₦)	Tax Base (₦)	Temporary Difference (₦)	Type of Temporary Difference & the Direction of Deferred Tax
Non-current assets	200,000	140,000	**+60,000**	**Taxable** difference (→ Deferred Tax Liability)
Receivable (taxed on cash basis)	10,000	0	**+10,000**	**Taxable** difference (→ Deferred Tax Liability)
Accrued expense (deductible only on payment)	20,000	0	**–20,000**	**Deductible** difference (→ Deferred Tax Asset)

Step 2: Net Temporary Difference

Total Temporary Difference = 60,000 + 10,000 − 20,000 = 50,000

Step 3: Calculate Closing Deferred Tax Balance

Assuming a **corporate tax rate of 30%** (standard for ICAN examples):

Deferred Tax Closing Balance = 30% × 50,000= ₦15,000

Step 4: Determine movement in deferred tax

Description	**₦**
Opening Deferred Tax Liability	12,000
Closing Deferred Tax Liability	15,000
Movement in the Year (to Income Statement)	**+3,000**

Step 5: Complete the proforma

Deferred tax movement schedule	**₦**
Opening balance	12,000
Transfer to income statement (balancing figure)	**3,000**
Closing Balance (as calculated)	15,000

Step 6: Journal entry to record deferred tax movement

	Debit	Credit
		₦
Income Tax Expense (P/L)	3,000 (Debit)	
Deferred Tax Liability (SFP)		3,000 (Credit)

Strategic Insight for Strategic Business Reporting candidates:

a) Always identify **all sources of temporary differences** — both taxable and deductible.
b) The net movement is recorded in the **statement of profit or loss**, unless it relates to other comprehensive income or equity.
c) Use **clear workings** to support your figures, especially in exam questions requiring journals and analysis.

13.4.4 Sources and examples of temporary differences

A. Understanding temporary differences

Temporary differences arise when the **recognition or measurement** of income, expenses, assets, or liabilities differs **between IFRS accounting rules** and **tax rules**, resulting in **timing mismatches** in profit recognition for accounting and tax purposes.

Common causes include:

1. **Income or expense** that is recognised in one period for accounting but in a different period for tax.
   - E.g., income taxed on **cash basis** but recognised under **accruals basis** for accounting.
   - E.g., depreciation differences: **accounting depreciation ≠ capital allowance**.
2. **Revaluation of assets** where the **tax base remains unchanged**, creating temporary differences between accounting and tax carrying values.

B. Deferred tax liabilities – Recognition examples

Example 1: Interest receivable (cash basis taxation)

a) **Scenario**: A plc recognises interest receivable of ₦600,000 in its financial statements.
b) **Tax rule**: Income is taxed only when cash is received.
c) **Tax base**: ₦0
d) **Temporary difference**: ₦600,000
e) **Deferred tax liability @ 30%** = ₦180,000

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Asset	Carrying amount	Tax base	Temporary difference	DTL @ 30%
Interest receivable	600,000	0	600,000	180,000

Example 2: Capitalised development costs

a) **Scenario**: B plc capitalises development costs of ₦320,000 with ₦15,000 amortised in the year.
b) **Carrying amount**: ₦305,000
c) **Tax Rule**: Costs are deductible only when paid.
d) **Tax base**: ₦0
e) **Temporary Difference**: ₦305,000
f) **Deferred Tax Liability @ 30%** = ₦91,500

Asset	Carrying Amount	Tax Base	Temporary Difference	DTL @ 30%
Development Costs	305,000	0	305,000	91,500

Example 3: Non-current assets (depreciation differences)

a) **Scenario**: C plc has a non-current asset with cost ₦5,000,000 and accumulated accounting depreciation of ₦2,250,000.
b) **Carrying amount** = ₦2,750,000
c) **Tax depreciation to date** = ₦3,000,000 → **Tax base** = ₦2,000,000
d) **Temporary Difference** = ₦750,000
e) **Deferred Tax Liability @ 30%** = ₦225,000

Asset	Carrying Amount	Tax Base	Temporary Difference	DTL @ 30%
Equipment	2,750,000	2,000,000	750,000	225,000

C. Deferred tax assets – Recognition examples

Example 4: Warranty Provision (IAS 37)

a) **Scenario**: D plc recognises a provision of ₦100,000 for future warranty costs.
b) **Tax Rule**: Tax deduction allowed only when actually paid.
c) **Tax base**: ₦0
d) **Temporary Difference**: ₦100,000
e) **Deferred Tax Asset @ 30%** = ₦30,000

Liability	Carrying amount	Tax base	Temporary difference	DTA @ 30%
Warranty Provision	100,000	0	100,000	30,000

Example 5: Expensed research costs

a) **Scenario**: E plc incurs ₦500,000 in research costs, expensed under IAS 38.
b) **Tax Rule**: Tax relief allowed **later**.
c) **Carrying Amount** = ₦0 | Tax Base = ₦500,000
d) **Temporary Difference** = ₦500,000
e) **Deferred Tax Asset @ 30%** = ₦150,000

Asset	Carrying amount	Tax base	Temporary difference	DTA @ 30%
Research costs	0	500,000	500,000	150,000

D. Key strategic insights for Strategic Business Reporting candidates

Deferred tax liability (DTL) arises when **taxable temporary differences** exist:

- *Accounting income > taxable income temporarily*

Deferred tax asset (DTA) arises from **deductible temporary differences**:

- *Taxable income > accounting income temporarily*

A temporary difference can exist even when **there is no asset or liability in the financial statements**.

- For example, research costs with zero carrying amount but future deductible tax base.

Comparison table: Deferred tax liabilities (DTL) vs deferred tax assets (DTA)

Criteria	Deferred tax liability (DTL)	Deferred tax asset (dta)
Definition	Arises when **taxable temporary differences** exist — the accounting profit exceeds taxable profit for a period.	Arises when **deductible temporary differences** exist — the taxable profit exceeds accounting profit for a period.
Cause	Items are taxed **later** than recognised in accounting (e.g., income received in advance, excess capital allowance).	Items are taxed **earlier** or expenses are deductible **later** than recognised in accounting (e.g., warranty provisions, unpaid expenses).
Tax effect	Results in **future tax payable**.	Results in **future tax recoverable**.
Typical examples	- Excess capital allowances over accounting depreciation	

Summary of deferred tax – Practical notes for Strategic Business Reporting candidates

Typical examples of temporary differences

Deferred tax liabilities (DTL)	Deferred tax assets (DTA)
Excess capital allowances over accounting depreciation	Accrued expenses deductible only when paid
Accrued income taxable on cash basis	Provisions (e.g., warranty, restructuring) not deductible yet
Revalued assets where no equivalent tax base adjustment	Tax losses carried forward, if future utilisation is probable

Journal entries (Origination)

For deferred tax liability:

Debit: Income Tax Expense (Profit or Loss)

Credit: Deferred Tax Liability (Statement of Financial Position)

For deferred tax asset:

Debit: Deferred Tax Asset (Statement of Financial Position)

Credit: Income Tax Expense (Profit or Loss)

Presentation in financial statements

Component	Presentation
Deferred tax liability	Under **non-current liabilities**
Deferred tax asset	Under **non-current assets** (*only if recovery is probable*)

Impact on profit or loss

Effect	Explanation
DTL	**Increases** income tax expense (i.e., additional charge)
DTA	**Decreases** income tax expense (i.e., tax credit)

Reversal of deferred tax

When deferred tax liability reverses	When deferred tax asset reverses
When the related income is taxed or asset is recovered	When the **related expense is paid** or becomes deductible
E.g., income previously accrued is now taxed	E.g., provision becomes deductible when cash is paid

Tip for Strategic Business Reporting candidates:

Always analyse the **timing** and **tax treatment** of transactions. Deferred tax is not about *what* is taxed but *when* it is taxed. Your goal is to **match tax effects to the same period as the underlying transaction**.

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When tackling deferred tax questions, always:

a) Compare **carrying amount vs tax base**;
b) Identify whether the difference is **taxable or deductible**;
c) Apply the **correct tax rate**; and
d) Determine whether it creates a **DTL or DTA** and the correct **journal entry**.

13.5 Recognition and measurement rules

13.5.1 Recognition of deferred tax liabilities

IAS 12: Recognition of deferred tax liabilities – Exceptions and practical applications

A. General principle

IAS 12 requires that **deferred tax liabilities** be recognised for **all taxable temporary differences**.

However, there are **two key exceptions** where a deferred tax liability is **not recognised**:

No deferred tax is recognised if:

a. The temporary difference arises from the **initial recognition of goodwill** (in a business combination).
b. The temporary difference arises from the **initial recognition of an asset or liability** in a transaction that:
   - **Is not a business combination**, and
   - **Does not affect accounting profit or taxable profit** at the time of the transaction.

B. Exception 1: Initial recognition of goodwill

Concept

a) Goodwill is usually generated through **business combinations**.
b) Tax authorities often **do not recognise goodwill** as an asset.
c) Hence, goodwill has a **tax base of nil**, resulting in a **temporary difference**.
d) Despite this, **IAS 12 prohibits recognising deferred tax liabilities** for this initial difference.

Why?

- Recognition of a deferred tax liability on goodwill would increase the goodwill amount itself, creating a **circular accounting issue**.

Example 1: Group goodwill (business combination)

A Plc acquires 80% of another company and recognises goodwill of ₦100,000.

a) Carrying amount = ₦100,000
b) Tax base = ₦0
c) Temporary difference = ₦100,000
d) Tax rate = 30%
e) **Deferred tax = Nil (due to IAS 12 exception)**

Goodwill	Carrying amount	Tax base	Temporary difference	Deferred tax
Group Goodwill	100,000	0	100,000	Nil (exception applies)

Example 2: Goodwill in separate entity (e.g. partnership or "LLP")

B Plc acquires a partnership and recognises goodwill of ₦100,000.

a) Here, the goodwill is recognised for tax purposes.
b) Carrying amount = ₦100,000
c) Tax base = ₦100,000
d) **No temporary difference → No deferred tax**

Goodwill	Carrying amount	Tax base	Temporary difference	Deferred tax
Recognised goodwill	100,000	100,000	Nil	Nil

In some jurisdictions where goodwill is tax deductible, the exception may not apply.

C. Exception 2: Initial recognition of asset or liability (outside business combination)

Concept

- Sometimes, a **taxable or deductible temporary difference** arises at initial recognition.
- If this happens **outside a business combination**, and the transaction **does not affect accounting or taxable profit**, **deferred tax is not recognised**.

Example 3: Loan arrangement cost (transaction affects profit)

C Plc lends ₦100,000 to another company and incurs arrangement costs of ₦5,000.

- Recognised at ₦105,000 (carrying amount)
- Tax base = ₦100,000 (tax allows ₦5,000 deduction immediately)
- Temporary difference = ₦5,000
- **Deferred tax = ₦1,500 (recognised)**
- Exception does **not** apply because the transaction **affects taxable profit**.

If the transaction is not a business combination, and affects neither accounting profit nor taxable profit, deferred tax would normally be recognised but the exception prohibits it.

Example 4: Asset outside the tax system (transaction does not affect profit)

In the year ended 31 December 2018, 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.

D Plc acquires an asset for ₦100,000 with no tax depreciation available.

- Tax base = ₦0
- Carrying amount = ₦100,000 ⟶ Temporary difference = ₦100,000
- **Deferred tax = Nil (exception applies)**

Year	Carrying amount	Tax base	Temporary difference	Deferred tax
Initial recognition	100,000	0	100,000	Nil (due to exception)
After 1 Yyar	80,000	0	80,000	Nil (still covered by the exception)

The exception continues to apply as long as the difference relates to the **initial recognition** of an asset in a transaction that does not affect profit or loss.

D. Strategic insight for Strategic Business Reporting candidates

Key question	Yes	No
Is it a taxable temporary difference?	Consider deferred tax	—
Does it arise from initial recognition of goodwill?	**Do not recognise** deferred tax	—
Is it from initial recognition of other asset/liability not in a business combination AND does not affect profit?	**Do not recognise** deferred tax	Recognise deferred tax

IAS 12 promotes a principle-based approach to deferred tax. Candidates must not only apply formulae but also understand **when not to recognise** deferred tax, especially in cases of **goodwill** and **initial recognition exemptions**.

13.5.2 Recognition of deferred tax assets

IAS 12: Recognition of deferred tax assets

Principles, exceptions, and measurement guidance

A. Recognition principles for deferred tax assets (DTA)

IAS 12 requires that a **deferred tax asset** must be recognised for **all deductible temporary differences only** to the extent that it is **probable** that taxable profits will be available against which the deductible difference can be utilised.

However, **deferred tax assets are not recognised** in the following circumstances:

Exceptions (IAS 12)

A deferred tax asset should not be recognised if the deductible temporary difference arises from the **initial recognition of an asset or liability** in a transaction that:

- **Is not a business combination**, and
- **At the time of the transaction**, affects **neither accounting profit nor taxable profit**.

B. Comparison: Recognition of deferred tax liabilities vs assets

IAS 12 Treatment	Deferred tax liabilities	Deferred tax assets
Recognition rule	Recognised **in full** for all taxable temporary differences (except specific exceptions)	Recognised **only if probable** that future taxable profit will be available
Common issue	Automatically recognised	Requires **probability test**
Review requirement	No further test required once recognised	Must be reviewed **at each reporting date** for continued recoverability

13.5.3 Review and reassessment of DTA

IAS 12 requires that at each reporting date, the **carrying amount of a deferred tax asset** be reassessed to determine if sufficient **future taxable profits** are still probable. If not:

- The DTA must be **reduced** to the amount expected to be recoverable.
- If circumstances later change, the **previously reduced amount may be reinstated**.

Temporary differences – Non-taxable or permanent items

A **temporary difference** arises only when there is a **timing difference** between the carrying amount and tax base -- **and** the item will be **taxable or deductible in the future**.

If an item is **never taxable or deductible**, it results in a **permanent difference**, and no deferred tax should be recognised.

Example: Permanent difference – Non-taxable income

Scenario:

E Plc recognises ₦100,000 income as a receivable in accounting profit. The income is **not taxable** at any point.

Asset	Carrying amount	Tax base	Temporary difference
Receivable	100,000	100,000	Nil

- Result: No deferred tax arises. Although a difference exists, it is **permanent**, not temporary.

Tax base guidance in IAS 12

IAS 12 provides clarity on how to compute the **tax base**:

- **Asset**:
  Tax base = Amount deductible for tax in future periods.
- **Liability**:
  Tax base = Carrying amount **less** any future amounts **not taxable** (e.g., income received in advance that will not be taxed).

Closing guidance and final reminders

Key Point

There is **no deferred tax** on items that are **not taxable or deductible**, even if a difference appears to exist in the carrying amount and tax base.

13.5.4 Measurement of deferred tax

a) **Do not discount** deferred tax assets or liabilities.
b) Measure using the **tax rates** that are enacted or substantively enacted at the **reporting date**.
c) Apply the rate expected to apply in the period when:
   a. The asset will be **recovered**, or
   b. The liability will be **settled**.

Strategic Summary for ICAN SBR candidates:

Concept	Key treatment
Temporary vs permanent	Deferred tax is recognised **only** for temporary differences
Non-business combination asset recognition	May trigger an exception (no DTA recognised if it doesn't affect accounting or tax profit)
Probable recovery test	Always needed for DTAs
Permanent difference example	Non-taxable income or expenses that will never receive tax relief

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13.6 IAS 12 and deferred tax: Business combinations

13.6.1 Introduction

When a **parent entity acquires control** over a subsidiary, it performs a **fair value measurement** of the subsidiary's identifiable assets and liabilities. This process introduces **new temporary differences** due to changes in the **carrying amounts**, while the **tax bases** remain unchanged (i.e., still based on historical cost).

Hence, **IAS 12 requires recognition of deferred tax** for all temporary differences identified in the fair value adjustments, unless exempted.

13.6.2 Revaluation of Assets and Liabilities – Fair Value Exercise

Under IFRS 3, the acquiring entity re-measures the assets and liabilities of the acquired business to fair value. However, the **tax base remains unchanged**, leading to **temporary differences**.

These differences are recognised automatically as **deferred tax balances during consolidation**. There is **no need for a separate journal entry** — the adjustment is made as part of the **purchase price allocation (PPA)**.

Example: Fair value adjustment and deferred tax

Scenario: P Ltd acquires 100% of a subsidiary for ₦600,000 on 31 December 20X6. The subsidiary's deferred tax position before revaluation is:

Asset / liability	Book value (₦'000)	Tax base (₦'000)	Temporary difference (₦'000)
Property, plant and equipment	180	150	30
Accounts receivable	210	210	—
Inventory	124	124	—
Pension liability	(120)	(120)	—
Net temporary difference			**30**
Deferred Tax @ 30%			**9**

After fair value adjustments are made in the acquisition, the updated balances become:

Asset / liability	Fair value (₦'000)	Tax base (₦'000)	Temporary difference (₦'000)
Property, plant and equipment	270	150	120
Accounts receivable	210	210	—
Inventory	174	124	50
Pension liability	(30)	—	(30)
Accounts payable	(120)	(120)	—
Total temporary differences			**140**
Deferred Tax @ 30%			**42**

Goodwill calculation:

To complete the acquisition accounting, goodwill is calculated as follows:

	Amount (₦'000)
Cost of Investment	600
Less: Fair value of net assets acquired	(504)
Less: Deferred Tax on Fair Value Adjustments	(42)
Goodwill on Acquisition	**138**

Strategic insight for SBR candidates:

a) The **increase in deferred tax liability** from ₦9,000 to ₦42,000 is recognised **through consolidation adjustments**.
b) This increase affects the **net assets** and thus directly **reduces goodwill**.
c) The fair value exercise under IFRS 3 can cause a **significant shift in deferred tax**, and must be carefully analysed during group reporting.

Key takeaways:

Concept	Application
Fair value uplift	Creates **taxable temporary differences**
Tax base	Typically remains at **original cost**
Deferred tax	Calculated on the **difference** between fair value and tax base
Recognition	Adjustment is made **automatically** in consolidation; no separate entry
Impact	Increases deferred tax liability; reduces goodwill

IAS 12 – Special group considerations for deferred tax

13.6.3 Unremitted earnings of group companies

Concept:

When a parent acquires a subsidiary or associate, it gains a right to receive dividends from the accumulated profits of the investee. A **temporary difference** arises on the **undistributed post-acquisition profits** of the subsidiary.

IAS 12 Requirement:

Deferred tax liability must be recognised on such **unremitted earnings** because future dividend distributions will trigger tax payments.

However, deferred tax is not recognised when:

(a) The **parent controls the timing** of the reversal (i.e., can decide when to declare dividends); and

(b) It is **probable that the earnings will not be distributed** in the foreseeable future.

For **subsidiaries**, deferred tax is rarely recognised because the parent usually controls distributions.

For **associates**, the parent does **not control** distribution decisions, so **deferred tax is more commonly recognised**.

13.6.4 Unrealised profit adjustments (intra-group transactions)

Concept:

In consolidated financial statements, **profits from intra-group sales** must be **eliminated** if the goods are still held within the group at year-end. This creates a **temporary difference** because:

- The **seller pays tax** on the profit.
- But the **group has not realised the profit externally**.

Deferred tax treatment:

- IAS 12 requires deferred tax on such temporary differences.
- The deferred tax should be **measured at the buyer's tax rate** since that is the entity that will eventually reverse the temporary difference when the inventory is sold externally.

13.6.5 Change in recoverability of parent's deferred tax asset due to acquisition

Scenario:

A parent may have an **unrecognised deferred tax asset** (e.g., tax losses) if it was not previously probable that sufficient taxable profits would be available for recovery.

Business combination impact:

Following an acquisition, the **probability of recovering a deferred tax asset** may increase. This may occur if:

- The **acquirer gains access** to future taxable profits of the acquired entity.
- The acquirer can now utilise **carried forward losses or tax credits** previously deemed unrecoverable.

IAS 12 Guidance:

a) The parent should now **recognise the deferred tax asset**, reflecting the **change in circumstances** triggered by the business combination.
b) This recognition is treated as part of **business combination accounting** under IFRS 3.
c) **This adjustment does not affect goodwill**.

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13.7 AMENDMENT TO IAS 12 – Deferred Tax Related To Assets And Liabilities Arising From A Single Transaction

13.7.1 Overview of the Amendment

In May 2021, the IASB introduced revisions to **IAS 12 Income Taxes** to address inconsistencies in how the **Initial Recognition Exemption (IRE)** was applied, particularly for transactions that generate **equal taxable and deductible temporary differences**.

13.7.2 Key changes:

a. The modifications add an exception to IAS 12's IRE.
b. When using this exception, an entity does **not apply the IRE** to transactions with **equal taxable and deductible temporary differences**.
c. Applies to transactions occurring **on or after the beginning of the earliest comparative period presented**.
d. Covers:
    i. Right-of-use assets and lease liabilities;
    ii. Decommissioning obligations and associated asset costs.
e. **Effective from January 1, 2023** (earlier adoption permitted).

Existing accounting treatment (before amendment)

Under the IRE, deferred tax **is not recognised** if:

- The transaction is not a business combination; and
- It affects neither accounting nor taxable profit.

Example

FinPolNomics Green Finance purchases an intangible asset for ₦1,000 (non-deductible).

a. **Journal entry 1:**
    - Debit: Intangible asset ₦1,000
    - Credit: Cash ₦1,000

b. Journal entry 2: No action required (deferred tax not recognised).

This could result in **lack of transparency**, as assets may be overstated without showing deferred tax obligations.

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Comparative Treatment Under the Amendment

Interpretation approach	Deferred tax treatment
IRE applied separately to asset and liability	No deferred tax recognised
Considered an "integrally linked" transaction	Deferred tax must be recognised for both asset & liability

The amendment eliminates inconsistencies and enhances clarity in financial reporting.

Lease-related application of the amendment

Example scenario:

a) 5-year lease; annual payment: ₦100
b) Advance payment: ₦15; Initial direct cost: ₦5
c) Incremental borrowing rate: 5%
d) PV of lease payments: ₦433
e) RoU Asset: ₦453 (433 + 15 + 5)

Tax law context:

- Tax rate: 30%
- Tax deductions apply to **lease liability repayment**.

Deferred tax recognition breakdown

Advance lease payment and initial costs

	Carrying amount (₦)	Tax base (₦)	Temporary diff. (₦)	DTL @ 30% (₦)
Advance Payment	15	0	15	(4.5)
Initial Cost	5	0	5	(1.5)

Lease liability and RoU asset:

	Carrying Amount (₦)	Tax Base (₦)	Temporary Diff. (₦)	DTA/DTL @ 30% (₦)
Lease Liability	433	0	433 (Deductible)	DTA: 130.0
Lease Asset	433	0	433 (Taxable)	DTL: (130.0)

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Summary table:

Element of financial position (assets & liabilities)	Carrying amount (₦)	Tax base (₦)	Temp. diff (₦)	Deferred tax (₦)
Advance lease payment	15	0	(15)	(4.5)
Initial direct cost	5	0	(5)	(1.5)
RoU Isset	433	0	(433)	(130.0)
Lease Liability	433	0	433	130.0

13.7.3 Transition and implementation

a. Applies to annual periods **beginning on or after 1 Jan 2023**.
b. On transition:
   - Recognise DTA and DTL for applicable balances.
   - Recognise cumulative effect as adjustment to **retained earnings** (or other equity component).
c. Applies to **first-time IFRS adopters**.

Strategic takeaways for ICAN SBR candidates

a) Understand when the IRE **does not apply** due to the amendment.
b) Be able to **calculate deferred tax** for lease-related transactions.
c) Recognise the **impact of equal taxable and deductible differences**.
d) Distinguish treatment for:
   a. Advance lease payments
   b. Initial direct costs

RoU asset and lease liability

13.8 Presentation and disclosure

13.8.1 Presentation

A. Offset of current tax assets and liabilities

IAS 12 permits an entity to **offset** current tax assets and current tax liabilities in the statement of financial position **only if**:

a. The entity has a **legally enforceable right** to offset the recognised amounts.
b. The entity intends to:
- **Settle the amounts on a net basis**, or
- **Realise the asset and settle the liability simultaneously**.

These offsetting conditions are consistent with those in IAS 1: *Presentation of Financial Statements*.

B. Offset of deferred tax assets and liabilities

An entity must **offset deferred tax assets and liabilities only when**:

a. A **legally enforceable right** exists to offset current tax assets against current tax liabilities.
b. The deferred tax assets and liabilities:
   - Relate to **income taxes levied by the same taxation authority**, and
   - Apply either to:

- The **same taxable entity**, or
- **Different taxable entities** within the same group that:
  i. Intend to settle **on a net basis**, or
  ii. Realise the assets and settle liabilities **simultaneously** in each reporting period.

Note: The existence of a deferred tax liability supports the recognition of a deferred tax asset from the same tax authority, since it evidences future taxable profit.

Example: Offset of deferred tax assets and liabilities

Situation	Deferred tax liability (₦'000)	Deferred tax asset (₦'000)	Net balance (₦'000)
1	12,000	(8,000)	4,000 (liability reported)
2	5,000	(8,000)	(3,000) (asset reported if probable to recover)

- **Situation 1**: Offset permitted. Net liability of ₦4,000 is presented.
- **Situation 2**: Offset leads to a net asset. Recognition depends on whether it is **probable** that future taxable profits will be available to utilise the asset.

13.8.2 Disclosure

A. Disclosure of components of tax expense (income)

IAS 12 requires that the **major components of tax expense (or income)** be disclosed **separately** in the financial statements. These include:

a) Current tax expense or income
b) Adjustments for under/over-provision of tax in prior periods
c) Deferred tax expense/income arising from:
   a. Origination and reversal of temporary differences
   b. Changes in tax rates or laws
d) Deferred tax arising from unrecognised tax losses or credits now recognised
e) Deferred tax impacts from the write-down or reversal of a deferred tax asset
f) Tax impacts of corrections of prior period errors and changes in accounting policies (under IAS 8)

Illustration: Taxation note to statement of comprehensive income

Taxation expense	Amount (₦'000)
Current tax	129,000
Adjustment for over-estimate of prior year	(5,000)
Deferred taxation:	
- Arising during the period	20,000
- Due to change in tax rate	(5,000)
Total Tax Expense	**139,000**

Strategic Insight for SBR Candidates

Focus Area	Exam-ready understanding
Offset rules	Must meet both **legal enforceability** and **intent to settle net/simultaneously**
Net DTA reporting	Allowed only if **probable** that the deferred tax asset will be recovered
Disclosure	Clearly itemise current and deferred components, and note the effect of changes in tax rates, laws, and prior period corrections

13.8.3 IAS 12 – Tax reconciliation and other disclosures

Tax reconciliation

Disclosure requirements:

Entities must provide a clear explanation of the relationship between **accounting profit** and **tax expense (income)** through:

a. **Numerical reconciliation**:
- Between the **tax expense** and the **product of accounting profit × applicable tax rate(s)**, stating the basis for computing the applicable tax rate(s); **or**
- Between the **effective tax rate** and the **applicable tax rate**, also explaining the computation basis.

b. **Explanation of tax rate changes**:
- Entities must disclose the **reason and impact** of any changes in the applicable tax rate(s) compared to the previous accounting period.

Example: Tax reconciliation (with permanent difference)

Scenario:

(i) B Plc's accounting profit: ₦500,000
(ii) Includes ₦20,000 **non-taxable income**
(iii) Accounting depreciation: ₦100,000
(iv) Tax allowable depreciation: ₦150,000
(v) Applicable tax rate: 30%

Computation:

Taxable Profit:

Description	**₦**
Accounting Profit	500,000
Add back: Depreciation	+100,000
Less: Non-taxable income	(20,000)
Assessable Profit	580,000
Less: Capital Allowances	(150,000)
Taxable Profit	**430,000**

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Tax Expense:

Component	**₦**
Current Tax (430,000 × 30%)	129,000
Deferred Tax (on TD of ₦50,000 × 30%)	15,000
Total Tax Expense	**144,000**

Reconciliation Formats

In absolute terms:

	₦
Accounting profit	**500,000**
Applicable tax rate	30%
Expected Tax (500,000 × 30%)	150,000
Adjustment for non-taxable income (30% × ₦20,000)	(6,000)
Tax Expense	**144,000**

In percentage terms:

Description	**%**
Applicable Tax Rate	30.0%
Adjustment for Permanent Difference	(1.2%)
Effective Tax Rate	**28.8%**

The difference between the applicable and effective rate highlights the **impact of permanent differences** (non-taxable income).

Other disclosure requirements

1. **Tax consequences of dividends**

   Entities must disclose the **income tax impact of dividends** proposed or declared **after year-end** but **before financial statements are authorised**, even if they are **not recognised as liabilities**.

2. **Deferred tax asset recognition**

   Disclosure is required when the recognition of a **deferred tax asset** is based on **judgement** or **uncertain recoverability**, especially when:

   a. **Future taxable profits** are needed **in excess** of those from reversing taxable temporary differences; and
   b. The entity has **incurred a loss** in either the current or preceding period in the same tax jurisdiction.

These disclosures provide transparency around assumptions made in recognising deferred tax assets and potential reversals.

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13.9 Chapter review – IAS 12: Income taxes

This chapter provided a comprehensive and strategically grounded exposition of IAS 12 – *Income Taxes*, exploring both current tax and deferred tax principles and their practical implications for financial reporting, including the recent amendments relevant to single transactions and business combinations.

Key takeaways for Strategic Business Reporting candidates

1. Nature and components of income tax

- Understand the distinction between **accounting profit** and **taxable profit**.
- Recognise that **income tax expense** comprises two components:
  - **Current tax**: based on taxable profit per tax laws.
  - **Deferred tax**: based on temporary differences between accounting and tax treatments.

2. Temporary differences: Core concept

- **Temporary differences** arise when the carrying amount of an asset or liability differs from its tax base.
- Classified into:
  - **Taxable temporary differences** → lead to deferred tax liabilities.
  - **Deductible temporary differences** → lead to deferred tax assets.

3. Recognition and measurement rules

Deferred tax liabilities are generally recognised for all taxable temporary differences unless:
- It relates to goodwill (initial recognition).
- It arises from transactions not affecting accounting or taxable profit (outside business combinations).

Deferred tax assets are recognised only if it is **probable** that taxable profits will be available to utilise them.

Measured using tax rates that are **enacted or substantively enacted** at the reporting date (not discounted).

4. Presentation and disclosure

- Deferred tax assets and liabilities may only be offset if:
  - There is a **legally enforceable right**, and
  - The taxes relate to the **same authority** and **settlement is expected to be simultaneous**.

- Disclosures must:
  - Break down current and deferred tax.
  - Explain changes in rates, under/overprovisions, and reconcile tax expense with profit.

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Business combinations and deferred tax

a) Deferred tax must be recognised on **fair value adjustments** in acquisitions.
b) Deferred tax on **unremitted earnings** is recognised **unless** the parent controls the timing and is unlikely to reverse.
c) **Unrealised intra-group profits** create temporary differences, with deferred tax measured at the **buyer's tax rate**.
d) A change in the **recoverability of the parent's deferred tax asset** due to acquisition is recognised (does not affect goodwill).

6. Amendments on single transactions (Effective 1 January 1, 2023)

a) The **initial recognition exemption (IRE)** no longer applies to transactions giving rise to **equal and opposite temporary differences** (e.g., RoU assets and lease liabilities, decommissioning obligations).
b) Entities must now recognise **both DTA and DTL**, even at initial recognition.
c) Affects lease accounting under IFRS 16 and similar setups.

Strategic insights for examination and practical application

a) Tax accounting is not merely computational—it demands **judgment** in assessing **timing**, **probability**, and **reversal patterns**.
b) Always distinguish between **temporary** and **permanent** differences—only the former qualify for deferred tax treatment.
c) In group accounting, understand how tax affects **goodwill**, **PPA adjustments**, and **intragroup eliminations**.
d) Leverage the **statement of financial position perspective** in computing deferred tax under IAS 12.

Before moving to the next chapter, check that you can:

a. Explain the distinction between current tax and deferred tax?
b. Identify and compute temporary differences?
c. Recognise when deferred tax should or should not be recognised?
d. Apply the liability method to determine deferred tax balances at future tax rates?
e. Account for deferred tax in business combinations and group scenarios?
f. Analyse the implications of the recent IAS 12 amendment on leases and decommissioning?
g. Reconcile income tax expense with accounting profit in line with disclosure requirements?

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13.11 End of chapter questions and suggested solutions

13.11.1 Questions

Question 1:

Faramola Plc — Accounting and tax computation scenario

Background information:

a. Faramola Plc commenced business operations on **1 January 2021**.
b. The company invested an **initial capital of ₦1 million** in the acquisition of **Plant and Equipment**.
c. The company's activities during the early years (2021 to 2024) are minimal, resulting in **stable accounting profits** of **₦400,000 per annum**.
d. The accounting profit is **after deducting** all operational costs, including **depreciation**.
e. The **depreciation policy** applies a **straight-line basis** over **4 years**.
f. The **Inland Revenue Service (IRS)** allows **Capital Allowances** on the plant as follows:
    i. **50%** in Year 1,
    ii. **30%** in Year 2, and
    iii. **20%** in Year 3, based on the original cost.
g. The **corporate tax rate** is fixed at **40%** throughout the period.

Required:

(a) Calculate the **current taxes**: **current tax liabilities** for each relevant year (2021 to 2024).
(b) Compute the **deferred tax balances** (assets or liabilities) for each year.
(c) Determine the **total income tax expense or income** to be recognised in the statement of comprehensive income for each year.
(d) Calculate the **effective tax rate** for each year and explain any variations observed between accounting profit and total tax expense.

Question 2: Farayola Plc — Accounting and tax computation Scenario

Background information:

a. Farayola Plc commenced business operations on **1 January 2021**.
b. The company invested an **initial capital of ₦1 million** in the acquisition of **Plant and Equipment**.
c. The company's activities during the early years (2021 to 2024) are minimal, resulting in **stable accounting profits** of **₦400,000 per annum**.
d. The accounting profit is **after deducting** all operational costs, including **depreciation**.
e. The **depreciation policy** applies a **straight-line basis** over **4 years**.

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f. The **Inland Revenue Service (IRS)** allows **Capital Allowances** on the plant as follows:
   i. **50%** in Year 1,
   ii. **30%** in Year 2, and
   iii. **20%** in Year 3, based on the original cost.

g. The **corporate tax rate** is **40%**, and as of year-end 31 December 2022 the government has approved and communicated the new tax rate effectively from the financial year-ended 31 December 2023.

Required:

(a) Calculate the **current tax liabilities** for each relevant year (2021 to 2024).
(b) Compute the **deferred tax balances** (assets or liabilities) for each year. Determine the **total income tax expense or income** to be recognised in the statement of comprehensive income for each year.
(c) Calculate the **effective tax rate** for each year and explain any variations observed between accounting profit and total tax expense.

Question 3: IAS 12: Business Combinations (fair value adjustments and goodwill)

Background Information:

On **July 1, 2024**, **Tolaram Plc**, a listed Nigerian entity, acquired **80%** of the issued share capital of **NuroTech Ltd**, a technology-focused private company operating in the same industry, for **₦380 million**, paid in full via bank transfer.

At the acquisition date, the **net assets** of NuroTech Ltd per its accounting records were ₦400 million, summarised as follows:

Assets and liabilities	**Carrying amount (₦'000)**
Property, Plant & Equipment (PPE)	250,000
Inventory	100,000
Trade receivables	80,000
Trade payables	30,000

However, a **fair value exercise** performed at acquisition revealed the following adjustments:

(i) The fair value of PPE was **₦300 million** (i.e., a fair value uplift of ₦50 million).
(ii) The fair value of inventory was revised to **₦120 million** (increase of ₦20 million).
(iii) A previously unrecorded contingent liability of **₦10 million** was identified and must be recognised.
(iv) None of the fair value adjustments are recognised for tax purposes. Tax depreciation (capital allowance) continues to be based on the original carrying amount.

Corporate income tax rate in Nigeria is **30%**.

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Tolaram Plc recognises **non-controlling interest (NCI)** using the **proportionate share of net assets method**.

Required:

(a) Determine the **fair value of net identifiable assets** of NuroTech Ltd at the date of acquisition, clearly showing the fair value adjustments.
(b) Calculate the **deferred tax liability** arising from the fair value adjustments in accordance with **IAS 12**, and explain the rationale for its recognition.
(c) Compute the **goodwill on acquisition** to be recognised in Tolaram Plc's consolidated statement of financial position at July 1, 2024.
(d) Explain the **presentation and impact** of the deferred tax liability on the **calculation of goodwill**, and whether such deferred tax is separately recognised or absorbed into goodwill.
(e) Outline **two disclosure requirements** under IAS 12 in relation to the deferred tax liabilities recognised on business combinations.

13.11.2 **Suggested solutions**

Solution 1

Faramola Plc

Deferred Tax and Current Tax Computations for 2021–2024

Step 1: Key information extracted

Item:	Detail
Initial Investment in Plant	₦1,000,000
Annual Accounting Profit (after depreciation)	₦400,000
Depreciation Method	Straight Line over 4 years
Annual Accounting Depreciation	₦1,000,000 ÷ 4 years = ₦250,000 per year
Capital Allowances (Tax Depreciation) Rates	Year 1: 50%, Year 2: 30%, Year 3: 20%
Corporate Tax Rate	40%

Step 2: Depreciation and capital allowances schedule

Year	Accounting Depreciation (₦)	Tax Capital Allowance (₦)
2021	250,000	500,000 (50% of ₦1,000,000)
2022	250,000	300,000 (30% of ₦1,000,000)
2023	250,000	200,000 (20% of ₦1,000,000)
2024	250,000	Nil (capital allowances fully used by 2013)

Step 3: Adjusted taxable profit calculation

Year	Accounting Profit (₦)	Add back: Depreciation (₦)	Less: Capital Allowance (₦)	Taxable Profit (₦)
2021	400,000	250,000	(500,000)	150,000
2022	400,000	250,000	(300,000)	500,000
2023	400,000	250,000	(200,000)	450,000
2024	400,000	250,000	(0)	650,000

Notes:

- Add back depreciation because it is disallowed for tax purposes.
- Deduct capital allowances to compute taxable profit.

Step 4: Current tax payable

Year	Taxable profit (₦)	Current tax payable (40%) (₦)
2021	150,000	40,000
2022	350,000	140,000
2023	450,000	180,000
2024	650,000	260,000

Step 5: Deferred tax calculation

Deferred tax arises due to timing differences between accounting depreciation and capital allowances.

Temporary difference (TD) = carrying amount (accounting value) – tax base (tax value)

Carrying amount at year-end:

- ₦1,000,000 – (cumulative depreciation)

Tax base at year-end:

- ₦1,000,000 – (cumulative capital allowance claimed)

Now calculate:

Year	Cumulative accounting depreciation (₦)	Carrying amount (₦)	Cumulative capital allowances (₦)	Tax base (₦)	Temporary difference (₦)	Deferred tax liability (40%) (₦)
2021	250,000	750,000	500,000	500,000	250,000	100,000
2022	500,000	500,000	800,000	200,000	300,000	120,000
2023	750,000	250,000	1,000,000	0	250,000	100,000
2024	1,000,000	0	1,000,000	0	0	0

Movement in deferred tax (income statement effect)

- 2021: Opening Nil ⟶ Closing ₦100,000 ⟶ Increase of ₦100,000 ***(expense)***
- 2022: Closing ₦120,000 ⟶ Increase Movement of ₦20,000 ***(expense)***
- 2023: Closing ₦100,000 ⟶ Decrease Movement of ₦(20,000) ***(credit or income)***
- 2024: Closing ₦80,000 ⟶ Decrease Movement of ₦(100,000) ***(credit or income)***

Step 6: Total income tax expense/(credit)

Year	Current tax (₦)	Deferred tax movement (₦)	Total tax expense/(credit) (₦)
2021	60,000	100,000	160,000
2022	140,000	20,000	160,000
2023	180,000	(20,000)	160,000
2024	260,000	(100,000)	160,000

Step 7: Effective tax rate (ETR)

Effective tax rate (ETR) = (income tax expense/profit before taxes) × 100%

Year	Total tax expense (₦)	Accounting profit (₦)	Effective tax rate (%)
2021	160,000	400,000	40%
2022	160,000	400,000	40%
2023	160,000	400,000	40%
2024	160,000	400,000	40%

Despite temporary differences, the **effective tax rate** stabilises across the years at **40%** after deferred tax adjustments are made — demonstrating correct matching of tax effects to accounting profits.

Strategic Business Reporting insights:

a) **Current tax** relates to the taxable profit of the period.
b) **Deferred tax** adjusts for timing differences between accounting and tax rules.
c) Proper deferred tax recognition ensures a **faithful representation** of the entity's financial performance over time.
d) **Effective tax rate stability** demonstrates correct application of deferred tax principles.

Solution 2

Farayola Plc — Revised tax computation and analysis (2021 – 2024)

Context: Following the pronouncement of a change in corporate tax rate from 40% to 30% effective from 2023, and in line with the **liability method under IAS 12**, the deferred tax computations have been adjusted accordingly. Deferred tax in 2022 has been computed using the new rate of 30%, reflecting the fact that temporary differences at the end of 2022 will reverse when the new rate becomes effective.

Key Assumptions and constants

a) Initial investment in plant: ₦1,000,000
b) Accounting profit: ₦400,000 per annum
c) Depreciation: Straight-line over 4 years = ₦250,000/year
d) Capital allowances: Year 1 = 50%, Year 2 = 30%, Year 3 = 20%

- Tax rate: 40% for 2021; **30% from 2022 onwards** (for deferred tax purposes)

Step-by-step breakdown

1. Depreciation and capital allowances schedule

Year	Depreciation (₦)	Capital allowance (₦)
2021	250,000	500,000
2022	250,000	300,000
2023	250,000	200,000
2024	250,000	Nil

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2. Taxable profit and current tax

Year	Accounting profit (₦)	Add depreciation (₦)	Less capital allowance (₦)	Taxable profit (₦)	Tax rate	Current tax payable (₦)
2021	400,000	250,000	(500,000)	150,000	40%	60,000
2022	400,000	250,000	(300,000)	350,000	40%	140,000
2023	400,000	250,000	(200,000)	450,000	30%	135,000
2024	400,000	250,000	(0)	650,000	30%	195,000

3. Deferred tax computation (using 40% for 2021, 30% from 2022)

Year	Carrying Amount (₦)	Tax Base (₦)	Temp. Diff. (₦)	Tax Rate	Deferred Tax Liability (₦)	Movement (₦)
2021	750,000	500,000	250,000	40%	100,000	100,000
2022	500,000	200,000	300,000	30%	90,000	(10,000)
2023	250,000	0	250,000	30%	75,000	(15,000)
2024	0	0	0	30%	0	(75,000)

4. Total tax expense (current + deferred)

Year	Current tax (₦)	Deferred tax movement (₦)	Total tax expense (₦)
2021	60,000	100,000	160,000
2022	140,000	(10,000)	130,000
2023	135,000	(15,000)	120,000
2024	195,000	(75,000)	120,000

Solution 3 – IAS 12: Business Combinations

a) Fair Value of net identifiable assets of NuroTech Ltd

Assets & Liabilities	Carrying Amount (₦'000)	Fair Value Adjustment (₦'000)	Fair Value (₦'000)
Property, Plant & Equipment (PPE)	250,000	+50,000	300,000
Inventory	100,000	+20,000	120,000
Trade Receivables	80,000	–	80,000
Trade Payables	(30,000)	–	(30,000)
Contingent Liability	–	(10,000)	(10,000)
Total	**400,000**	**+60,000**	**460,000**

b) Deferred tax liability (DTL) on fair value adjustments

IAS 12 requires that deferred tax liabilities be recognised on all taxable temporary differences arising from fair value adjustments in a business combination, even if the acquiree had not previously recognised them.

Computation:

- **PPE adjustment**: ₦50 million
  → Temporary difference = ₦50 million (no tax base uplift)
  → DTL = ₦50m × 30% = ₦15 million
- **Inventory adjustment**: ₦20 million
  → Temporary difference = ₦20 million
  → DTL = ₦20m × 30% = ₦6 million
- **Contingent liability**: (₦10 million)
  → Recognised at fair value, but not deductible for tax until settled
  → Temporary difference = ₦10 million
  → **Deductible** difference → **Deferred Tax Asset** (DTA) = ₦10m × 30% = ₦3 million

Net deferred tax liability (DTL)

Total DTL (₦15million + ₦6million)	= ₦21million
Less: DTA on contingent liability	= (₦3million)
Net deferred tax liability	= **₦18million**

c) Goodwill on acquisition

Step 1: Consideration transferred

- Cost of investment = ₦380 million

Step 2: Net Identifiable Assets (adjusted for DTL)

a)	Fair value of net assets (from a)	= ₦460 million
b)	Less: Deferred Tax Liability	= (₦18 million)
c)	**Net adjusted assets**	= **₦442 million**

Step 3: Non-controlling interest (NCI)

- NCI (20% of ₦442 million) = ₦88.4 million

Step 4: Net assets attributable to Tolaram Plc

- 80% of ₦442 million = ₦353.6 million

Step 5: Goodwill

Goodwill = Consideration transferred − Group's share of net assets
= ₦380million − ₦353.6million= **₦26.4million**

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d) **Explanation of Deferred Tax Impact on Goodwill**

(i) Under **IAS 12 paragraph 19**, deferred tax liabilities arising from **fair value adjustments** are **recognised separately** as part of the **acquisition accounting**.

(ii) These deferred taxes **reduce the fair value of net assets acquired**, thereby **increasing goodwill**.

(iii) The deferred tax liability is **not included in goodwill**, but its **recognition indirectly inflates goodwill** due to its effect on net identifiable assets.

This treatment ensures that the tax implications of temporary differences are accounted for at acquisition, providing a more faithful representation of the net investment acquired.

e) **Disclosure Requirements (IAS 12)**

Two key disclosures relevant to this business combination include:

(i) **The amount of deferred tax liabilities and assets recognised in connection with a business combination**, as required under **IAS 12.81(g)**.

(ii) **A reconciliation of the movement in the deferred tax balances**, including amounts recognised in the profit or loss and directly in equity or OCI, as per **IAS 12.81(c)**.

Summary Recap for SBR Candidates:

a) Always assess all **fair value adjustments** for their **tax base** treatment.
b) Recognise deferred tax on temporary differences between **fair values and tax bases** at the **acquisition date**.
c) Understand that deferred tax impacts **net asset value**, thus **affecting goodwill**.
d) The use of the **proportionate method for NCI** excludes any goodwill attributable to NCI.
e) Ensure all deferred tax balances are **separately disclosed** in the group financial statements.

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Professional Level

Strategic Business Reporting

CHAPTER 14

EMPLOYEE BENEFITS: IAS 19

Contents

14.0	Learning objective
14.1	Learning outcomes
14.2	Employee benefits
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14 Employee Benefits: IAS 19

14.0 Learning objective

To provide a comprehensive understanding of IAS 19 (Employee Benefits), enabling learners to identify, classify, measure, and disclose employee benefit obligations, including short-term, post-employment, and other long-term benefits. This chapter focuses particularly on the accounting mechanics of defined benefit plans, actuarial assumptions, curtailments, settlements, and the asset ceiling test.

14.1 Learning outcomes

By the end of this chapter, learners should be able to:

a. **Explain** the scope and key principles of IAS 19, including the distinction between short-term employee benefits, post-employment benefits, and other long-term employee benefits.
b. **Differentiate** between defined contribution and defined benefit plans, and describe the accounting treatment for each.
c. **Apply** the projected unit credit method to determine the present value of a defined benefit obligation.
d. **Calculate** pension expense components: current service cost, net interest cost, past service cost, and actuarial gains or losses.
e. **Account** for settlements, curtailments, and the impact of plan amendments.
f. **Determine** the effect of the asset ceiling and apply it to limit the recognition of defined benefit assets where applicable.
g. **Prepare** journal entries related to defined benefit plans and other employee benefits in line with IFRS reporting standards.
h. **Present and disclose** employee benefit obligations appropriately in the financial statements and notes in accordance with IAS 19.

14.2 Employee Benefits (IAS 19)

14.2.1 Scope and basic principles

Definition

Employee benefits comprise every form of consideration an entity provides to employees in return for their services or for the termination of employment.

Why It matters

Entities reward staff through salaries, paid leave, bonuses, medical cover, pension promises and similar packages. IAS 19 prescribes how each promise is measured and presented, other than share-based payments which fall under IFRS 2.

Categories set out in IAS 19

Category	Typical Examples
Short-term benefits	Wages, salaries, statutory contributions, paid holiday, paid sick leave, profit-sharing, non-cash perks for current employees
Post-employment benefits	Pensions, lump-sum retirement payments, post-employment life or medical cover
Other long-term benefits	Long-service leave, sabbatical leave, long-term disability, jubilee awards
Termination benefits	Payments linked to redundancy or early retirement packages

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Accounting principle

Match the cost of providing a benefit to the period in which the employee earns that entitlement, even when the cash outflow occurs later.

IAS 19 therefore requires an entity to:

(a) **recognise a liability** once the employee has rendered service that creates a valid expectation of payment; and

(b) **recognise an expense** for the service received in the same reporting period.

Typical Journal Entry:
Debit: Employment Cost (Profit or Loss)
Credit: Employee Benefit Liability (Statement of Financial Position or Balance Sheet)

14.2.2 Short-Term Employee Benefits

Definition
Short-term employee benefits are benefits (excluding termination benefits) that an entity expects to settle wholly within twelve months after the end of the reporting period in which the employee renders the related service. Benefits expected to be settled entirely within twelve months after the end of the reporting period in which the employee provides the service.

Examples: wages, salaries, social security, paid annual leave, paid sick leave, profit-sharing payments, company-funded medical insurance or accommodation.

Core accounting principle
Match the cost of each benefit with the service period in which the employee earns it. At the reporting date:

(a) recognise **an expense** in profit or loss for the period of service;

(b) recognise **a liability** for any unpaid amount or **a prepayment** for any amount paid in advance.

Typical journal entry:

When the cost is accrued?	Journal
Accrual of wages	*Debit:* Staff costs (Profit or Loss) *Credit:* Salaries payable (Statement of Financial Position or Balance Sheet)
Payment of wages	*Debit:* Salaries payable *Credit:* Bank

Where statutory deductions (e.g. PAYE, pension contributions) apply, split the credit among the relevant payable accounts and settle each when paid to the authorities.

Recognition and measurement rules
Measurement: accrue the cost and recognise any unpaid amount as a current liability. Discounting is unnecessary because settlement is within one year.

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Scenario	Recognition point	Measurement basis
Unpaid benefits at year-end	Accrue as a liability	Undiscounted amount expected to be paid
Benefits paid in advance	Record as a prepayment	Carry amount forward and offset against future expense

No discounting is required because settlement occurs within one year.

Short-term paid absences

Type	Treatment
Accumulating	Carry unused entitlement forward. Measure the liability at the additional amount expected to be paid for unused entitlement outstanding at year-end.
Non-accumulating	No carry-forward. Expense and liability arise only when the absence occurs.

Illustrative example – Unused holiday

At 31 December 2018 an entity carries forward 50 unused days of leave. Daily wage ₦100.

Liability at December 31, 2018: 50 days × ₦100 = ₦5,000

Debit:	Staff costs	₦5,000
Credit:	Holiday pay accrual	₦5,000

Release the accrual when employees take the leave or when entitlement expires.

Short-term sick pay

When sick pay entitlement may be carried forward, measure the liability as the additional amount the entity expects to pay because of unused entitlement at the reporting date, reflecting expected usage patterns (*e.g. FIFO or LIFO basis stated in company policy*).

Illustrative example – sick leave

Entitlement unused at year-end: 10 days per employee. Based on past experience, 92 employees will use five days or fewer, eight employees will use an average of 6.5 days next year.
Additional sick pay expected: 12 days (92 employees × 0 + 8 employees × 1.5 days).
Recognise cost and liability for 12 days.

Profit-sharing and bonus schemes

Recognise an expense and liability when, and only when:

the entity has a present legal or constructive obligation arising from past events, and

a reliable estimate of the obligation can be made.

Constructive obligation

IAS 19 requires an entity to recognise not only legal obligations under the formal terms of a pension plan, but also any constructive obligation. A constructive obligation exists when the entity has created a valid expectation in employees that it will pay the benefits, and it has no practical ability to avoid the outflow. For example, a change to an informal practice that would damage employee relations is treated as unavoidable.

A constructive obligation may stem from:

(a) formal plan terms;

(b) management decisions announced before financial statements are authorised; or

(c) established practice of settling similar bonuses in the past.

No option to avoid payment is the key test. Measure the liability at the best estimate of the amount payable.

Illustrative Example – profit share

Moore Co pays three percent of net profit to employees if none have left during the year. Staff turnover is expected to reduce the payout to 2.5 percent.

Recognise expense: 2.5 percent of net profit.

Debit: Staff costs

Credit: Bonus payable

14.2.3 Termination benefits

Definition

Payments made in exchange for ending employment either through the employer's decision to terminate before normal retirement or through the employee's acceptance of an offer to leave early.

Termination benefits are benefits provided in exchange for ending employment, either:

(a) through the employer's decision to terminate before normal retirement, or

(b) through an employee's decision to accept an offer to leave early.

Recognition

Record a liability and expense at the earlier of:

(a) the date the entity can no longer withdraw the offer, or

(b) the date the entity recognises restructuring costs that involve termination payments.

Measurement

Classify and measure by nature: short-term, other long-term or post-employment, then follow the relevant IAS 19 rules for that category.

Measurement

Identify the nature of the payment and apply the appropriate IAS 19 guidance:

Nature of Benefit	Accounting Treatment
Enhancement of other post-employment benefits	Treat as part of the defined benefit or defined contribution plan
Payment expected within twelve months	Short-term employee benefit rules
Payment expected after twelve months	Other long-term employee benefit rules

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14.2.5 Other long-term employee benefits

These are all employee benefits not captured as short-term, post-employment or termination benefits, for example long-service leave or disability benefits extending beyond twelve months.

Other long-term employee benefits include every benefit that:

(a) is not a short-term benefit, a post-employment benefit or a termination benefit, and

(b) will not be settled in full within twelve months after the end of the reporting period in which the employee renders the related service.

Common examples

Category	Illustration
Long-service leave or sabbatical leave	Paid absence earned over many years, taken after a qualifying period
Deferred profit-sharing or long-term bonus plans	Bonus earned over several periods and paid two or more years later
Long-term disability benefits	Payments to employees unable to work for an extended period

Measurement

Component	Approach
Present value of the obligation	Discount future payments using a high-quality corporate bond yield (or government bond where no deep market exists).
Minus fair value of plan assets	Deduct any assets set aside to meet the obligation.

Recognise movements in the net liability or asset through profit or loss each year.

While the benefits share similarities with defined benefit pensions, IAS 19 applies a streamlined approach:

Component recognised in profit or loss	What it represents?
Service cost	Benefit earned in the current period
Net interest on the net liability (or asset)	Unwinding of the discount and return on plan assets
Remeasurement of the liability (or asset)	Actuarial gains and losses plus any return on plan assets above or below the discount rate

There is **no** separate presentation in other comprehensive income. Everything goes through profit or loss.

Journal Entry
Debit: Staff costs – service cost
Debit: Finance cost – net interest
Debit: Staff costs – remeasurement loss
Credit: Other long-term benefit liability
Credit: Staff costs – remeasurement gain

Plan assets (*brief reminder*) – see more in 14.3 "Post-Employment Benefits"
Plan assets for any employee benefit plan must be held by a legally separate fund and be unavailable to the entity's own creditors. Insurance policies qualify only when they exactly match the benefit terms.

14.3 Post-employment benefits

14.3.1 What the standard covers

Post-employment benefits are promises an entity settles after the employee has stopped working. They exclude termination benefits and short-term benefits. The most common example is a retirement pension, although life assurance or medical cover may also be provided.

A **post-employment benefit plan** may be formal or informal. IAS 19 classifies plans into:

Plan type	Key feature	Risk borne by:	Typical example
Defined contribution plan (DCP)	Employer pays fixed contributions into a separate fund and has no further legal or constructive duty	Employee	Statutory pension scheme where the employer pays ten per cent of basic pay each month
Defined benefit plan (DBP)	Employer guarantees a specified level of benefit, usually linked to final salary and years of service	Employer	Final salary pension paying one-sixtieth of final salary for each year of service

14.3.2 Defined contribution plans (DCP)

Accounting treatment (*Straightforward Accrual Basis*):
(a) **Expense** the contributions due for the period in profit or loss.
(b) **Liability** for any unpaid contributions at the reporting date.
(c) **Prepayment** for any contributions paid in advance.

Example:

Journal at Each Month-End:

Debit:	Staff costs	xx	
Credit:	Pension payable (net pay ledger)		xx

Payment to the fund:

Debit: Pension payable xx
Credit: Bank xx

No actuarial assumptions or discounting are required because the entity has no further obligation once the contribution is paid.

14.3.3 Defined benefit plans (DBP)

Under a DBP the employer promises a specified pension. The employer must ensure sufficient assets exist to meet that promise, so actuarial techniques and discounting are necessary.

Core measurement steps

Step	Description
1	**Estimate the defined benefit obligation (DBO)**: present value of future payments, using demographic and financial assumptions (mortality, salary growth, discount rate).
2	**Measure plan assets at fair value** at the reporting date.
3	**Calculate the net position**: DBO less plan assets gives either a liability (deficit) or an asset (surplus).
4	**Apply the asset ceiling**: recognise the lower of the surplus and the present value of available economic benefits (refunds or future contribution reductions).

Components recognised

Recognised in profit or loss	Recognised in other comprehensive income
Service cost (current, past, curtailments and settlements)	Remeasurements (actuarial gains and losses, return on plan assets excluding interest, change in effect of asset ceiling)
Net interest on the net liability or net asset	–

Typical current year journal

Debit:	Staff costs – service cost		xx
Debit:	Finance cost – net interest		xx
Debit:	OCI – actuarial remeasurement loss	xx	
	Credit: Pension liability (*or Debit if surplus*)		xx
Credit:	OCI – actuarial remeasurement gain	xx	

14.3.4 Role of the actuary in pension planning and accounting

An **actuary** is a specialised financial professional trained to assess and manage the financial implications of **risk and uncertainty**, particularly over long-term horizons. In the context of **pension plans**, actuaries provide expert advice to companies on how best to manage and fund their pension obligations.

The actuary advises on contribution levels and estimates the DBO using professional judgement about mortality, staff turnover, salary progression and investment returns. Because estimates change, the plan can be in surplus or deficit each time it is remeasured.

A key responsibility of the actuary is to advise the employer on the **appropriate level of annual contributions** required to ensure that the pension fund remains sufficiently funded to meet future payment obligations to retired employees.

This advice is based on a range of forward-looking estimates and assumptions, including:
(a) **Average life expectancy** of pensioners,
(b) **Length of service** at retirement,
(c) **Final salary** levels,
(d) And the **expected investment returns** on pension assets.

The actuary estimates demographic and financial variables such as mortality, staff turnover, salary growth and investment returns. These assumptions drive the valuation of the DBO. As new information emerges, remeasurements arise that pass through OCI.

Due to the long-term nature and inherent uncertainties of these assumptions, it is rare that actual outcomes perfectly align with forecasts. As such, companies may periodically discover a **surplus or deficit** when comparing:
(a) The **value of the pension fund's assets**, and
(b) The **present value of the employer's pension obligations**.

14.3.5 Understanding pension fund positions:

(a) **Deficit**: Arises when the value of future pension obligations exceeds the value of the pension fund assets.
(b) **Surplus**: Occurs when the pension fund's assets exceed the projected pension liabilities.

Company responses to surplus or deficit:

(a) In cases where the company believes the imbalance is **temporary**, it may choose **not to take immediate action**, anticipating that actuarial assumptions will balance out over time.
(b) If the **fund is in deficit**, the company might address it by making **additional contributions**, although this may not be immediate or lump-sum.
(c) If the **fund is in surplus**, the company may:
  (i) **Pause contributions** temporarily (commonly referred to as a "**pension holiday**"), or
  (ii) Seek to **withdraw the surplus** (subject to regulatory and trust deed provisions), thereby using it for corporate benefit.

Multi-employer and state plans (*brief Note*)
If sufficient information is unavailable to apply the DBP model, treat the plan as a DCP. Disclose the reason and describe any contractual funding obligations.

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14.3.6 Defined benefit pension plans – An accounting overview

Nature of the arrangement
A defined benefit pension plan is a separate legal entity that holds assets dedicated to paying employees' retirement benefits. Although the plan is distinct, the sponsoring company retains the legal responsibility to honour the promised pensions.

Presentation in the statement of financial position
The reporting entity must show a single net figure for the plan:

(a) **Defined benefit obligation (DBO)**: the present value of expected future payments for service already rendered, calculated by an actuary using the projected unit credit method and a high-quality corporate bond rate.

(b) **Plan assets (PA)**: investments held in the fund, measured at fair value.

Net defined benefit position = Defined benefit obligation (DBO) *minus* plan assets (PA)

If the plan is in surplus, recognise the lower of :

(a) the surplus, and

(b) the **asset ceiling**, being the present value of economic benefits available as refunds or reductions in future contributions.

Movements during the year
IAS 19 analyses changes in the net position into items taken to profit or loss and items taken to other comprehensive income (OCI).

Movement	Where recognised	Explanation
Current service cost	*Profit or loss*	Benefit earned in the current period.
Past service cost (plan amendment or curtailment)	*Profit or loss*	Immediate impact of improving or reducing benefits for past service.
Net interest on the net liability or asset	*Profit or loss*	Opening net position multiplied by the discount rate.
Settlements	*Profit or loss*	Transactions that eliminate further obligations, apart from direct benefit payments.
Remeasurements: actuarial gains or losses, return on plan assets in excess of interest, change in effect of asset ceiling	*OCI*	Reflect changes in assumptions, experience variances and investment performance.

Benefit payments reduce both the DBO and plan assets and therefore do not affect the net position.

Typical reconciliation schedule

	Debit	Credit
Opening Net Defined Benefit Liability/(Asset)	–	–
Current service cost	Debit: Staff costs	
Past service cost/curtailment	Debit: Staff costs	
Net interest expense	Debit: Finance cost	
Net interest income		Credit: Finance cost
Remeasurement loss	Debit: OCI	
Remeasurement gain		Credit: OCI
Contributions paid		Credit: Bank
Benefits paid	*(Contra entry)*	*(Contra entry)*
Closing net defined benefit liability/(Asset)	–	–

Plan assets – Composition and year-end reconciliation

Typical Investments	Why Included
Listed shares	Growth and dividend income
Government and corporate bonds	Stable interest returns
Treasury bills and money-market instruments	Liquidity management
Real-estate investment trusts (REITs) or property funds	Inflation hedge
Qualifying insurance policies	Match benefits with guaranteed payouts

IAS 19 requires plan assets to be measured at **fair value** at each reporting date.

Illustration of the year-end roll-forward

	₦'000
Fair value at 1 January	1,000
+ Interest income (expected return)	105
+ Contributions (employer and employees)	300
− Benefits paid to retirees	(120)
− Settlements on curtailment	(30)
Expected fair value at December 31	**1,255**
Actual fair value at December 31 (By Portfolio Valuation)	**1,300**
Remeasurement gain (***to OCI***)	**45**

The difference between actual and expected return is presented as a remeasurement in other comprehensive income.

Defined Benefit Obligation – Measurement and Reconciliation

IAS 19 uses the **projected unit credit method** to discount future benefit payments that relate to completed service.

	₦'000
Present value of obligation at 1 January	**1,000**
+ Current service cost	130
+ Interest cost (using discount rate)	100
+ Past service cost (if any)	40
− Benefits paid	(120)
− Settlements from curtailment	(25)
Expected PV of DB Obligation at December 31	**1,125**
Actual PV of DBO at December 31 (By Actuarial Report)	**1,280**
Remeasurement loss *(to OCI)*	**155**

Benefit payments reduce both the obligation and plan assets, so they do not affect the net position.

Selecting the discount rate

(a) **Primary reference**: yield on high-quality government bonds of a maturity consistent with the average remaining life of the plan.

(b) **If no suitable government bonds exist**: use the yield on high-quality corporate bonds of similar maturity.

The chosen rate must reflect conditions at the reporting date.

Benefits paid, settlements and curtailments

(a) **Benefits paid**: routine pension or lump sum payments to retirees. They reduce the DBO and plan assets and have no direct impact on profit or loss.

(b) **Settlement**: a transaction that eliminates further obligations, for example by paying a lump sum to transfer the liability to an insurer. Recognise the gain or loss in profit or loss when the settlement occurs.

(c) **Curtailment**: a significant reduction in employees covered, such as a plant closure. Recalculate the net liability immediately, recognise past service cost, and update assumptions for the remainder of the period.

Journal for a settlement:

Debit: Defined benefit obligation (DBO) [*With the present value by actuary*]		xx	
Credit: Plan assets (PA) [*with the fair value of assets transferred*]			xx
Debit/Credit:	Bank [*with the cash received or paid*]	xx	xx
Debit/Credit:	Profit orlLoss (***balancing figure***	xx	xx

Current service cost

This is the increase in the present value of DBO attributable to employee service in the current period. Recognise staff costs within profit or loss.

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Illustrative example – Gratuity plan and IAS 19 calculations

Given that ABC Ltd in its conditions of employment for the "X" says, after 5 years of service in the company, the employee qualifies for gratuity, which will be paid upon final exit as thus:
Gratuity = *10% × Years of service × Final annual salary*

Question 1:

Kindly estimate the Gratuity, if Mr. X had retired at:

(a) Year 7, when his salary was ₦10 million
(b) Year 10, when the salary was ₦12 million
(c) Year 11, when the salary was ₦13 million
(d) Year 12, when the salary was ₦13 million

Question 2: Based on question 1, kindly determine the "current service cost" for year 11 & Year 12 respectively.

Plan rules:

- Benefit formula: gratuity = 10 % × completed years of service × final annual salary.
- Eligibility: employee qualifies after five years' service.
- Benefit is paid on retirement or exit from the firm.
- Discounting is ignored for simplicity (short illustration).

Year of hypothetical retirement	Completed service (Years)	Final salary ₦	Gratuity obligation ₦
7	7	10,000,000	7,000,000
10	10	12,000,000	12,000,000
11	11	13,000,000	14,300,000
12	12	13,000,000	15,600,000

Current service cost (CSC)

Under the projected unit credit method, the CSC for a period equals the **incremental** increase in the present value of the defined benefit obligation that arises from employee service in that period.

Year	Obligation @ Start ₦	Obligation @ End ₦	CSC Recognised in Profir or Loss ₦
11	12,000,000	14,300,000	**2,300,000**
12	14,300,000	15,600,000	**1,300,000**

Journal each year:

Year	Obligation @ Start ₦	Debit ₦	Credit ₦
11	Debit: Staff costs – current service cost	2,300,000	
	Credit: Defined benefit obligation	15,600,000	2,300,000
12	Debit: Staff costs – current service cost	1,300,000	
	Credit: Defined benefit obligation		1,300,000

Past Service Cost (Plan Amendment)

Assume management amends the plan in year 12, changing the gratuity rate from 10 % to:

- **8 %** (benefit reduction)
- **12 %** (benefit enhancement)

Past service cost is the immediate change in the obligation for **all** past service, as thus:

Scenario	Revised obligation ₦	Change vs original ₦	Past service cost – *profit or loss*
Rate falls to 8%	12 % × 12 years × 13 m = 12,480,000	**(3,120,000)**	Negative (Gain)
Rate rises to 12%	12 % × 12 years × 13 m = 18,720,000	**+3,120,000**	Expense

Journal for increase:

Debit: Staff costs – past service cost ₦3,120,000
Credit: Defined benefit obligation **₦3,120,000**

Journal for Reduction:

Debit: Defined benefit obligation ₦3,120,000
Credit: Staff costs – past service cost ₦3,120,000

Examination pointers:

a) **CSC** tests your ability to isolate the extra benefit earned this year; always use the difference between opening and closing obligations, excluding actuarial effects.
b) **Past service cost (PSC)** is recognised **immediately** when the plan amendment or curtailment occurs, never amortised.
c) **Narrative marks**: link answers to IAS 19 definitions, explain why CSC reflects current service and why past service cost captures retroactive changes.
d) **Calculations**: show formula, workings and totals. Marks are awarded for method even if the final figure is incorrect.

14.3.7 Projected unit credit (PUC) method

With this method, it is assumed that each period of service by an employee gives rise to an ***additional unit of future benefits***. The present value of that unit of future benefits can be calculated, and attributed to the period in which the service is given. The units, each measured separately, build up to the overall obligation. The accumulated present value of (discounted) future benefits will incur interest over time, and an interest expense should be recognised.

These calculations are complex and would normally be carried out by an actuary. In the exam, you will be given the figures but the following example (from IAS 19) is included to explain the method.

Key Feature	Explanation
Unit of benefit	Each year of service gives rise to an additional unit of future benefit.
Attribution	Discount each unit to its present value, then allocate that cost to the period in which the service is rendered.
Outputs	Current service cost, interest cost and the present value of the defined benefit obligation.

Illustrative example (simplified)

Assumptions:

- Initial salary year 1: ₦10,000
- Annual salary growth: 7 %
- Discount rate: 10 %
- Service period: 5 years
- Benefit: lump sum equal to 10 % of final salary for each completed year of service

Step-by-step calculation

Step	Result	Note
1 Estimate final salary in year 5	₦13,107	₦10,000 compounded at 7 % for four increases
2 Project total benefit payable at exit	₦655.40	10 % × ₦13,107 × 5 years
3 Determine incremental current service cost (CSC)	₦131.08 each year	Total benefit divided by 5 years
4 Discount each yearly CSC back to present value	PV of CSC stream = ₦565.58	Use 10 % discount factor for each year
5 Roll forward the defined benefit obligation (DBO)	Year 5 PV of DBO = ₦655.40	Add current service cost and interest, subtract benefit paid

(Values are rounded for illustration; in practice the actuary provides precise figures.)

Four-step accounting framework (IAS 19)

Step	Required action
1 Measure deficit or surplus	Use the PUC method and discount rate to calculate the DBO, then deduct fair value of plan assets.
2 Apply the asset ceiling (if surplus)	Limit any recognised asset to the present value of economic benefits available as refunds or contribution reductions.
3 Recognise profit or loss items	Current service cost, past service cost, net interest, plus any gain or loss on settlement or curtailment.
4 Recognise remeasurements in OCI	Actuarial gains and losses, return on plan assets excluding interest, change in effect of asset ceiling. These items are never reclassified.

Comprehensive illustrative example

At January 1, 2022 the fair value of the assets of a defined benefit plan were valued at ₦1,100,000 and the present value of the defined benefit obligation was ₦1,260,000. On December 31, 2022, the plan received contributions from the employer of ₦490,000 and paid out benefits of ₦190,000.

The current service cost for the year was ₦360,000 and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan's assets at December 31, 2022 was ₦1.5 million. The present value of the defined benefit obligation was ₦1,553,600.

Required
Calculate the gains or losses on remeasurement through OCI and the return on plan assets and illustrate how this pension plan will be treated in the statement of profit or loss and other comprehensive income and statement of financial position for the year ended December 31, 20X2.

Suggested solution for SBR candidates:

Date	Plan assets (PA) (₦)	Defined benefit obligation (DBO) (₦)
Jan 1, 20X2	1,100,000	1,250,000

Transactions during the year:
- Employer contributions 490,000
- Benefits paid to retirees (190,000)
- Current service cost 360,000
- Discount rate 6%

The actuarial valuation at Dec 31, 20X2 gives:
- Fair value of plan assets 1,500,000
- Present value of DBO 1,553,600

Profit or loss for the year:

Component	Calculation	Debit/(Credit) ₦
Current service cost	As Given	360,000
Interest cost	6% × 1,250,000	75,000
Interest income on plan assets	6% × 1,100,000	(66,000)
Net Pension Expense		**369,000**

Post to profit or loss as an operating expense and finance cost as appropriate.

Remeasurements in other comprehensive income (OCI):
Plan Assets (PA):

Opening Fair Value of Plan Assets	**1,100,000**
+ Expected return (6%)	66,000
+ Contributions	490,000
− Benefits paid	(190,000)
Expected fair value at 31 Dec 20X2	**1,466,000**
Actual fair value (Portfolio Report)at 31 Dec 20X2	**1,500,000**
Gain on Re-Measurement of Plan Assets	**34,000**

Defined Benefit Obligation (DBO):

Opening DBO	**1,250,000**
+ Interest cost (6%)	75,000
+ Current service cost	360,000
− Benefits paid	(190,000)
Expected DBO at 31 Dec 20X2	**1,495,000**
Actual DBO (Actuarial Report) at 31 Dec 20X2	**1,553,600**
Loss on Re-Measurement of DBO	**58,600**

Net actuarial (loss) recognised in OCI = ₦58,600 (*Loss*) − ₦34,000 (*Gain*)
= **₦24,600 *(Net Loss)***

Post the net loss of ***₦24,600*** to other comprehensive income.

Statement of financial position at Dec 31, 20X2:

	₦
Present value of DBO	1,553,600
Less: fair value of plan assets	(1,500,000)
Net retirement benefit liability	**53,600**

Disclose as a non-current liability, subject to confirmation that the entire obligation is long term.

Presentation summary

Statement	Item	Amount ₦	Direction
Profit or loss	Pension expense	369,000	Expense
Other comprehensive income	Actuarial loss	24,600	Loss
Statement of financial position	Net defined benefit liability	53,600	Liability

Examination pointers

a. Separate sections: keep profit or loss, OCI and SOFP figures clearly labelled.
b. Interest components: always apply the discount rate to both opening DBO and opening plan assets.
c. Remeasurement: difference between actual and expected outcomes goes to OCI, never profit or loss.
d. Method marks: show workings even if pressed for time; partial credit is awarded for the correct approach.

Past service cost (PSC)

Key point	Practical meaning for SBR exams
Definition	Immediate increase or decrease in the present value of the DBO that results from a plan amendment or curtailment.
Recognition	Expense (or credit) recognised **straight-away** in profit or loss on the earlier of: ▪ the date the amendment or curtailment takes effect; or ▪ the date the entity recognises related restructuring or termination costs.
Common triggers	▪ Introducing enhanced medical cover ▪ Closing a section of the plan and reducing member numbers

Exam focus – show the adjustment to the DBO first, then post the equal and opposite entry to staff costs in profit or loss.

Discount rate selection

Requirement	Examiner expectations
Use yields on high-quality corporate bonds denominated in the currency of the benefits.	If no deep market exists, use **government bonds** in that currency.
Maturity of the bonds should match the average term of the benefit payments.	Quote this link between payment profile and bond term; avoid one-size-fits-all rates.
Long-term maturities (30–40 years) are rarely material and should not dominate the rate.	Justify rate selection with prudence and faithful representation.

Net interest on the net liability (Asset)

Formula	Explanation
Opening Net DBO (-)/Asset (+) × Discount rate	Represents the unwinding of the net position, similar to accreting interest on a loan or deposit.

Debit finance cost if liability, *Credit* finance income if asset.

Re-measurements recognised in OCI

(a) **Actuarial gains and losses**
  (i) Experience variances: actual salary growth, staff turnover, mortality.
  (ii) Changes in assumptions: discount rate, inflation, longevity.

(b) **Return on plan assets** *excluding* the amount already recognised as interest income.

(c) **Change in the effect of the asset ceiling** (again, excluding the interest element).

These items **never recycle** to profit or loss.

14.3.8 Asset ceiling test (ACT)

When we looked at the recognition of the net defined benefit liability (or asset) in the statement of financial position at the beginning of Section 5, the term "asset ceiling" was mentioned. This term relates to a threshold established by IAS 19 to ensure that any defined benefit asset (i.e., a pension surplus) is carried at **no more than its recoverable amount**.
In simple terms, this means that any net asset is restricted to the amount of **cash savings** that will be available to the entity in the future.
Asset ceiling – Example and application
IAS 19 requires that an entity must recognise a defined benefit item - either a **net liability (deficit)** or a **net asset (surplus)** in the statement of financial position.

The **net defined benefit liability (or asset)** is measured as:
(i) The **present value of the defined benefit obligation (DBO)**
less
(ii) The **fair value of the plan assets (if any)**

However, if this results in a **surplus**, an **asset ceiling test** must be applied.
A **surplus in a defined benefit plan** is recognised as the **lower of**:
(a) The actual **surplus** in the defined benefit plan, and
(b) The **asset ceiling**, which is the present value of any **economic benefits available** in the form of:
(i) **Refunds from the plan**, or
(ii) **Reductions in future contributions** to the plan.

In essence, the surplus must be **adjusted downwards** to reflect only those amounts the entity can **realistically access or benefit from** in the future.

The approach remains consistent with previous measurement methods, but **any recognised net asset (surplus)** must be **restricted to the asset ceiling** where applicable.

Step	Action
1	**Calculate Surplus** = Plan Assets – DBO (*if positive*).
2	Calculate **Recoverable Amount** = present value of future economic benefits available by: ▪ refunds from the plan; or ▪ reductions in future contributions.
3	Recognise the smaller of the surplus and the recoverable amount. Any excess is a remeasurement loss to OCI.

Net defined benefit asset – when permitted
A surplus meets the conceptual framework definition of an **asset** only when:
(a) the surplus represents a **resource controlled** by the entity; and
(b) future economic benefits will **flow to** the entity through refunds or lower future contributions.

If both conditions hold, present the surplus net of any asset-ceiling restriction.

Illustrative Example: Defined benefit accounting with asset ceiling –
The following information relates to the defined benefit plan of Company X for the year to December 31 2016.

At January 1, 2016:

Description	**₦000**
Fair value of the plan assets	1,150
Present value of the plan obligations	1,100
Present value of economic benefits available due to rules in the jurisdiction	40

During 2016:

Description	**₦000**
Current service cost	125
Contributions paid into the plan	80
Benefits paid out by the plan	130

Actuarial assumptions:
Discount rate = 10%

New actuarial valuation at December 31, 2016:

Description	**₦000**
Fair value of the plan assets	1,395
Present value of the plan obligations	1,315
Present value of economic benefits available due to rules in the jurisdiction	65

Required :
Construct a journal to show the movement on the defined benefit account.

Suggested solution:

Summary and journal construction
Opening Position (January 1, 2016):

- Fair value of plan assets: ₦1,150,000
- Present value of plan obligation (DBO): ₦1,100,000
- **Initial net defined benefit asset: ₦50,000**
- Economic benefit available (asset ceiling): ₦40,000
- Asset ceiling adjustment: balancing figure = **₦(10,000)**
- **Net defined benefit asset (carried forward): ₦40,000**

Transactions during 2016:

- Current service cost: ₦125,000
- Employer contributions: ₦80,000
- Benefits paid out: ₦130,000
- Discount rate: 10%

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At December 31, 2016 (actuarial valuation):

- fair value of plan assets: ₦1,395,000
- Present value of plan obligation: ₦1,315,000
- Economic benefit available (asset ceiling): ₦65,000
- Net defined benefit asset (recognisable): ₦65,000
- Movement in net asset: ***₦25,000 (₦65,000 – ₦40,000)***

Journal entries and recognition:

Step 1: Opening position adjustment

Opening Net Asset = ₦40,000
Plan Surplus = ₦80,000 (₦1,395,000 – ₦1,315,000)
Asset Ceiling Adjustment = ₦(15,000) ⟶ Recognisable Net Asset = ₦65,000

Step 2: Journal entry summary

Description	Debit (₦000)	Credit (₦000)
Profit or loss	-	121
Other comprehensive income (OCI)	66	-
Cash (employer contributions)	80	-
Defined benefit net asset	-	25
Total	**146**	**146**

Step 3: Profit or loss breakdown

Current service cost = ₦(125,000)
Interest income (10% x ₦40,000) = ₦4,000
Net expense to profit or loss = ₦(121,000)

This clearly illustrates the **impact of the asset ceiling test** by restricting the recognised surplus to the present value of economic benefits, thus ensuring compliance with IAS 19.

Step-By-Step Journal Roadmap for a Defined Benefit Plan

S/N	What happens during the year	*Debit*	*Credit*	Where it appears
1	Bring forward opening balances – plan assets and defined benefit obligation (DBO).	–	–	Statement of financial position (SOFP)
2	**Net interest on opening liability (asset)**: discount rate × opening balance. Recognise finance cost or income.	*Interest cost (Profit or Loss)*	*PV defined benefit obligation (SOFP)**	*If surplus, reverse the entry.
3	**Interest on plan assets**: discount rate × opening fair value of assets.	*Plan assets (SOFP)*	*Interest income (Profit or Loss)*	

S/N	What happens during the year	*Debit*	*Credit*	Where it appears
4	**Current service cost** earned by employees this year.	*Current service cost (Profit or Loss)*	*PV defined benefit obligation (SOFP)*	
5	**Employer contributions** paid into the fund.	*Plan assets (SOFP)*	*Bank / Cash*	
6	**Benefits paid** to retirees.	*PV defined benefit obligation (SOFP)*	*Plan assets (SOFP)*	
7	**Past service cost** from a plan amendment or curtailment. • Increase in obligation → expense. • Decrease → credit.	*Past service cost (Profit or Loss) or PV defined benefit obligation (SOFP)*	*PV defined benefit obligation (SOFP) or Past service cost (Profit or Loss)*	
8	**Settlement gains or losses**: difference between obligation settled and cash or assets transferred.	*Gain → PV DBO (SOFP)* *Loss → Service cost Profit or Loss)*	*Service cost (Profit or Loss)* *PV DBO (SOFP)*	
9	**Remeasurements – actuarial gains / losses** on the obligation.	*PV defined benefit obligation (SOFP)*	*Other comprehensive income (OCI) or reverse for gain*	
10	**Remeasurements – return on plan assets** (actual less interest income).	*Plan assets (SOFP)*	*Other comprehensive income (OCI) or reverse for loss*	
11	**Disclose** movements and closing balances in line with IAS 19, separating: • P & L items (service cost, net interest, past service cost, settlements) • OCI items (remeasurements).	–	–	Notes to the accounts

PV = present value

14.3.9 multi-employer plans

Multi-employer plans may operate either as defined contribution schemes (excluding state arrangements) or as defined benefit schemes. These plans:

(a) pool contributions from several unrelated entities, and

(b) provide benefits to employees of more than one entity without linking individual contributions and benefits to a specific employer.

An entity must classify any multi-employer plan as either defined contribution or defined benefit.

(a) **Defined benefit classification**: Account for the entity's proportionate share of the plan's defined benefit obligation, plan assets and related costs in the same manner as for any single-employer defined benefit plan.

(b) **Defined contribution classification**: Apply defined contribution accounting if adequate information is not available to follow the defined benefit method.

14.3.10 Group plans

Defined benefit plans that share risk only among entities within the same group (for example, a parent and its subsidiaries) are not multi-employer plans. Where such a group plan exists, each participating entity must disclose:

(a) the contractual agreement or stated policy for charging each entity's share of the net defined benefit cost, or a statement that no such policy exists, and
(b) the method used to determine each entity's contribution to the plan.

14.4 Chapter review

Before moving to the next chapter, ensure you can:

a. **Define** and provide examples of each category of employee benefits covered under IAS 19.
b. **Explain** the key differences between a defined contribution plan and a defined benefit plan. Which one introduces actuarial risk to the employer?
c. **Outline** the steps involved in measuring a defined benefit obligation using the projected unit credit method.
d. **Calculate** the pension expense for a year given the service cost, net interest, contributions, and remeasurement adjustments.
e. **Explain** the meaning of the asset ceiling under IAS 19. What happens if the net defined benefit asset exceeds the economic benefits available to the entity?
f. **Discuss** how actuarial gains or losses are recognised and where they are presented in the financial statements.
g. **Provide journal entries** for a defined benefit plan for a reporting period with contributions made, service costs incurred, and actuarial remeasurements recognised.
h. **Interpret** disclosures required under IAS 19 and assess how they impact the transparency and comparability of financial statements.

14.5 End of chapter questions and suggested solutions

14.5.1 Questions

Question 1

(For the sake of simplicity and clarity, all transactions are assumed to occur at the year end.)

The following data applies to the post employment defined benefit compensation plan of BCD Co.

Discount rate:	10% (each year)
Present value of obligation at start of 2022:	₦1 million
Market value of plan assets at start of 2022:	₦1 million

The following figures are relevant.

	2022 ₦'000	2023 ₦'000	2024 ₦'000
Current service cost	140	150	150
Benefits paid out	120	140	160
Contributions paid by entity	100	120	120
Present value of obligation at year end	1,200	1,650	1,700
Fair value of plan assets at year end	1,250	1,450	1,610

Additional information:

At the end of 2023, a division of the company was sold. As a result of this, a large number of the employees of that division opted to transfer their accumulated pension entitlement to their new employer's plan. Assets with a fair value of ₦48,000 were transferred to the other company's plan and the actuary has calculated that the reduction in BCD's defined benefit liability is ₦50,000. The year end valuations in the table above were carried out before this transfer was recorded.

At the end of 2024, a decision was taken to make a one-off additional payment to former employees currently receiving pensions from the plan. This was announced to the former employees before the year end. This payment was not allowed for in the original terms of the plan. The actuarial valuation of the obligation in the table above includes the additional liability of ₦40,000 relating to this additional payment.

Required:
Show how the reporting entity should account for this defined benefit plan in each of years 2022, 2023 and 2024.

Question 2

Background

Ebony Plc sponsors two post-employment benefit plans:

(i) A final-salary defined benefit pension plan that consistently reports a surplus. Management intends to reduce future cash contributions because refunds are not legally permitted.

(ii) A multi-employer plan arranged by an industry association. The association supplies only the contribution rate for the coming year; no actuarial information is available to participants.

Required

(a) Explain, with reasons, how Ebony Plc should determine the amount to recognise in the statement of financial position for the surplus on the final-salary plan for the current year-end.

(b) Discuss, with reference to IAS 19, how the multi-employer plan must be accounted for in Ebony Plc's financial statements.

(c) State two disclosure requirements that relate specifically to the multi-employer plan.

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Question 3

Background
Data for Bold Ltd.'s single defined benefit pension plan are summarised below. All figures are in ₦'000 and relate to the year ended December 31 20X5.

	Jan 1 2015	Dec, 31 2015
Fair value of plan assets	18,400	?
Present value of defined benefit obligation (DBO)	20,100	24,000

Additional Information for 2015:

a. Employer contributions paid into the fund: ₦2,700.
b. Benefits paid to retirees: ₦1,900 (equal amounts deducted from assets and obligation).
c. Current service cost: ₦3,000.
d. Discount rate throughout the year: 8 per cent.

- Actual return on plan assets: ₦1,950.

Required

a) Calculate:
i) the interest cost on the DBO,
ii) the interest income on plan assets,
iii) the remeasurement gain or loss on plan assets,
iv) the remeasurement gain or loss on the DBO.

b)Prepare the pension figures that will appear in:
i) profit or loss, and
ii) other comprehensive income for the year ended 31 December 20X5.

c) Show the net defined benefit liability or asset that will be presented in the statement of financial position at 31 December 20X5.

14.5.2 Suggested solutions

A) Fair Value of the Plan Assets as @ 31 December

Year	2022 ₦	2023 ₦	2024 ₦
Fair value of plan assets as @ 1 January	**1,000,000**	**1,250,000**	**1,402,000**
Add: Expected Returns (*Discount* × *Opening Balance*)	100,000	125,000	140,200
Contributions made by the Employer in the year	100,000	120,000	120,000
Settlements made during the year (*on Curtailment*)	–	(48,000)	–
Benefits to retirees	(120,000)	(140,000)	(150,000)
Expected fair value of plan assets @ 31 December	**1,090,000**	**1,307,000**	**1,512,200**
Loss/(Gain) on re-measurement of plan assets [Diff.]	***160,000***	***95,000***	***97,200***
Actual Fair Value of Plan Assets @ 31 December	**1,250,000**	***1,402,000**	**1,610,000**

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***Technical Note:** In 2023, there was a curtailment that resulted in Settlement of the accrued obligation as at the end of 2023, but the Fair Value of the Plan Assets had been set before the date for the in-force Employee before the value of curtailment was obtained. Hence, the amount of the settlement SHOULD be deducted from the Actual Value as thus: ₦1,450,000 – ₦48,000 to obtain **₦1,402,000**.*

B) Present value of DBO as @ 31 December

Year	2022	2023	2024
PV of Defined benefits obligations (DBO) @ 1 Jan.	**1,000,000**	**1,200,000**	**1,600,000**
Current service cost	140,000	150,000	150,000
Interest Cost (*discount* × *opening balance*)	100,000	120,000	160,000
Past Service Costs	–	–	40,000
Settlements made during the year (*on curtailment*)	–	(50,000)	–
Benefits paid to retirees	(120,000)	(140,000)	(150,000)
Expected PV of defined benefits obligation @ 31 Dec.	**1,120,000**	**1,280,000**	**1,800,000**
(Gain) / Loss on Re-measurement of DBO	**80,000**	**320,000**	**(100,000)**
Actual PV of defined benefits obligation @ 31 Dec.	**1,200,000**	***1,600,000**	**1,700,000**

***Technical Note**: In 2023, there was a Curtailment that resulted in Settlement of the accrued obligation as at the end of 2023, but the Present Value of the DBO had been so been determined for the in-force Employee before the value of the curtailment was obtained. Hence, the amount of the settlement SHOULD be deducted from the Actual Value as thus: ₦1,650,000 - ₦50,000 to Obtain **₦1,600,000**.*

C) PENSION EXPENSE (through Profit or Loss) for the year

Component:	2022 ₦	2023 ₦	2024 ₦
Current Service Cost	140,000	150,000	150,000
Net Interest Cost (Income)	–	(5,000)	19,800
Past Service Cost	–	–	40,000
(Gains)/Loss on Curtailment & Settlement	–	(2,000)	–
Total	**140,000**	**145,000**	**209,800**

Working Note 1: Net interest cost/(income):

= Interest cost – expected returns

- 2012: 100,000 – 100,000 = 0
- 2013: 120,000 – 120,000 = (5,000)
- 2014: 160,000 – 140,200 = 19,800

Working Note 2: Loss/(Gain) on curtailment/settlement:

- ***2023:***
  - Settlement made from available Plan Assets: ₦48,000
  - *Less:* Present value of the Plan Liabilities Curtailled and settled out: ₦50,000
  - **(Gain)/Loss on Curtailment**: (₦2,000)

D) Net Loss/(Gain) on Re-measurement of the Defined Benefits Plan (R-DBP)

Year	2022 ₦	2023 ₦	2024 ₦
Loss on Re-measurement of Defined Benefit Obligation	80,000	320,000	(100,000)
(Gain)/Loss on Re-measurement of Plan Assets	(160,000)	(95,000)	(97,800)
Net Actuarial (Gain)/Loss for the year (through OCI)	**(80,000)**	**225,000**	**(197,800)**

E) Net Retirement Benefits Obligation (Assets)

Year	2022 ₦	2023 ₦	2024 ₦
Actual PV of Defined Benefits Obligation @ 31 Dec.	1,200,000	1,600,000	1,700,000
Actual Fair Value of Plan Assets (as above) @ 31 Dec.	1,250,000	1,402,000	1,610,000
Net Retirement Benefits (Assets)/Obligation @ 31 Dec.	**(50,000)**	**198,000**	**90,000**

Technical Note: ***(asset ceiling test)*** *The amount to be recognised by the entity as retirement benefits asset should not be more than what the entity can enjoy in the future periods by way of reduction in the contribution to the Plan Asset (based on the Defined Benefits Scheme and the requirement of the law of the jurisdiction), and/or the amount that may be plough back (or obtain by way of cash refunds) from the Plan Asset.*

Solution 2

Point	Key discussion	Guidance note
(a) Asset ceiling	IAS 19 limits a recognised surplus to the lower of the surplus itself and the present value of economic benefits available. Because refunds are prohibited, Ebony may recognise only the amount recoverable through reduced future contributions. Calculate the present value of the contribution reductions using the same discount rate applied to the DBO.	▪ Quote IAS 19:64 and IAS 19:76. ▪ Emphasise recoverable amount test.
(b) Multi-employer plan classification	IAS 19:34 requires classification as Defined Benefit (DB) or Defined Contribution (DC). Adequate information is unavailable, therefore Ebony must treat the arrangement as a defined contribution plan.	▪ Mention that if sufficient information later becomes available, retrospective application is required (IAS 19:41).

Point	Key discussion	Guidance note
	Contributions are expensed when employees render service.	
(c) Disclosures	• The fact that the plan is a multi-employer arrangement classified as defined contribution due to insufficient information. • The level of contributions recognised as an expense during the period.	▪ Link to IAS 19:148 and IAS 19:150.

Examiner tip: Marks are awarded for clear reference to the standard, the asset-ceiling logic and the inability to obtain reliable information from the association.

Solution 3

Step	Working	₦'000
1 Interest cost on DBO	20,100 × 8 %	**1,608**
2 Interest income on assets	18,400 × 8 %	**1,472**
3 Expected closing assets	18,400 + 1,472 + 2,700 – 1,900	20,672
4 Remeasurement on assets	*Actual closing assets (balancing figure) – expected closing assets = ? – 20,672*	**(?)**

Actual closing assets can be derived:
Opening 18,400 + contributions 2,700 + *actual* return 1,950 – benefits 1,900 = **21,150**
Hence remeasurement gain on assets = 21,150 – 20,672 = **478**.

		₦'000
5 Expected closing DBO	20,100 + 3,000 + 1,608 – 1,900	22,808
6 Remeasurement loss on DBO	Actual DBO 24,000 – expected 22,808	**1,192**

Profit or loss (P/L):

Component:	₦'000
Current service cost	3,000
Net interest (1,608 – 1,472)	136
Pension expense in profit and loss	**3,136**

Other comprehensive income (OCI):

Component:	₦'000
Remeasurement gain on assets	478
Remeasurement loss on DBO	(1,192)
Net actuarial loss in OCI	**(714)**

Statement of financial position (SOFP):

Component:	**₦'000**
Present value of DBO	24,000
Fair value of plan assets	(21,150)
Net defined benefit liability	**2,850**

Guidance Note:

(i) Interest components always use the opening balances.

(ii) Benefits paid reduce both the obligation and the assets.

(iii) Remeasurements are the balancing figures that reconcile expected to actual closing numbers and are reported only in OCI.

(iv) Check that the change in the net liability ties back: ***opening deficit 1,700 (20,100 – 18,400) + Profit or Loss charge 3,136 – contributions 2,700 + net OCI loss 714 = closing deficit 2,850*** (*proof for exam confidence*).

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Professional Level

Strategic Business Reporting

CHAPTER 15

SHARE-BASED PAYMENT: IFRS 2

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15 Share – based Payment: IFRS 2

15.0 Learning objective

This chapter equips readers with the knowledge and professional judgement required to recognise, measure, present and disclose financial instruments and related risks in accordance with IFRS 2.

15.1 Learning outcomes

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

a. **Classify SBP schemes** – distinguish equity-settled, cash-settled and choice-of-settlement awards.
b. **Identify measurement dates** – pinpoint the grant date, vesting date and (for cash-settled awards) re-measurement dates.
c. **Measure equity-settled awards** – fix grant-date fair value, allocate the expense over the vesting period and adjust for service/non-market performance conditions.
d. **Measure cash-settled awards** – re-measure the liability to fair value at each reporting date and on settlement, recognising changes in profit or loss.
e. **Account for SBP with cash alternatives** – split compound instruments into debt and equity components or assess the entity's present obligation.
f. **Deal with modifications, cancellations and replacements** – calculate incremental fair value, accelerated charges and any profit-or-loss impact.
g. **Handle group and treasury-share transactions** – apply IFRIC 11 to identify how parent and subsidiary treat the same award.
h. **Apply IFRIC 8 & IFRS 2 scope guidance** – recognise unidentifiable goods or services and special-purpose entities (trusts).
i. **Prepare clear disclosures** – present nature, valuation techniques and Profit or Loss & SOFP effects that satisfy IFRS 2's three disclosure pillars.
j. **Demonstrate exam technique** – structure calculations, journals and narrative explanations that gain maximum marks in ICAN-SBR.

15.2 Introduction

Share-based payments have become a normal feature of employee and supplier remuneration. Entities often issue shares or options rather than cash because:

(a) Shares can be perceived as an attractive currency for securing skilled staff and professional services.
(b) Some tax jurisdictions reward equity-based remuneration with favourable reliefs.

When options are granted at an exercise price that equals or exceeds the market price on grant date, the instruments appear to have no intrinsic value. If the transaction is ignored, a mismatch arises: cash remuneration would be recognised as an expense yet equity remuneration would not.

IFRS 2 sets out how to recognise, measure, and present share-based payment transactions. A share-based payment transaction occurs when an entity:

(a) receives goods or services in return for its own equity instruments, or
(b) accepts goods or services and incurs a liability that is linked to the entity's share price.

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Common objectives to recognition and the IASB's response

Objective	IASB response
No cost therefore no charge – the entity does not sacrifice cash or other assets.	A transaction has taken place. The entity has received valuable services in exchange for equity instruments, so an expense must be recognised.
Earnings per share is hit twice – profits fall while the share count rises.	Two separate economic events occur and both must be recorded: the issue of shares (denominator increases) and the consumption of resources received (numerator decreases).
Adverse economic consequences – compulsory recognition might discourage equity schemes.	If recognition reveals economic consequences that were previously hidden, the resulting transparency improves, rather than distorts, decision-making.

15.2.1 Scope of IFRS 2

Area	Guidance
Included	All transactions where goods or services are acquired or received in exchange for equity instruments or for amounts that depend on the entity's share price.
Excluded	• Transfers of equity instruments by shareholders when the transfer is not payment for goods or services supplied to the entity. • Deals with employees (or others) acting only as shareholders. • Shares issued to obtain control of another business (accounted for under IFRS 3). • Contracts for non-financial items that fall inside IAS 32 or IFRS 9.

IFRS 2 requires an entity to capture the effect of share-based payment transactions in profit or loss and the statement of financial position. The Standard applies to three transaction types:

(a) Equity-settled – goods or services are exchanged for equity instruments.
(b) Cash-settled – the entity incurs a liability measured by reference to its share price.
(c) Choice of settlement – either party can select equity or cash settlement.

Transactions outside IFRS 2

The Standard does not apply to:

(a) Deals with employees or others purely in their capacity as shareholders (for example, a rights issue).
(b) Shares issued to obtain control of another entity (accounted for under IFRS 3).
(c) Contracts for non-financial items that fall within IAS 32 or IFRS 9.

15.2.2 Classification of share-based payment (SBP) transactions

SBP arrangements can be classified into:

(a) Equity-settled SBP:
  (i) Recognised as Equity Instruments.
  (ii) The entity delivers shares to the counterparty.

(b) Cash-settled SBP
  (i) Recognised as a Financial Liability.
  (ii) The entity settles in cash, based on the value of shares.

(c) Option of either "Equity-Settled" or "Cash-Settled SBP":

The entity may have the option to either:

(i) Deliver shares, or

(ii) Settle in cash (equivalent to the value of shares)

Type	Features	Settlement
Equity-settled	Entity pays for goods or services by issuing equity instruments.	Shares or share options are delivered.
Cash-settled	Entity records a liability that is measured by reference to the share price.	Liability is satisfied in cash.
Choice of settlement	Either the entity or the supplier can decide whether settlement is in cash or equity instruments.	Decision determines whether equity or liability accounting applies.

IFRS 2 uses the umbrella term *equity instruments*. In practice these are usually ordinary shares or share options.

IFRS 2 is not applicable to transactions involving the issuance of shares as consideration in a business combination, nor to contracts for the purchase of goods that fall within the scope of **IAS 32** or **IFRS 9**.

Although IFRS 2 refers to the concept of **fair value**, it does so using a measurement approach that **differs from the definition and guidance provided under IFRS 13**. Consequently, when applying IFRS 2, entities must measure fair value based on the specific requirements set out within IFRS 2 itself, and **not** by reference to IFRS 13.

15.2.3 Key terms for the examination

Term	Meaning for IFRS 2 Purposes
Share-Based Payment Arrangement	Agreement between an entity and another party to deliver equity instruments or pay an amount based on share price.
Grant Date	Date on which the entity and counterparty agree to the arrangement, including any approvals.
Measurement Date	Point at which fair value of the equity instruments is fixed. * For employees this is the grant date. * For other suppliers it is when the goods are obtained or the service is rendered.
Fair Value	Amount for which the equity instrument could be exchanged in an orderly transaction between knowledgeable, willing parties at the measurement date. IFRS 2's fair value guidance overrides IFRS 13 for these instruments.
Vest/Vesting Condition	Vesting is the counterparty's becoming entitled to the benefit. A vesting condition specifies the required service or performance target.
Vesting Period	Period during which the vesting condition must be satisfied.

Group structures

A subsidiary may receive goods or services but the parent may issue the equity instruments or make the cash payments that are linked to the parent's share price. IFRS 2 still applies to the subsidiary that benefits, even though it has no legal obligation to settle.

Vesting conditions

Vesting conditions determine whether the counterparty becomes entitled to the equity instrument or cash payment. IFRS 2 distinguishes between:

Category	Illustration
Non-market vesting conditions – linked to service or internal performance. Examples: minimum service period, profit targets, project completion.	Expense recognised over the vesting period. If the condition is not met, reverse the cumulative expense for unvested awards.
Market-based vesting conditions – linked to market price or return. Examples: minimum share price, shareholder return targets, performance relative to an index.	Fair value at grant date already reflects the likelihood of meeting the target. Do not reverse the expense if the market condition is not achieved.

A vesting period is the span during which the specified service or performance conditions must be satisfied.

Examination pointers for SBR candidates

a) Identify the transaction type first because this dictates whether an equity or a liability is recognised.
b) Explain any settlement alternatives clearly as these can split a single scheme into equity and liability components.
c) **Classify the transaction correctly** – equity, cash, or choice.
d) **Identify the grant date** – when both parties have a shared understanding and approvals are in place.
e) **Select the correct measurement date** – grant date for employees; receipt date for suppliers.
f) **Account for vesting conditions** – allocate cost over the vesting period and adjust only for non-market failures.
g) Fix the fair value at the correct measurement date and allocate the expense systematically over the vesting period.
h) Re-measure cash-settled schemes at each reporting date until settlement.
i) **Keep disclosures clear** – explain scheme features, valuation methods, and the impact on profit or loss and equity.

A disciplined focus on classification, measurement date, and vesting conditions will help you tackle the most common IFRS 2 scenarios set by ICAN examiners.

15.2.4 Recognition of goods and services

Goods or services obtained through a share-based payment are recognised when they are received.

(a) If the items qualify for recognition under another Standard, record an asset.
(b) If they do not, record an expense.

Transaction Type	Debit	Credit
Equity-settled	Asset or expense	Equity
Cash-settled	Asset or expense	Liability

The timing of the recognition mirrors the delivery of the goods or the rendering of the service.

15.2.5 Grants of share options to employees

Why the accounting rules were needed

Before IFRS 2, entities could pay employees with share options without recognising any charge, even though the options were part of total remuneration. Cash bonuses were expensed, yet equity remuneration was ignored, creating inconsistent financial statements.

Key accounting consequences

(a) An option grant is consideration for employee service.
(b) The fair value of the options, measured at grant date, represents the cost of the benefit consumed.
(c) The cost is recognised over the vesting period as part of employment expenses.

Controversy arose because no cash leaves the entity, but IFRS 2 focuses on the consumption of benefit rather than the cash flow.

Recognition and measurement framework

Classification	Valuation Approach	Subsequent Measurement
Equity-Settled	Fair value fixed at measurement date (grant date for employees)	No re-measurement
Cash-Settled	Fair value first measured at grant date, then re-measured at each reporting date and on settlement	Changes in fair value recognised in profit or loss
Settlement Alternatives	• Issuer chooses: treat as equity unless a present obligation to deliver cash exists • Holder chooses: treat as a compound financial instrument	Account separately for equity and liability components

The amount recognised each year is based on the best estimate of the number of instruments expected to vest. Adjust the estimate until the awards finally vest.

Vesting Conditions

Condition type	Examples	Impact on accounting
Service Condition (Non-Market)	Complete three years' service	Exclude from grant date fair value. True-up for actual forfeitures.
Performance Condition (Non-Market)	Achieve cumulative profit target	Exclude from fair value. True-up for actual results.
Market Condition	Reach a specified share price or total shareholder return	Include in fair value. Do not reverse expense if the target is not met.

Failure to meet conditions

(a) **Service or non-market performance** – reverse the portion of expense relating to awards that will not vest.
(b) **Market performance** – keep the recognised expense because the grant date valuation already considered the likelihood of failure.

If a non-vesting condition prevents exercise, either continue expensing (if neither party controls the outcome) or recognise an immediate reversal or additional charge, depending on whether the condition is cancelled or modified.

Summary checklist for SBR examination

a. **Identify** the scheme: equity, cash, or choice.
b. **Determine** the grant date and measurement date.
c. **Measure** fair value using an option-pricing model if necessary.
d. **Allocate** the fair value over the vesting period based on the expected number of instruments that will vest.
e. **Adjust** only for non-market vesting failures.
f. **Re-measure** cash-settled liabilities at each reporting date.
g. **Disclose** scheme descriptions, assumptions, and the impact on profit or loss and equity.

A disciplined application of these steps will ensure faithful representation of share-based transactions and maximise your marks in the Strategic Business Reporting paper.

15.3 Measurement of equity-settled share-based payment Transactions

15.3.1 Purpose

When an entity acquires goods or services in exchange for its own shares or options it must measure the consideration at fair value and add the same amount to equity. Three practical questions arise:

(a) **How** is fair value determined?
(b) **When** is fair value measured?
(c) **When** is the resulting cost recognised?

IFRS 2 answers these questions differently for transactions with employees and for transactions with external suppliers.

Key question	External suppliers	Employees (or similar)
How is fair value measured?	Directly – use the fair value of the goods or services received, unless this cannot be measured reliably.	Indirectly – use the fair value of the equity instruments granted.
When is fair value measured?	On the date the goods are obtained or the service is rendered.	On the grant date, when both parties agree to the arrangement and any approvals are in place.
When is the cost recognised?	*No vesting conditions*: recognise on receipt. *Vesting conditions*: recognise over the vesting period as the service is provided.	Same principle – immediate recognition if no vesting conditions, otherwise spread over the vesting period.

15.3.2 Direct or indirect measurement

(a) **Direct approach** (preferred)
  (i) Use the fair value of the goods or services themselves.
  (ii) Presumed reliable except in rare cases – mainly share-based transactions with employees.

(b) **Indirect approach**
  (i) Measure the fair value of the equity instruments granted.
  (ii) Mandatory when the fair value of the goods or services cannot be measured reliably, and for all employee awards.

15.3.3 Determining fair value of equity instruments

(a) **Shares** – *use the quoted market price*. If the shares are not publicly traded, estimate the market price and adjust for any special terms.

(b) **Options** – apply a recognised option-pricing model (*e.g. Black-Scholes or Binomial Options Pricing Models*). Key inputs include:

(i) Exercise price
(ii) Expected term of the option
(iii) Current share price and expected volatility
(iv) Expected dividends
(v) Risk-free interest rate
(vi) Market-based vesting conditions

Fair value is fixed at the measurement date for equity-settled awards and is **not** revisited.

15.3.4 Recognition rules

(a) **No vesting conditions** – presume the service has already been received. Recognise the full cost immediately with a matching credit to equity.

(b) **Vesting conditions** – spread the cost over the vesting period:

(i) At each year-end estimate the number of instruments expected to vest, based on service and non-market performance conditions.
(ii) True-up the cumulative expense for changes in that estimate.
(iii) Do **not** adjust for market-based conditions; the grant-date fair value already captures the probability of meeting the target.

If options ultimately fail to vest because a non-market condition is not satisfied, reverse any unrecognised portion of the expense. Never reverse charges relating to market conditions.

A systematic application of this framework will ensure accurate, principles-based answers in the ICAN Strategic Business Reporting examination.

Share options and share grants

Instrument	Key Feature	Cash Flow from Employee	Typical Use
Share option	Gives the holder a right, not an obligation, to buy shares at a fixed exercise price	Employee pays the exercise price on exercise date	Long-term incentive that aligns interests with shareholders
Share grant	Delivers shares outright once vesting conditions are met	No cash outflow from employee	Share bonus to reward performance or retain staff

Practical checklist for SBR candidates

a. **Classify** the counterparty – employee or external supplier.
b. **Select** the measurement basis – direct if possible, indirect if required.
c. **Fix** the fair value at the correct measurement date.
d. **Identify** vesting conditions and determine the vesting period.
e. **Allocate** the cost using the best estimate of awards expected to vest, updating annually.
f. **Disclose** key assumptions, valuation techniques, and the impact on profit or loss and equity.

15.3.5 Options: Rights, Obligations, and Positions

Party	Position	Description
Option Buyer	**Long Call**	Right to buy the underlying shares in the future
Option Seller	**Short Call**	Obligation to deliver shares if the buyer exercises
Option Buyer	**Long Put**	Right to sell the underlying shares in the future
Option Seller	**Short Put**	Obligation to buy shares if the buyer exercises

Underlying asset is usually the entity's ordinary shares.

Pay-off profiles

Option type	Pay-off at expiry: S_t = Share price, X = Exercise Price
Call option	Max [0, $(S_t - X)$]
Put option	Max [0, $(X - S_t)$]

Illustrative examples:
Exercise/Strike price = ₦10 per share
Share/Stock price at expiry: (a) ₦12, and (b) ₦9

Suggested solution:

Scenario	Call Pay-Off Max [0, $(S_t - X)$]	Put Pay-Off Max [0, $(X - S_t)$]
₦12	*Max [0, (₦12 − ₦10)]* = **₦2**	*Max [0, (₦10 − ₦12)]* = **₦0**
₦9	*Max [0, (₦9 − ₦10)]* = **₦0**	*Max [0, (₦10 − ₦9)]* = **₦1**

Option valuation components
Fair value of an option = Intrinsic value + Time value

Component	Main drivers
Intrinsic value	Difference between current share price and exercise price, floored at zero
Time value	Time to expiry, expected volatility, risk-free rate, expected dividends, any market-based vesting condition

Determining fair value

(a) *Quoted shares* – use the observable market price on grant date.
(b) *Options* – apply an accepted option pricing model such as:
(i) **Black-Scholes–Merton (BSM) Model**
(ii) **Binomial (Lattice) Model**

Key inputs:

(i) Exercise price
(ii) Current share price
(iii) Expected volatility
(iv) Expected dividends
(v) Risk-free interest rate for the option life
(vi) Expected term of the option
(vii) Market-based vesting conditions

Intrinsic value and time value in practice

(a) *Intrinsic value* equals the pay-off if the option were exercised immediately.
(b) *Time value* is the excess of fair value over intrinsic value and reflects the probability that the option will move further into the money before expiry.

Option valuation – Structured learning guide

Decomposing the fair value of an option

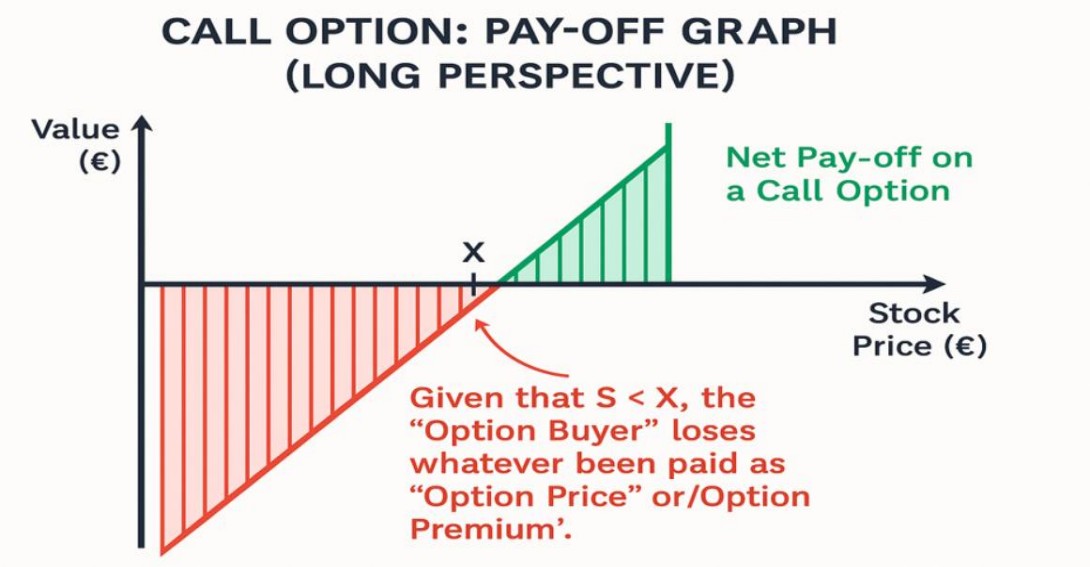
Recall: Fair value = Intrinsic value + Time value

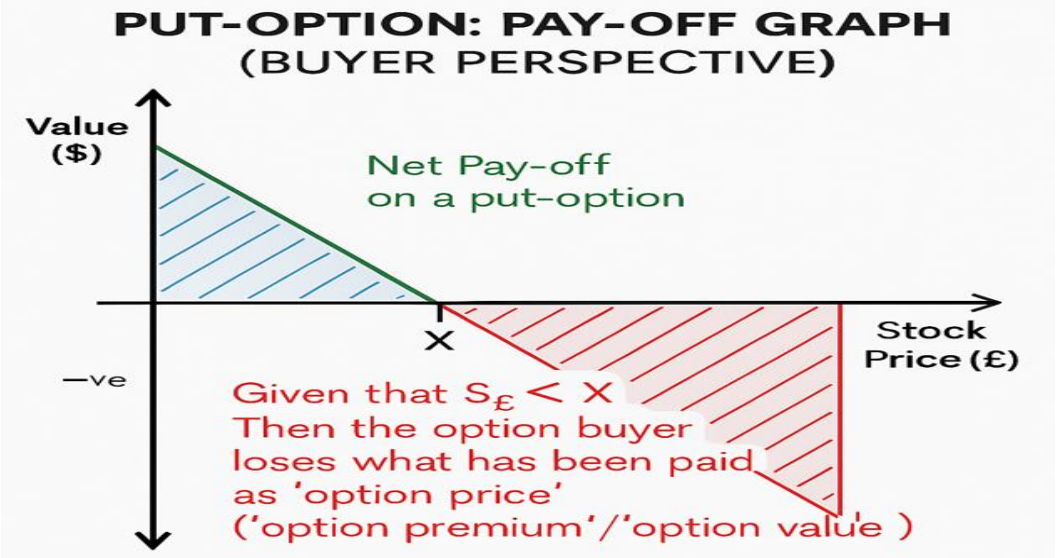
Component	Meaning	Primary drivers
Intrinsic Value	Immediate economic benefit if the option is exercised now.	Current share price ***S***, exercise price ***X***.
Time Value	Additional value arising from future uncertainty and the time remaining to expiry.	*Time to expiry* ***(T−t)***, *expected volatility* ***(σ)***, *risk-free rate* (***r_f***), expected dividends, market-based vesting conditions.

Intrinsic Value (IV) Formulas

Option	Formula	Interpretation
Call	$IV_{call} = Max\ [0,\ (S_t - X)]$	Positive when share price exceeds exercise price.
Put	$IV_{put} = Max\ [0,\ (X - S_t)]$	Positive when exercise price exceeds share price.

**Intrinsic value equals the pay-off that would be realised on immediate exercise.*





Present-Value Shortcut for the Fair Value (No Model Inputs)

A quick approximation discounts the exercise price to present value and compares it with the current share price:

Option	Present-value test
Call	$$\mathrm{FV}_{\mathrm{call}} = \max\left[0,\ S_t - \frac{X}{(1+r_f)^{(T-t)/360}}\right]$$
Put	$$\mathrm{FV}_{\mathrm{put}} = \max\left[0,\ \frac{X}{(1+r_f)^{(T-t)/360}} - S_t\right]$$

This is not a full option-pricing model but is useful for classroom illustration.

Moneyness of an Option:
Moneyness expresses the relationship between an option's exercise price and the current market price of the underlying share. It signals whether exercising the option would create an immediate gain.

Status	Call Option Test	Put Option Test	Example (Exercise Price ₦10)
In-the-Money (ITM)	Share price is above exercise price	Share price is below exercise price	• Call: share price ₦12 gives intrinsic value ₦2. • Put: share price ₦8 gives intrinsic value ₦2.
At-the-Money (ATM)	Share price equals exercise price (or very close)	Share price equals exercise price (or very close)	Share price ≈ ₦10: Intrinsic value is zero for both call and put.
Out-of-the-Money (OTM)	Share price is below exercise price	Share price is above exercise price	• Call: share price ₦9 gives no intrinsic value. • Put: share price ₦11 gives no intrinsic value.

ITM options already contain intrinsic value, ATM options are poised at the break-even point, and OTM options hold only time value until the market moves in their favour.

Moneyness Terminology

Status	Call Option	Put Option
In-the-Money	$S_t > X$	$S_t < X$
At-the-Money	$S_t = X$	$S_t = X$
Out-of-the-Money	$S_t < X$	$S_t > X$

Illustrative Examples: (Call and Put)

Consider a Call Option and a Put Option with a strike price of ₦10 per share. The risk-free interest rate is 5% per annum. The option is to be exercised in 90 days, and for the purpose of this calculation, assume that 360 days constitute a full calendar year.

The objective is to compute the Fair Value of both options (Call and Put), which consists of the intrinsic value and time value, evaluated 30 days into the option contract.

(a) Assume the share price on day 30 is as follows:
  (i) Share price = ₦12 per share
  (ii) Share price = ₦9 per share

(b) Based on the above prices, determine the moneyness of the options:
  (i) In-the-Money (ITM): When the actual share price is greater than the exercise (strike) price (for Call Options), or lower (for Put Options).
  (ii) At-the-Money (ATM): When the actual share price is equal to the exercise price.
  (iii) Out-of-the-Money (OTM): When the actual share price is less than the exercise price (for Call Options), or higher (for Put Options).

Suggested solution:

Contract data

- Exercise price ***X***: ₦10 per share
- Risk-free rate r_f:5 per cent p.a.
- Original life: 90 days
- Valuation date: 30 days after grant, therefore ***(T− t)*** = ***90 days – 30 days = 60 days***

(Assumed 30 days a month, and 360 days a year)

5.1 Scenario A – *Share price* ***(S_t) = ₦12***

Item	Call OPTION	Put OPTION
Fair value	Max[*0, (12 − 10/(1.05)$^{60/360}$)]* = **₦2.08**	*Max[0, 10/(1.05)* $^{60/360}$ *−12]* = **₦0**
Intrinsic value	Max[*0, (12 − 10)]* = **₦2.00**	*Max[0, 10 −12]* = **₦0.00**
Time value	₦2.08 − ₦2.00 = **₦0.08**	₦0.00 − ₦0.00 = **₦0.00**
Status	*In-the-Money*	*Out-of-the-Money*

5.2 Scenario A – *Share price (S_t) = ₦9*

Item	Call OPTION	Put OPTION
Fair value	Max[*0, (9 − 10/(1.05)$^{60/360}$)]* = **₦0.00**	*Max[0, 10/(1.05)* $^{60/360}$ *−9]* = **₦0.92**
Intrinsic value	Max[*0, (9 − 10)]* = **₦0.00**	*Max[0, 10 −9]* = **₦1.00**
Time value	₦0.00 − ₦0.00 = **₦0.00**	₦0.92 − ₦1.00 = (**₦0.08**) ***(rounding difference)*** ***(Rounded:₦0.00)***
Status	*Out-of-the-Money*	*In-the-Money*

***Note:** Minor negative time value for the put in Scenario B arises from using the shortcut present-value method. A full option-pricing model would produce a non-negative time value.*

Vesting conditions – Core concepts

Condition	What it means	Recognition approach
Service Condition	Employee must complete a specified period of service, for example three years.	Expense is spread evenly over the vesting period because the benefit is received gradually.
Market Condition	Vesting depends on a share-price target, such as a 20 percent rise over three years.	Probability of meeting the target is factored into grant-date fair value. There is **no** reversal if the target is missed; expense is recognised as if the target were met.

Illustrative example – Equity-settled share options with a service condition

In 2020 and 2021, AVA Plc estimates the number of options expected to vest and bases the amount that it recognises for the year on this estimate.

In 2022 it recognises an amount based on the number of options that actually vest. A total of 220 employees left during the 3-year period and therefore others vested to the tune of 160,000 options (*i.e. 1,600 employees – 220 employees that left times 100 share options*).

Required:
Determine the amount that should be recognised as share-based payments for each of the three years, assuming the fair value of the option at Grant date to be ₦5.00.

Suggested solution:

Fact pattern	Data
Grant date	*1 Jan 2020*
Employees granted options	***1,820**** <= *1,600 (existing) + 220 (left)*
Options per employee	*100*
Fair value per option	*₦5*
Vesting condition	*Three years' service*
Employees leaving during vesting	*220*
Options expected to vest	*1,600 employees × 100 options = 160,000*
Total expense	160,000 options × ₦5 = **₦800,000**
Annual charge	₦800,000 ÷ 3 = **₦266,666.67**

Schedule of Share-Based Payments Recognition

Year	Basis of Computation	Equity [Credit] (₦)	Expense (P/L) Debit] (₦)
2010	Year-End: (1,820−220) staff × 100 shares × ₦5 × 1/3 years	₦266,666.67	₦266,666.67
2011	**Balance B/fwd**	**₦266,666.67**	**—**
	Year-End: (1,820−220) staff × 100 shares × ₦5 × 2/3 years	₦533,333.33	₦266,666.67
2012	**Balance B/fwd**	**₦533,333.33**	**—**
	Year-End: (1,820−220) staff × 100 shares × ₦5 × 3/3 years	₦800,000.00	₦266,666.67

Journal Each Year (2020 – 2022):

Debit:	Employee cost (P/L)	₦266,666.67	
Credit:	Share-based payment reserve (Equity)		₦266,666.67

Key learning points for ICAN candidates:

1. **Service conditions** require true-ups: revise the estimate of options expected to vest until the vesting date.
2. **Market conditions** affect measurement only, not recognition; expense is never reversed for failure to hit the market target.
3. **Annual expense** equals cumulative grant-date fair value allocated over the vesting period, adjusted for updated service estimates.

Illustrative Example – Equity-settled share options with a service Condition

On April 1, 2021, **EVA Plc** grants **500 share options** to each of its **1,000 employees**. The only condition attached to the grant is that the employees should continue to work for the entity **until March 31, 2025**. During the year to March 31, 2022, **50 employees left** the entity.

The **market price** of each option was **₦4.00** at March 1, 2021 and **₦4.50** at March 31, 2022.

Required:
Show how this transaction will be reflected in the financial statements for the year ended **March 31, 2022**.

Suggested Solution:

Equity-settled share-based payment grant details

Item	Information
Type of SBP	Equity-settled
Grant date	April 1, 2021
Measurement date	April 1, 2021
Fair value per option	₦4.00
Vesting condition	Service
Vesting period	4 years
Vesting date	March 31, 2025
Number of share options	500
Number of employees	1,000
Employees who left in 2022	50

Share-based payment expense schedule

Accounting year	Entry	Basis of computation	Equity (Credit)	Expense (P/L) (Debit)
Apr 1, 2011 – Mar 31, 2012	Current-year charge	[(1,000 − (50 × 4)) staff × 500 shares × ₦4 × 1⁄4 years]	₦100,000.00	₦100,000.00
Apr 1, 2012 – Mar 31, 2013	***Balance b/fwd***	**–**	***₦100,000.00***	**–**
	Current-year charge	[(1,000 − (50 × 4)) staff × 500 shares × ₦4 × 2⁄4 years]	₦200,000.00	₦100,000.00
Apr 1, 2013 – Mar 31,2014	***Balance b/fwd***	**–**	***₦200,000.00***	**–**
	Current-year charge	[(1,000 − (50 × 4)) staff × 500 shares × ₦4 × 3⁄4 years]	₦300,000.00	₦100,000.00
Apr 1, 2014 – Mar 31, 2015	***Balance b/fwd***	**–**	***₦300,000.00***	**–**
	Current-year charge	[(1,000 − (50 × 4)) staff × 500 shares × ₦4 × 4⁄4 years]	₦400,000.00	₦100,000.00

Each annual charge equals one-quarter of the total grant-date fair value (₦400,000). Balances carried forward reflect the cumulative credit in the share-based payment reserve.

Year-end date	Debit – expense (employee cost)	Credit – Equity (share-based payment reserve)
Mar31, 2022	₦100,000.00	₦100,000.00
Mar 31, 2023	₦100,000.00	₦100,000.00
Mar 31, 2024	₦100,000.00	₦100,000.00
Mar 31, 2025	₦100,000.00	₦100,000.00

Illustrative example – Equity-settled share-based payment

Faramade Plc offered directors an option scheme based on a 3-year period of service. The number of options granted to directors at the inception of the scheme was 10 million. The options were exercisable shortly after the end of the 3rd year. The fair value of the options and the estimates of the number of the options expected to vest were:

Fair value of options at various dates

Date	Rights expected to vest	Fair value per option
January 1, 2020	8,000,000	₦3.00
December 31, 2020	7,000,000	₦3.30
December 31, 2021	8,000,000	₦3.70
December 31, 2022	8,000,000	₦7.40

Note: The final vesting number and valuation used in accounting is based on 8 million options and ₦3.00 fair value (from grant date), not the remeasured amounts unless modified.

Suggested solution:

Option grant parameters

Item	Information
Type of SBP	Equity-settled
Grant date	January 1, 2020
Measurement date	January 1, 2020
Grant-date fair value	₦3.00
Vesting condition	Service
Vesting period	3 years
Vesting date	December31, 2022
Options granted	10,000,000
Employees	Directors
Options ultimately vesting	8,000,000

Rights expected to vest (Management estimates)

Reporting Date	Options expected to vest
December 31, 2020	7,000,000
December 31, 2021	8,000,000
December 31, 2022	8,000,000

Expense allocation and equity reserve

Year	Basis of computation	Equity *- Balance* (Credit)	Expense (P/L) *- Movement* (Debit)
2020	7 million shares × ₦3 × 1/3 years	₦7,000,000	₦7,000,000
2021	8 million shares × ₦3 × 2/3 years	₦16,000,000	₦9,000,000
2022	8 million shares × ₦3 × 3/3 years	₦24,000,000	₦8,000,000

Accounting entries

Year-end	Debit – expense (employee cost)	Credit – equity (Share-based payment reserve)
Dec 31, 2020	₦7,000,000	₦7,000,000
Dec 31, 2021	₦9,000,000	₦9,000,000
Dec 31, 2022	₦8,000,000	₦8,000,000

Total share-based payment reserve by end of 2022 (i.e. from 2020 to 2022): **₦24,000,000**

Illustrative example – Equity-settled share-based payment

ZOE Plc has set up an employee option scheme to motivate its sales team of the **10 key marketing personnel**.

Each person was offered **100,000 options exercisable at ₦10**, conditional upon the employee remaining with the company during the **vesting period of 5 years**. The options are then exercisable three weeks after the end of the vesting period.

This is the **2nd year** of the scheme. At the start of this year, **2 marketing personnel** suggested that they would be leaving the company during the 2nd year. However, although **one did leave**, the other recommitted his service to the company and the scheme. The other employees have always been committed to the scheme and stated their intention to stay within the company during the 5-year period of the scheme.

Relevant market values:

Date	Share Price (₦)	Option Price (₦)
Grant date	25	12
End of Year 1	30	15
End of Year 2	45	24

The option price is the market price of an equivalent marketable option on the relevant dates.

Required:
Show the effect of the scheme on the financial statements of ZOE for **2nd Year**.

Suggested solution:

Option grant parameters

Item	Information
Type of SBP	Equity-Settled
Grant date	Beginning of Year 1
Measurement date	Beginning of Year 1
Fair value	₦12.00
Vesting condition	Service
Vesting period	5 years
Vesting date	End of Year 5
Number of share options	100,000
Number of employees	10

Year	Basis of Computation	Equity *- Balance* (Credit)	Expense (P/L) *- Movement* (Debit)
Year 1	[(10 − 2) staff × 100,000 shares × ₦12 × 1/5 years]	₦1,920,000.00	₦1,920,000.00
Year 2	***Balance B/fwd***	***₦1,920,000.00***	**—**
	[(10 − 1) staff × 100,000 shares × ₦12 × 2/5 years]	₦4,320,000.00	₦2,400,000.00

Accounting entry – End of Year 2

	Debit	Credit
Expense (Employee cost)	₦2,400,000.00	
Equity (Share-based payment reserve)		₦2,400,000.00

The Year 2 charge increases the cumulative reserve from ₦1,920,000.00 to ₦4,320,000.00 and is recognised as an employee cost of ₦2,400,000.00 in profit or loss.

Illustrative example – Equity-settled share-based payment

Matilda Plc has singled out the **Inventory Control Director** for an employee option scheme. He has been offered 3 million options execisable at ₦2, conditional upon him remaining with the company for the next three years and improving the inventory control by the end of that period. The proportion of the options that vest is dependent upon the inventory days on the last day of the three years. The schedule is as follows:

Vesting schedule based on inventory days

Inventory days on last day of Year 3	Proportion of options vesting
5	100 %
6	90 %
7	70 %
8	40 %
9	10 %

Additional market-based condition: options vest **only if the share price is above ₦15** on the vesting date.

This is the 2nd year of the 3 years. At the start of this year, it was estimated that the inventory days at the end of the 3rd year would be 7. However, during the year Inventory Control improved and at the end of the year, the estimate of the inventory days at the end of the 3rd year was revised to 6.

Relevant market data

Date	Share price (₦)	Option price (₦)
Grant date	18	13
End of Year 1	20	16
End of Year 2	25	20

The option price is the market price of an equivalent marketable option on each relevant date.

Required:
Show the effect of the scheme on the financial statements of **ZOE Plc** for **Year 2**.

Suggested solution:

Option grant parameters

Item	Information
Type of SBP	Equity-Settled
Grant Date	Beginning of Year 1
Measurement Date	Beginning of Year 1
Fair Value per option	₦13.00
Vesting condition	1. Service condition 2. Performance condition: (a) Non-market – inventory days (b) Market – increased share price
Vesting period (years)	3
Vesting date	End of Year 3
Number of share options	3,000,000
Number of employees	1

Performance Scale – inventory days

Inventory Days	% Vesting
5	100 %
6	90 %
7	70 %
8	40 %
9	10 %

Market data

Date	Share price (₦)	Option price (₦)
Grant date	18.00	13.00
End of Year 1	20.00	16.00
End of Year 2	25.00	20.00

(The option price is that of an equivalent marketable option on each date.)

Other extracted facts:

He has been offered **3 million options exercisable at ₦2**, conditional upon:

- remaining with the company for the next **three years**, and
- improving inventory control by the end of that period.

Current status (Year 2 of 3)

- At the start of Year 2 the expected inventory days at the end of Year 3 were **7**.
- By year-end, improvements led to a revised estimate of **6** inventory days at the end of Year 3.

Expense allocation and equity reserve

Year	Basis of computation	Equity *- Balance* [Credit]	Expense (P/L) *- Movement* [Debit]
Year 1	[(70 % × 3 million) shares × ₦13 × 1/3 years]	₦9,100,000	₦9,100,000
Year 2	***Balance b/fwd***	***₦9,100,000***	**—**
	[(90 % × 3 million) shares × ₦13 × 2/3 years]	₦23,400,000	₦14,300,000

Accounting entry – End of Year 2

	Debit	Credit
Expense (Employee cost)	**₦14,300,000**	
Equity (Share-based payment reserve)		**₦14,300,000**

Cancellation and reissuance

Where an entity has been through a capital restructuring or there has been a significant downturn in the equity market through external factors, an alternative to repricing the share options is to cancel them and issue new options based on revised terms. The end result is essentially the same as an entity modifying the original options and therefore should be recognised in the same way.

As well as the entity, two other parties may cancel an equity instrument:

(a) Cancellations by the counterparty (For example, the employee)

(b) Cancellations by a third party (For example, a shareholder)

Cancellations by the employee must be treated in the same way as cancellations by the employer, resulting in an accelerated charge to profit or loss of the unamortised balance of the options granted.

A cancellation is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised over the vesting period is recognised immediately.

An entity may make a payment to the employee in compensation for the cancellation. Such a payment is accounted for as the repurchase of an equity interest and deducted from equity. However if the payment exceeds the fair value of the equity instruments repurchased any excess is recognised as an expense.

An entity may grant new equity instruments to the employee and identify them as a replacement for those cancelled on the date when those new equity instruments are granted. When this happens the grant of the new instruments is accounted for in the same way as a modification.

The incremental fair value granted is calculated at the date the replacement equity instruments are granted as the difference between:

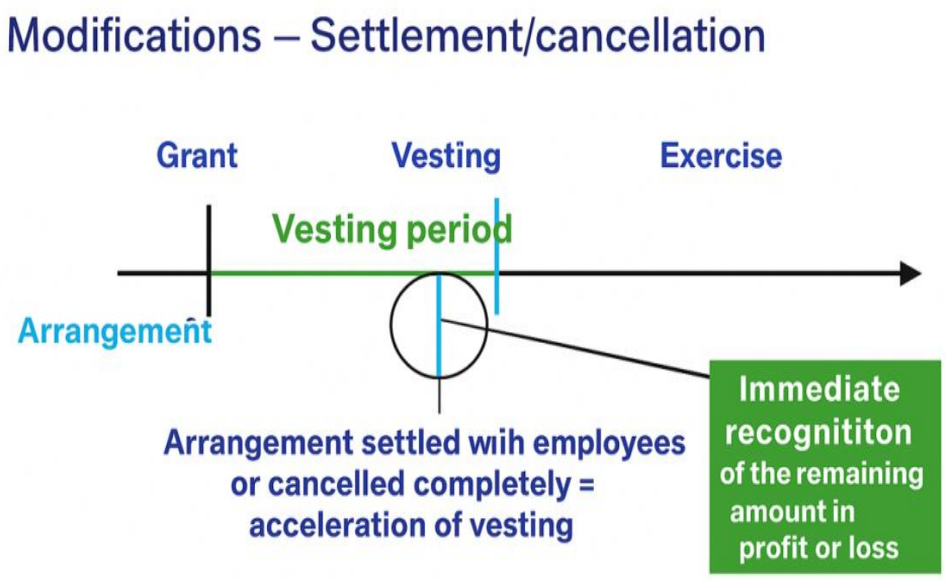
(a) the fair value of the replacement equity instruments; and

(b) the net fair value of the cancelled equity instruments which is:

  (i) the fair value of the cancelled equity instruments immediately before the cancellation, *less*

  (ii) the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity.

A cancellation is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised over the vesting period is recognised immediately.



An entity may make a payment to the employee in compensation for the cancellation. Such a payment is accounted for as the repurchase of an equity interest and deducted from equity. However if the payment exceeds the fair value of the equity instruments repurchased any excess is recognised as an expense.

In Summary: Cancellation and replacement with a new share-based payment scheme

Where new instruments are granted:

(a) Treat as a modification of the original grant or as a cancellation with an issuance of new instruments depending on the facts and circumstances.

(b) If the grants of the new instruments are treated as replacement awards the incremental fair value granted is the difference between the fair value of the replacement instruments and of the old instruments (both measured at the date of the replacement).

After equity instruments have vested
Once goods or services have been recognised in accordance with IFRS 2 (with a corresponding increase in equity) an entity is not allowed to adjust total equity.

For example an entity is not allowed to reverse the transaction when:
(a) vested equity instruments are later forfeited; or
(b) options are not exercised.

However an entity is allowed to recognise a transfer from one component of equity to another.

Cancellation of a share-based payment transaction
Treat as an acceleration of vesting and recognise immediately the amount that otherwise would have been recognised for the services received over the remainder of the vesting period.

Illustrative example – Cancellation
X plc is a company with a December 31st year end.
On January 1st Year 1 X plc grants 100 options to each of its 500 employees. Each grant is conditional upon the employee working for X plc over the next five years. The grant date fair value of each option is ₦10. X plc expects 80% of employees to leave over the vesting period. X Plc cancelled the scheme in Year 3 when 460 employees were still in the scheme.

Required:
Calculate the income statement expense for each year.

Suggested Solution:

	₦	Equity
December 31st Year 1:		
Expected outcome (at grant date value) 500 × 80% × 100 × ₦10	**400,000**	
Year 1 charge (400,000 × 1/5)	**80,000**	
Accumulated in equity by end of year 1		**80,000**
December 31st Year 2:		
Expected outcome (at grant date value) 500 × 80% × 100 × ₦10	**400,000**	
Recognised by the year end (400,000 × 2/5)	160,000	
Less: expense previously **recognise**d as at End of Year 1	(80,000)	
Year 2 charge	**80,000**	
Accumulated in equity by end of year 2		**160,000**
t December 31s Year 3:		
Total expense 460 × 100 × ₦10	**460,000**	
Less: expense previously recognised	(160,000)	
Year 3 charge	**300,000**	
Accumulated in equity by end of year 3		**460,000**

Total expenses over a 3-year period (up to the date of cancellation) amounted to ₦460,000 (i.e., ₦80,000 in year 1 + ₦80,000 in year 2 + ₦300,000 in year 3).

Modifications

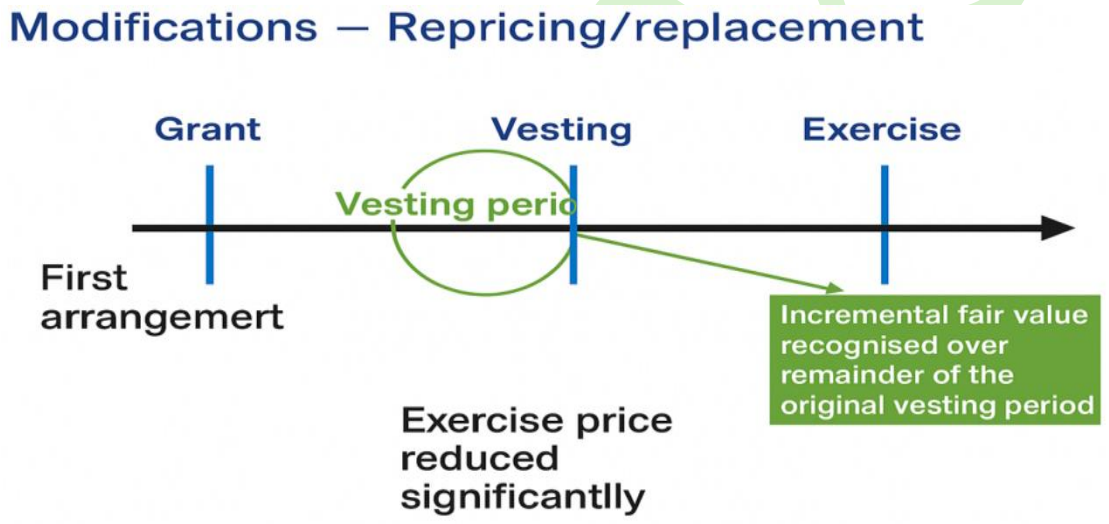
The entity recognises (as a minimum) the services received measured at the grant date (even if modification is beneficial for the entity).

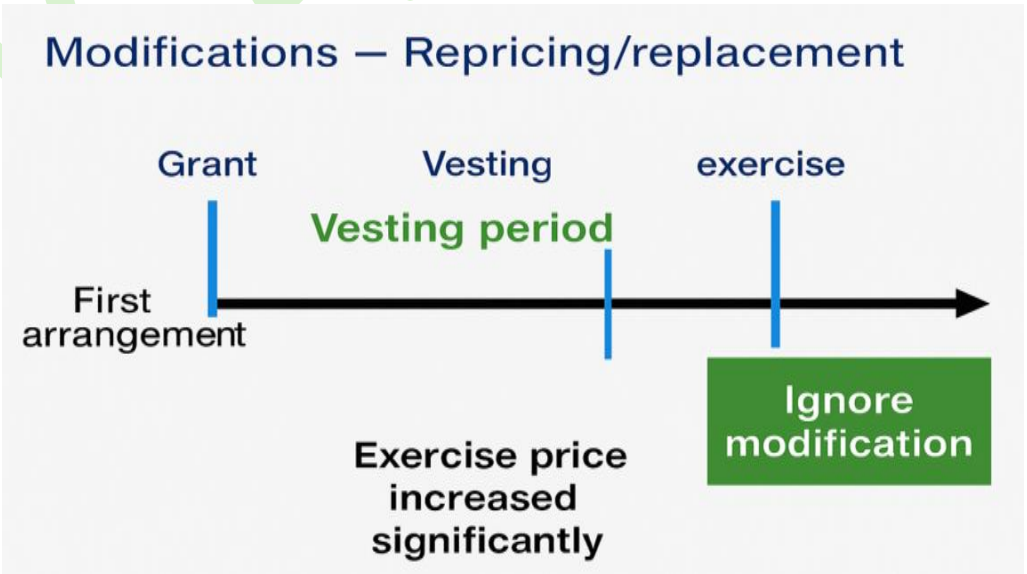
(a) **Effects of modifications that increase the total fair value of the share-based payment arrangement:**

(i) *Incremental fair value recognised over the remaining revised vesting period*.

(ii) *Original fair value recognised over remaining original vesting period.*

(b) **Effects of modifications that reduce the fair value of the equity instruments granted** shall not be taken into account and an entity shall continue to measure the amount recognised for services received as consideration for the equity instruments based on the grant date fair value of the equity instruments granted.





Illustrative example: Modification (change in exercise price)

At the beginning of year 1, Cello Co grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. Cello Co estimates that the fair value of each option is ₦15. On the basis of a weighted-average probability, Cello Co estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the share options.

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, Cello Co's share price has dropped, and the company modifies the options by repricing them. The repriced share options vest at the end of year 3. Cello Co estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees.

During year 2, a further 35 employees leave, and Cello Co estimates that a further 30 employees will leave during year 3, bringing the total expected employee departures over the three-year vesting period to 105 employees.

During year 3, a total of 28 employees leave, so 103 employees in total cease employment during the vesting period. For the remaining 397 employees, the share options vest at the end of year 3.

Cello Co estimates that, at the date of modification, the fair value of each of the original share options granted (i.e. immediately before taking into account the repricing) is ₦5, and that the fair value of each repriced share option is ₦8.

What could bring about a repricing of Option price?
For example, if there is a downturn in the equity markets, an entity may modify its share options by reducing the exercise price. Reducing the exercise price would cause the fair value of the share-based payment to increase. IFRS 2 requires that this increase in value must be recognised **over the remaining period until the options vest.**

Suggested solution:

Share-based payment (Equity-settled SBP) with modification

Year	Basis of Computation	Equity [Credit] ₦	Expense (P/L) [Debit] ₦
1	Original Scheme: Year-End: [(500 - {40 + 70*}) staff × 100 shares × ₦15 × 1/3 years]	195,000	195,000
2	**Balance B/fwd** Original Scheme: Year-End: [(500 - {40 + 35 + 30*}) staff × 100 shares × ₦15 × 2/3 years] Incremental Effect of Modification: [(500 - {40 + 35 + 30*}) staff × 100 shares × (₦8 - ₦5) × 1/2 years] **Balance C/fwd**	**195,000** 395,000 59,250 **454,250**	259,250
3	**Balance B/fwd** Original Scheme: Year-End: [(500 - {40 + 35 + 28}) staff × 100 shares × ₦15 × 3/3 years] Incremental Effect of Modification: [(500 - {40 + 35 + 28}) staff × 100 shares × (₦8 - ₦5) × 2/2 years] **Balance C/fwd**	**454,250** 595,500 119,100 **714,600**	260,350

Accounting entry:

- **Debit:** Expense (employee cost)
- **Credit:** Equity (share-based payment reserve)

Year	Expense recognised in P/L
Year 1	₦195,000
Year 2	₦259,250
Year 3	₦260,350

Examination guidance for ICAN SBR candidates

a. Classify the scheme – distinguish between share grants and share options.
b. Identify the option position – long or short, call or put.
c. Calculate intrinsic value at measurement date to understand minimum expense.
d. Use an option pricing model for time value where market prices are unavailable.
e. Explain the impact on profit or loss and equity, linking back to IFRS 2 recognition rules.
f. Break option value into intrinsic and time components for clear analysis.
g. Intrinsic value equals immediate pay-off and is never negative.
h. Time value reflects future possibilities and is driven by time, volatility, interest rates, and dividends.
i. Shortcut present-value tests are acceptable for exam illustrations, yet professional work requires a recognised model such as Black-Scholes–Merton or a binomial lattice.
j. Moneyness affects both intrinsic and time value and therefore influences IFRS 2 expense recognition when options are granted to employees.

15.4 Measurement of cash-settled share-based payment transactions

15.4.1 Introduction

Cash-settled share-based payment transactions – this is where an entity incurs a liability for goods and **services** and the settlement amount is based on the price (or value) of the entity's shares or other equity instruments.

Illustrative cash-settled arrangements are:

(a) **Share appreciation rights (SARs)** – employees earn a cash payment that mirrors the rise in the company's share price above a set benchmark during a defined period.
(b) **Redeemable share rights (RSRs)** – employees receive a promise of future cash, linked to shares that the company must redeem for cash at a later date.

In both cases, the entity records the goods or services received, and the corresponding liability, at the liability's fair value.

Basic rules:
The liability incurred is measured at its fair value at each reporting date until it is settled.
(a) Any change in the fair value of **the liability** is recognised in profit or loss.

Cash-settled share-based payment transactions (Narrative)

A cash-settled share-based payment transaction is one where, for example, an employee is promised a cash reward based on the future movement of the entity's share price.

(a) For such transactions, the employee's services received by the entity and the corresponding liability incurred should be measured at the fair value of the liability.
(b) The entity should re-measure the liability at each reporting date and at the date the liability is settled.
(c) Changes in the liability should be recognised directly in profit or loss.

The services received by the entity and the liability to pay for those services are recognised as the employee's services are provided.

15.4.2 Cash-settled share-based payment transactions – Examples

(a) Share appreciation rights granted to employees: the employees become entitled to a future cash payment (rather than an equity instrument) based on the increase in the entity's share price from a specified level over a specified period of time, or
(b) An entity might grant its employees a right to receive a future cash payment by granting to them a **right to shares that are redeemable**.

Basic principle: the entity measures the goods or services acquired and the liability incurred at the **fair value of the liability**.

Re-Measurement guidance
The entity should **re-measure** the fair value of the liability at each reporting date **until the liability is settled and at the date of settlement**.

Any changes in fair value are recognised in profit or loss for the period.

The entity should recognise the services received, and a liability to pay for those services, **as the employees render service**.

For example, if share appreciation rights do not vest until the employees have completed a specified period of service, the entity should recognise the services received and the related liability **over that period**.

Illustrative example:
On January 1, 2018, **Faramola Plc** grants **50 Cash Share Appreciation Rights (SARs)** to each of its **1,000 employees**, on condition that each employee continues to work for the entity until **December 31, 2020**.

(i) **During 2018:** 70 employees leave. The entity estimates that a further 120 will leave during 2019 and 2020.
(ii) **During 2019:** 80 employees leave. The entity estimates that a further 50 will leave during 2020.
(iii) **During 2020:** 44 employees leave.

At **December 31, 2020**, 150 employees exercise their SARs. Another 140 employees exercise their SARs at **December 31, 2021** and the remaining employees exercise their SARs at the **end of 2022**.

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The fair values of the SARs for each year in which the SARs exist are shown below, together with the intrinsic values at the dates of exercise.

Date	Fair value (₦)	Intrinsic value (₦)
December 31, 2018	7.20	—
December 31, 2019	7.75	—
December 31, 2020	9.10	7.50
December 31, 2021	10.70	10.00
December 31, 2022	—	12.50

Required:

Calculate the amount to be recognised in the profit or loss for each of the five years ended December 31,2022 and the corresponding liability or equity to be recognised in the Statement of Financial Position at 31 December for each of the five years.

Suggested solution:

Cash-settled SAR grant – Key parameters

Item	Details
Type of SBP	Cash-Settled
Grant Date	January 1, 2018
Measurement Date	Each reporting date
Vesting Condition	Service
Vesting Period (years)	3
Vesting Date	December 31, 2020
Number of SARs per employee	50
Number of employees	1,000

Fair-value and intrinsic-value data

Reporting/Settlement date	Fair Value (₦)	Intrinsic Value (₦)
December 31, 2018	7.20	—
December 31, 2019	7.75	—
December 31, 2020	9.10	7.50
December 31, 2021	10.70	10.00
December 31, 2022	—	12.50

Employee movements

Date	Employees exited (actual)	Additional exits (expected)	Comment
December 31, 2018	70	120	expected to leave 2009 and 2010
December 31, 2019	80	50	expected to leave 2010 only
December 31, 2020	44	—	—

Employees who exercised SARs

Date	Number (Actual)
December 31, 2018	150
December 31, 2019	140
December 31, 2012	**516 ***

516 = [1,000 − (70 + 80 + 44) − 150 − 140]

Share-based payment (cash-settled SBP) - computation and accounting

Year [or Periods]	Basis of Computation	Liability [Credit] ₦	Expense (P/L) [Debit] ₦
1/1/2018 to 31/12/2018	*Year-End:* [(1,000 - {70 + 120}) x 50 SARs x 7.20 x 1/3 years]	97,200.00	97,200.00
1/1/2019 to 31/12/2019	Balance B/fwd *Year-End:* [(1,000 - {70 + 80 + 50}) x 50 SARs x 7.75 x 2/3 years]	97,200.00 206,666.67	109,466.67
1/1/2020 to 31/12/2020	Balance B/fwd **Exercised:** 150 staff × 50 SARs × 7.50 **Yet to Exercise:** *Year-End:* [(1,000 - {70 + 80 + 44} - 150) × 50 SARs × 9.10 × 3/3 years]	206,666.67 298,480.00	56,250.00 91,813.33 **148,063.33**
1/1/2021 to 31/12/2021	Balance B/fwd **Exercised:** 140 staff × 50 SARs × 10.00 **Yet to Exercise:** *Year-End:* [(1,000 - {70 + 80 + 44} - 150 - 140) × 50 SARs × 10.00]	298,480.00 276,060.00	70,000.00 22,420.00 **47,580.00**
1/1/2022 to 31/12/2022	Balance B/fwd **Exercised:** 516* staff × 50 SARs × 10.00 **Yet to Exercise:** *Year-End:* [(1,000 - {70 + 80 + 44} - 150 - 140 - 516) × 50 SARs × Fair Value]	276,060.00 0.00	322,500.00 276,060.00 **46,440.00**

Accounting Entries:

Accrued Expense (Cash-Settled SBP)

- **Debit:** Expense (employee cost)
- **Credit:** Liability (share-based payment obligation)

Date	Amount (₦)
Dec-31, 2018	97,200.00
Dec- 31, , 2019	109,466.67
Dec-31, 2020	148,063.33
Dec-31, 2021	47,580.00
Dec-31, 2022	46,440.00
Total expenses accrued for 2018 - 2022	**448,750.00**

Settlement (cash-settled SBP)

- **Debit:** Liability (share-based payment obligation)
  Credit: Bank

Date	Amount (₦)
Dec-31, 2018	0.00
Dec-31, 2019	0.00
Dec-31, 2020	56,250.00
Dec-31, 2021	70,000.00
Dec-31, 2022	322,500.00
Total Cash Expenses for 2018 - 2022	**448,750.00**

15.4.3 Effects of vesting conditions on the measurement of a cash-settled share-based payment

IFRS 2 requires that the liability for a cash-settled share-based payment should be measured initially and at the end of each reporting period until settled, at its fair value **taking into account the terms and conditions under which it was issued.**

Accounting for the effects of vesting and non-vesting conditions on the measurement of a cash-settled share-based payment should follow the approach used for measuring equity-settled share-based payments.

15.4.4 Classification of share-based payment transactions with net settlement features

Some tax jurisdictions require entities to withhold an amount for an employee's tax obligation associated with share-based payments and pay that amount to the taxation authorities.

Entities in such jurisdictions might include terms and conditions in employee share-based payment arrangements which allow them to deduct equity instruments up to the monetary value of the employee's tax liability from the total number of equity instruments that would otherwise be issued on vesting. The employer would then make a cash payment on behalf of the employee to the tax authority.

In the absence of other guidance it might be difficult to identify the employee share scheme as equity-settled or cash-settled.

Such a transaction should be classified as equity-settled in its entirety **as long as the entire share-based payment would otherwise be classified as equity-settled if it had not included the net settlement feature.**

15.4.5 Accounting for a modification to terms and conditions that result in a cash share-based payment changing to equity-settled

IFRS 2 provides specific guidance on the following two situations:

(a) Modifications to the terms of a cash-settled share-based payment transaction that result in it changing to an equity-settled share-based payment transaction.

(b) The settlement of a cash-settled share-based payment and its replacement by a new equity-settled share-based payment.

At the date of the modification:

(a) the share-based payment transaction is measured by reference to the modification-date fair value of the equity instruments **granted as a result of the modification**;

(b) the previously recognised liability in respect of the cash-settled share-based payment is **derecognised**;

(c) the equity-settled share-based payment is recognised to the extent that the services have been rendered up to this date; and

(d) any difference between the carrying amount of the liability derecognised and the amount recognised in equity is recorded in profit or loss immediately.

15.5 Measurement of share-based payment transaction with cash alternatives

15.5.1 Introduction

Some employee share-based payment arrangements give the employees (or the employer) the right to choose to receive (or pay) cash instead of shares or options, or instead of exercising options.

The standard contains different accounting methods for cash-settled and equity-settled share-based payment transactions. Where there is a choice of settlement, it is necessary to determine which accounting method should be applied.

This depends on whether:

(a) the employee has the choice of settlement; or

(b) the entity has the choice of settlement.

15.5.2 Share-based payment transactions in which the counterparty has the choice of settlement

Background

The counterparty has been granted rights to a compound financial instrument (i.e. a financial instrument that includes both debt and equity components). **Thus the counterparty has:**

(a) the right to be paid in cash; with,

(b) an option to take shares.

The entity must measure the fair value of the compound financial instrument at grant date identifying a value to both components.

Transactions where the fair value of goods and services is measured directly

This category will not include transactions with employees. The equity component is measured as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when the goods or services are received.

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Other transactions

This category includes transactions with employees. The debt component and the equity component are measured separately. The fair value of the compound financial instrument is the sum of the fair values of the two components.

Share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other (for example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights).

In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. (This is because the fair value of the equity component must take into account the fact that the holder forfeits the right to receive cash in order to exercise the option.) In addition the entity must account separately for the goods or services received or acquired in respect of each component of the compound financial instrument.

(a) For the debt component, the entity must recognise the goods or services acquired, and a liability to pay for those goods or services, as the counterparty supplies goods or renders service, in the same way as other cash-settled share-based payment transactions.

(b) For the equity component (if any), the entity must recognise the goods or services received, and an increase in equity, as the counterparty supplies goods or renders service, in the same way as other equity-settled share-based payment transactions.

Date of settlement
The liability is **re-measured** at its fair value at the date of settlement.

(a) If the entity issues equity instruments on settlement (instead of paying cash), the liability is transferred direct to equity, as the consideration for the equity instruments issued.

(b) If the entity pays cash on settlement (instead of issuing equity instruments), any equity component previously recognised remains in equity. (The entity is allowed to recognise a transfer within equity, i.e. a transfer from one component of equity to another).

15.5.3 Share-based payment transactions in which the entity has the choice of settlement

Where an obligation exists
The entity must determine whether it has a present obligation to settle in cash and account for the share-based payment transaction accordingly.

The entity has a present obligation to settle in cash if the choice of settlement in equity instruments:
(a) has no commercial substance; or,
(b) if the entity has a **past practice** or a stated policy of settling in cash.

Where an obligation exists, the entity must account for the transaction according to the rules applied to cash-settled share-based payment transactions.

Where there is no obligation
Where an obligation does **not exist,** the entity must account for the transaction according to the rules applied to equity-settled transactions.
In this case the entity may still decide to settle in cash at the settlement date.

(a) If the entity elects to settle in cash, the cash payment is accounted for as the **repurchase** of an equity interest, i.e. as a deduction from equity.

(b) If the entity elects to settle by issuing equity instruments, no further accounting is required (other than a transfer from one component of equity to another, if necessary).

There is a special rule to amend the above where the entity elects the settlement alternative with the higher fair value, as at the date of settlement. If this is the case the entity must recognise an additional expense for the excess value given:

(a) If cash is paid and the fair value of this is greater than the fair value of the shares that could have been issued in settlement the difference must be taken to profit.

(b) If shares are issued in settlement and they have a fair value greater than that of the cash alternative the difference must be taken to profit.

Share-based payment transactions – cash-settled or equity-settled

Where either the entity or the employee has a choice of issuing shares or paying cash in return for the provision of the employees' services, the entity shall recognise a liability if it determines that it has an obligation to settle the liability in cash. If on settlement the entity issues shares rather than by paying in cash then the value of the liability should be transferred to equity.

Illustrative example – GBEMSKI Co (choice of settlement)

On **October 1, 2022**, GBEMSKI Co granted **one of its directors** the right to choose either **24,000 shares** in GBEMSKI or **20,000 phantom shares** (a cash payment equal to the value of 20,000 shares).

The right is conditional on the director remaining in employment for **three years** from the grant date.

Fair-value data:

(i) Fair value of the share alternative at grant date: **₦4.50 per share**

(ii) Fair value of each option (cash alternative) on October 1, 2022: **₦5.20 per share**

(iii) Fair value of each option on September 30, 2023: **₦6.10 per share**

Required:

Explain, with suitable calculations, the accounting treatment for the year ended **September 30, 2023**.

Suggested solution:

Step	Narrative and Figure
Identification	The right granted to the director represents **a share-based payment with a choice of settlement** – a *compound financial instrument* split into an equity component (share alternative) and a liability component (cash-settled alternative).
Fair-value split at grant date	• Share alternative: 24,000 shares × ₦4.50 = **₦108,000** • Cash alternative: 20,000 phantom shares × ₦5.20 = **₦104,000** • **Equity component** = ₦108,000 – ₦104,000 = **₦4,000**
Vesting period	Three years (service condition).

Year ended September 30, 2023 – Journal entries:

Component	Calculation	Profit or loss (Debit)	(Equity & Liability) Credit
Equity component (*treated as equity-settled*)	₦4,000 × 1/3 years	**₦1,333**	Equity: ₦1,333
Liability component (*treated as cash-settled*)	20,000 × ₦6.10 × 1/3 years	**₦48,800**	Liability: ₦48,800

Key points:

(a) The equity expense (₦1,333) is based on the grant-date fair value and is **spread evenly** over the vesting period; it is **not re-measured** thereafter.

(b) The liability expense (₦48,800) is also spread over the vesting period **but is re-measured to fair value at each reporting date**; above, the year-end fair value used is ₦6.10 per phantom share.

In summary:

Entity has the choice of settlement

Where the **entity** has the option to settle a share-based payment either in **cash** or **equity instruments**, the accounting depends on whether there is a **present obligation** to settle in cash.
If a present obligation exists (e.g., due to a stated policy, past practice, or established pattern of cash settlement):

1. **Treat as a cash-settled share-based payment.**
2. **If no present obligation exists** to settle in cash:
3. **Treat as an equity-settled share-based payment.**

The existence of a constructive obligation may result in cash settlement even if the contract appears to offer a choice

Counterparty has the choice of settlement

If the **counterparty** (e.g., employee or supplier) can choose between **cash** or **equity instruments**, the arrangement is accounted for as a **compound financial instrument**.

Accounting treatment

a) The transaction is ***split*** into:
b) **Debt Component**: Measured as if it were a cash-settled share-based payment.
c) **Equity Component**: Measured as the ***residual amount*** at the grant date, i.e.: **Fair value of total award – Fair value of cash alternative.**

Once the debt and equity elements are established, each is accounted for in accordance with its classification under IFRS 2.

15.6 Other considerations

15.6.1 Selected IFRS 2 application issues – focused guidance for SBR candidates

Topic	Key principles	Practical implications	Examiner hints
Fair value where identifiable goods services are low (IFRIC 8)	▪ If the fair value of identifiable goods or services is *lower* than the fair value of the equity instruments granted, the difference is treated as the fair value of **unidentifiable services**. ▪ Measure the unidentifiable portion as *fair value of SBP – fair value of identifiable goods / services*.	Typical example: shares donated to a charity. No direct goods or services are received but corporate image improves. The excess is debited to expense and credited to equity.	In calculations always show both legs: value of equity instruments and identifiable consideration received, then plug the balance.
Special-purpose entities (SPEs) and employee benefit trusts	▪ An employee benefit trust (EBT) created to hold shares for SBP schemes is consolidated by the sponsoring entity (SIC 12 logic). ▪ IFRS 2 applies to the group; IAS 19 no longer used for equity compensation plans.	Shares held by the EBT are treated as *treasury shares* until allocated. Any transactions between the entity and the trust are *equity* in consolidated statements.	When you see an EBT holding own shares, think "consolidate and treat as equity-settled" rather than as an investment.
Group and treasury share transactions (IFRIC 11)	▪ The classification depends on **who receives the services** (subsidiary or parent) **and who settles** (subsidiary or parent). ▪ IFRIC 11 requires using an **equity view in the books of the entity receiving the service**, unless the subsidiary itself settles in cash.	If the parent issues its own equity to employees of a subsidiary, the *subsidiary* recognises an equity-settled SBP (credit to equity) while the *parent* shows the grant in its own equity. The consolidated statements also show equity-settled.	Memorise the decision grid below and state both the separate and consolidated treatments.
4 Decision grid – common group SBP arrangements			

15.6.2 Group share-based payment classification summary

Entity receiving service	Entity settling	Settlement form	Parent financials	Subsidiary financials	Consolidated Financials
Subsidiary	Subsidiary	Subsidiary's equity	N/A	**Equity**	**Equity**
Subsidiary	Subsidiary	Cash	N/A	**Cash**	**Cash**
Subsidiary	Subsidiary	Parent's equity	N/A	**Cash**	**Equity**
Subsidiary	Parent	Subsidiary's equity	**Cash**	**Equity**	**Equity**
Subsidiary	Parent	Cash	**Cash**	**Equity**	**Cash**
Subsidiary	Parent	Parent's equity	**Equity**	**Equity**	**Equity**

**Read the grid horizontally: identify who gets the service first, then who pays, then map the accounting in each set of financial statements.*

15.6.3 Deferred tax implications of share-based payments (Guidance tailored for ICAN SBR candidates)

Core issue
Entities often obtain a tax deduction that differs in timing or amount from the remuneration expense recognised under IFRS 2.

Example – Service-only options

Event	Accounting treatment	Tax outcome
Grant and vesting	Expense is recognised over the vesting period at the option's fair value.	**No deduction** until exercise.
Exercise	No further expense (equity-settled).	Deduction equals the **intrinsic value** (share price – exercise price) on exercise.

This difference creates a **temporary difference that must be dealt with under IAS 12.*

Measuring the deferred tax asset (DTA)
At each reporting date calculate: DTA = Temporary difference × Tax rate

Temporary difference = (Tax base of future deduction) – (Carrying amount of SBP expense)

Where:
(i) Carrying amount = Cumulative IFRS 2 expense in equity*
(ii) Tax base = Estimated future tax deduction (*intrinsic value* × *no. of options expected to vest*)

*For equity-settled awards the carrying amount in equity is the cumulative expense. If the estimated deduction **exceeds** the cumulative expense, the surplus (excess tax benefit) is credited to **equity** rather than profit or loss.

Illustrative worked example (amounts in ₦)

On January 1, 2022, Bruce granted 5,000 share options to an employee vesting two years later on December 31, 2023. The fair value of each option measured at the grant date was ₦3.

Tax law in the jurisdiction in which the entity operates allows a tax deduction of the intrinsic value of the options on exercise. The intrinsic value of the share options was ₦1.20 at December 31, 2022 and ₦3.40 at December 31, 2023 on which date the options were exercised.
(Assume a tax rate of 30%.)

Required:
Show the deferred tax accounting treatment of the above transaction at December 31, 2022, December 31, 2023 (*before exercise*), and on exercise.

Suggested solution

Facts

a) Grant date: Jan 1, 2022 – **5,000** options, vest Dec 31, 2023 (two-year service).
b) Grant-date fair value per option: **₦3.00**.
c) Year-end share prices (intrinsic value per option):
   (i) Dec 31, 2022 – **₦1.20**
   (ii) Dec 31, 2023 – **₦3.40** (options exercised).
d) Corporate tax rate: **30%**.
e) All options expected to vest and do vest.

	Dec 31, 2022	Dec 31, 2023 (*Before Exercise*)
Carrying amount of share-based payment expense	₦0	₦0
Less: Tax base of share-based payment expense		
(5,000 × ₦1.20 ×1/2 years) / (5,000 × ₦3.40)	(₦3,000)	(₦17,000)
Temporary difference	**(₦3,000)**	**₦17,000**
Deferred Tax Asset @ 30% (***Debit**:* DTA)	₦900	₦5,100
Deferred Tax Charge (***Credit**:* P/L) [₦5,100 – ₦900]	₦900	₦4,200
Deferred Tax Charge (***Credit**:* Equity)	₦0	₦600

On Exercise – Replace deferred tax asset with current tax

Entry	Debit: ₦	Credit: ₦	Note
Deferred tax (P/L)	4,500		*Reversal*
Deferred tax (Equity)	600		
Deferred tax asset		5,100	
Current tax asset	5,100		
Current tax (P/L)		4,500	
Current tax (Equity)		600	

Working

	Dec 31, 2022	Dec 31, 2023
Accounting expense **recognise**d: (5,000 × ₦3 ×1/2 years) (5,000 × ₦3)	₦7,500	₦15,000
Tax deduction (intrinsic value)	(₦3,000)	(₦17,000)
Excess Temporary Diff. (Excess on Intrinsic Value over the Expense)	**–**	**₦2,000**
Excess deferred tax asset @ 30%	**–**	**₦600**

Examination pointers:

a) **Identify timing mismatch** – tax relief on exercise versus accounting expense on vesting.
b) **Compute temporary difference** each year using expected intrinsic value.
c) **Split excess** deduction over accounting expense: profit or loss up to cumulative expense, surplus to equity.
d) **Replace DTA with current tax** on exercise.
e) Use **clear workings** and label all journal entries – crucial for ICAN SBR marks.

15.7 Disclosures

15.7.1 IFRS 2 Disclosure Requirements – Practical Guide for ICAN SBR Candidates

IFRS 2 asks entities to give users enough information to understand **what share-based payment (SBP) schemes exist, how they were valued, and how they affect profit or loss and the statement of financial position**.

15.7.2 The disclosures fall into three linked areas.

Area	Purpose	Key information to present
Nature and extent of SBP arrangements	Help users grasp the scale and terms of schemes.	▪ Description of each scheme, including vesting requirements, maximum options, and settlement method (cash or equity). ▪ Reconciliation of option numbers and weighted average exercise prices: outstanding at start, granted, forfeited, exercised, expired, outstanding at end, and exercisable at end. ▪ For exercised options: weighted average share price at exercise, or an average if exercises are frequent. ▪ For options outstanding: range of exercise prices and weighted average remaining life, split into bands if the range is wide.
How fair value is determined	Allow users to understand the valuation technique.	▪ Valuation model used (for example Black-Scholes or binomial). ▪ Key inputs and assumptions: share price, exercise price, expected volatility, option life, expected dividends, risk-free rate. ▪ Whether market conditions were included in the model.

Area	Purpose	Key information to present
Effect on profit or loss and financial position	Show the monetary impact.	▪ Total expense recognised for the period where no asset is recorded, split between cash-settled and equity-settled parts. ▪ Closing liability for cash-settled schemes, plus the intrinsic value of vested but unsettled rights at period-end.

Step-by-step disclosure checklist

1. **Describe each scheme clearly**
   Example wording: "The Company operates an employee share option plan that grants options with a three-year service condition and a maximum life of ten years. Options are settled in equity."

2. **Reconcile option movements**

Movement	Number of options	Weighted average exercise price
Outstanding 1 January	x,xxx	₦xx.xx
Granted	x,xxx	₦xx.xx
Forfeited	x,xxx	₦xx.xx
Exercised	x,xxx	₦xx.xx
Expired	x,xxx	₦xx.xx
Outstanding 31 December	x,xxx	₦xx.xx
Exercisable 31 December	x,xxx	₦xx.xx

3. **Explain the valuation**
   "Fair value at grant was measured using a Black-Scholes model with the following inputs: share price ₦28.50, exercise price ₦30.00, expected volatility 25 percent, expected life six years, risk-free rate 11 percent, no expected dividends."

4. **Show the profit or loss effect**
   Expense for the year: ₦x,xxx,xxx for equity-settled, ₦x,xxx,xxx for cash-settled.

5. **Show the statement of financial position effect**
   Share-based payment reserve: ₦x,xxx,xxx (*Equity*).
   Cash-settled liability: ₦x,xxx,xxx, of which ₦x,xxx,xxx is intrinsic value related to vested rights.

Exam Tips for SBR:

a) Focus on **linking the numbers back to the scheme description**. The examiner expects you to state why each figure matters.
b) Remember that **equity-settled amounts are not re-measured** after grant, but **cash-settled liabilities are updated to fair value at each reporting date**.
c) Clearly separate **fair value at grant** (for equity) from **intrinsic value at period-end** (for liabilities).
d) Use **tables** to summarise movements and valuation inputs; this scores presentation marks and keeps your answer concise.

15.8 Chapter review

A. Key take-aways

Theme	Core message
Classification	Correctly identify whether an award is equity, liability or compound – this drives every other step.
Fair-value focus	Equity awards are measured once (grant date); cash awards are updated continuously.
Vesting conditions	Service & non-market targets affect *quantity* of options expensed; market targets affect only *valuation*.
Modifications & cancellations	Increases in fair value → recognise incremental value prospectively; cancellations → accelerate remaining charge.
Group schemes	Subsidiary always recognises the expense for services it receives, even if the parent settles.
Disclosure discipline	Explain scheme features, option-pricing inputs and the P/L / SOFP impact – users must see the story behind the numbers.

B. Quick-test questions

a. **Measurement date:**
When is the fair value of options granted to external consultants measured?

b. **Cash-settled liability:**

c. How is the liability for share appreciation rights updated at year-end and what entry is made?

d. **Modification:**
An option's exercise price is reduced mid-vesting. Outline the journal for the incremental fair value.

e. **Choice of Settlement – Employee Option:**

f. *Explain how to split the compound instrument and which component is re-measured.*

g. **Disclosure:**
List four key inputs that must be disclosed for an option-pricing model.

**(Answers: 1 – When the service is received; 2 – Re-measure to fair value, Dr P/L Cr Liability; 3 – Dr P/L Cr Equity for incremental FV over remaining vesting; 4 – Debt (cash) component re-measured, equity component fixed; 5 – Share price, exercise price, expected volatility, option life, risk-free rate, expected dividends.)*

C. Exam-technique reminders

a) Start with classification and vesting period – marks are available even before you touch numbers.
b) Lay out option-movement tables – they earn presentation marks and guide your calculations.
c) Quote IFRS 2 paragraph references sparingly but precisely – shows authority without wasting time.
d) Show workings clearly – incremental fair value, truing-up for leavers, and liability roll-forwards must be transparent.

15.9 Worked examples - questions and suggested solutions

15.9.1 Questions

Question 1

Background

On January 1, 2021, **Alphatek Plc** granted **5,000 share options** to each of its **300 senior managers**.

a) Exercise price: ₦20
b) Grant-date fair value per option: ₦6
c) Vesting condition: three years' service (vests on 31 December 20X3)
d) Expected forfeiture at grant: 10 per cent of managers
e) Expected dividend: nil

At December 31, 2021 management expected total forfeiture over the vesting period to be 12%. At December 31, 2022 the estimate changed to 8%.

All remaining managers remained in service during 2023.

On January 1, 2022 Alphatek repriced the options by reducing the exercise price to ₦15.

- Fair value of each original option immediately before repricing: ₦4
- Fair value of each repriced option: ₦7

Required

(a) Theoretical questions:

(i) Explain how IFRS 2 classifies this arrangement and why

(ii) State the general recognition and measurement principles for equity-settled share-based payments

(iii) Describe how a modification that increases fair value is accounted for.

(b) Practical questions:

(i) Calculate the total expense to be recognised in profit or loss for each of the years ended December 31, 2021, 2022 and 2023.

(ii) Show the journal entry required on 31 December 2022 for the incremental fair value arising from the repricing.

(iii) State the balance that will appear in the Share-based Payment Reserve at December 31, 2023.

QUESTION 2 – Targeted Quantitative and Short Theory Case

Background

Beta Ltd granted **cash-settled share appreciation rights (SARs)** to all 120 staff on July 1, 2024.

a) Rights per employee: 200
b) Vesting condition: two years' service
c) Fair value of each SAR at grant: ₦9
d) Fair value at 30 June 2025: ₦11
e) Fair value at 30 June 2026: ₦14

Staff turnover: five employees left in the first year and another three left in the second year. All others remained and exercised immediately on vesting.

Required

(a) **Theory**

(i) Explain why this arrangement is classified as cash-settled under IFRS 2.

(ii) State the re-measurement requirement for cash-settled awards.

(b) **Calculation**

(i) Compute the liability and expense to recognise at 30 June 2025

(ii) Compute the liability, expense and settlement entry at 30 June 2026 (vesting date).

Question 3: Cancellation and reissuance

On January 1, 2021, Popsy FARAs Co made an award of 3,000 share options to each of its 1,000 employees. The employees had to remain in employment until December 31, 2023 in order to be entitled to the share options. At the date of the award and at December 31, 2021, management estimated that 100 employees would leave the company before the vesting date. Popsy FARAs Co accounted for the options correctly in its financial statements for the year ended December 31, 2021. The fair value of each option on January 1, 2021 was ₦5.

The share price of Popsy FARAs Co fell substantially during 2021. On January 1, 2022 the fair value of the share options had fallen to ₦1 each and 975 of the employees who were awarded options remained in the company's employ. During the year ended December 31, 2022, 35 of those employees left and the company estimated that a further 40 would leave in the year to 31 December 31, 2023.

Required

Discuss, with suitable calculations, the accounting treatment of the share options in Popsy FARAs Co's financial statements for the year ended December 31, 2022 if on January 1, 2022:

(a) The original options were cancelled and ₦4 m is paid to employees as compensation.

(b) Popsy FARAs Co's management cancelled the share options and replaced them with new share options, vesting on December 31, 2024, the fair value of each replacement option on January 1, 2022 being ₦7. No compensation was paid. The company estimates that a further 40 employees would leave during the year to December 31, 2024.

15.8.2 Suggested solutions

Question 1

(a)

Scenario Question	Suggested Practical Answer
(i) Classification	IFRS 2 treats the grant as an equity-settled share-based payment because employees will receive options over the entity's own shares and the entity has no present obligation to pay cash.
(ii) Recognition and measurement principles	• Measure the options at their grant-date fair value. • Recognise the fair value as an expense over the vesting period in proportion to the services received. • Update the number of awards expected to vest for service and non-market performance conditions; do not re-measure fair value after grant.
(iii) Accounting for an increase in fair value (modification)	Treat the repricing as a modification of the original award: ▪ Continue to expense the original grant-date fair value over the original vesting period. ▪ Calculate the incremental fair value (new fair value minus the fair value of the old options immediately before modification). ▪ Recognise that incremental amount prospectively over the remaining vesting period.

(b)

Step	Computation	Explanation
1 - Initial valuation	300 managers × 5,000 options × ₦6 = ₦9,000,000	Grant-date fair value fixed.
2 - Revised expected vesting – year 1	Expected to vest: 300 × 88% = 264 managers Options expected to vest: 264 × 5,000 = 1,320,000	IFRS 2 requires best estimate each year.
3 - Expense year 1	1,320,000 × ₦6 × 1/3 years = ₦2,640,000	One-third of total, spread over service period.
4 - Incremental fair value	Increment per option: ₦7 − ₦4 = ₦3	Increase caused by modification.
5 - Expected vesting – year 2	Expected managers: 300 × 92% = 276 Options: 276 × 5,000 = 1,380,000	Updated estimate end of year 2.
6 - Original scheme cumulative by 2022	1,380,000 × ₦6 × 2/3 years = ₦5,520,000	Cumulative original charge.
7 - Incremental element cumulative by 2022	1,380,000 × ₦3 × 1/2 years = ₦2,070,000	Increment spread over remaining two years.
8 - Expense year 2	(5,520,000 + 2,070,000) − 2,640,000 = **₦4,950,000**	Current year charge.
9 - Final vesting – year 3	Actual managers: 300 × 92% = 276 (no further leavers)	True-up to actual.
10 - Original cumulative by 2023	1,380,000 × ₦6 × 3/3 years = ₦8,280,000	Full original amount.
11 - Incremental cumulative by 2023	1,380,000 × ₦3 × 2/2 years = ₦4,140,000	Full incremental amount.
12 - Expense year 3	(8,280,000 + 4,140,000) − (5,520,000 + 2,070,000) = **₦4,830,000**	Balancing figure.
13 - Equity reserve 31 Dec 2023	8,280,000 + 4,140,000 = **₦12,420,000**	Cumulative credit.

(ii) **Journal for incremental fair value on December 31, 2022**

Debit:	Employee Cost (P/L)	₦2,070,000	
	Credit: Share-based Payment Reserve		₦2,070,000

(iii) The balance that will appear in the share-based payment reserve at December 31, 2023 stood at **₦12,420,000.**

Guidance note:

(i) Identify equity-settled status, fix grant-date fair value and update only for service and non-market performance conditions.

(ii) For favourable modifications recognise the incremental fair value over the remaining vesting period.
(iii) Always revisit the expected number of options to vest and true up annually.

Solution 2

(a) Theoretical Questions – Concise Answers

Scenario Question	Suggested Practical Answer
(i) Classification	The award is cash-settled because employees will receive a cash amount linked to the share price (share appreciation rights). This creates a liability rather than an equity instrument, so IFRS 2 treats it as a cash-settled share-based payment.
(ii) Re-measurement rule	Measure the liability at fair value at each reporting date and again on settlement. Recognise all changes in that fair value immediately in profit or loss.

(b) (i) 2025 Financial Year:

Item	Working	Amount ₦
Employees expected to vest – 30 June 2025	120 − 5 = 115	
Rights expected	115 × 200 = 23,000	
Liability 30 June 2025	23,000 × ₦11 × 1/2 years	**126,500**
Expense year 1	126,500	**126,500**

(ii.) 2026 Financial Year:

Item	Working	Amount ₦
Employees vesting 30 June 2026	120 − 5 − 3 = 112	
Rights vesting	112 × 200 = 22,400	
Liability before settlement	22,400 × ₦14	**313,600**
Previous liability	126,500	
Expense year 2	313,600 − 126,500	**187,100**

Settlement entry June 30, 2026

Debit:	Liability (SBP obligation)	₦313,600	
	Credit: Cash		₦313,600

Guidance note:

(i) Cash-settled awards create a liability measured at fair value at each reporting date until settlement.
(ii) Service conditions affect the number of rights expected to vest, not the per-unit fair value.
(iii) The profit or loss charge each year equals the movement in the liability.

Solution 3 – Popsy FARAs Co Cancellation and Reissuance (Year Ended December 31, 2022)

(a) Original options cancelled and ₦4 million compensation paid

Cancellation is treated as accelerated vesting, so the expense that would have been recognised over the remaining two-year vesting period is recognised immediately in profit or loss:

Step	Calculation	₦ m
Equity already recognised at 1 January 2022	(1,000 – 100) employees × 3,000 options × ₦5 × 1/3 years	4.5
Accelerated vesting (two years' unrecognised fair value)	(900* employees × 3,000 × ₦5) − 4.5	9.0
Equity c/d at cancellation date	₦4.5 million + ₦9.0 million	**13.5**

Journal – Immediate expense for acceleration

Entry	Account	₦ million
Debit	Profit or loss	**9.0**
Credit	Equity	**9.0**

Settlement treated as repurchase of equity

Entry	Account	₦ million	Note
Debit	Equity (900 × 3,000 × ₦1)	**2.7**	fair value of options repurchased
Debit	Profit or loss (excess)	**1.3**	
Credit	Cash	**4.0**	

** EY's interpretative guidance suggests that, given the ambiguity of IFRS 2 paragraph 28(a), the entity may base its calculations on the actual number of employees still in service at the cancellation date (975 in this case); and Popsy FARAs uses 900 estimated to vest in this case.*

(b) Original Options Cancelled and Replaced with New Options (No Compensation)

In this scenario, replacing the share options is regarded as a ***modification*** of the original award. Any excess of the replacement options' fair value over the fair value of the cancelled options is recognised as an expense, spread across the new vesting period.

1. Incremental fair value at 1 January 2022

Item	₦ m
Fair value of replacement options (3,000 × ₦7)	7
Net fair value of cancelled options (3,000 × ₦1)	(1)
Incremental amount (spread over new vesting period)	**6**

2. Expense for 2022

Component	Working (W)	₦ million
Original grant – charge for Y2 (*years 2–3 of original period*)	((975 – 35 – 40 – 40 = 860**) × 3,000 × ₦5 × 2/3 years)	8.60
Replacement options – incremental value for Y2 (*year 1 of new 3-year period*)	(860 × 3,000 × ₦6 × 1/3 years)	5.16
Total P/L charge (*balancing figure*)	₦8.60 + ₦5.16	**13.76**

3. Equity reconciliation

	₦ million
Equity B/fwd 1 Jan 2022 (from part (a))	4.50
+ Profit or Loss, charge 2022	9.26
Equity C/fwd 31 Dec 2022 (*"W" - above*)	**13.76**

Journal for 2022

Entry	Account	₦ million
Debit	Profit or loss	**9.26**
Credit	Equity	**9.26**

Working note:

(i) **860 employees** = *975* in service *minus* *35* leavers in 2022 and expected *40* + *40* further leavers.

(ii) This is invariably based on the number of employees whose awards are finally expected to vest for both elements.

(iii) Original fair-value element continues over the *original* vesting period; incremental element is recognised over the *new* period (IFRS 2 B43(a)).

ICAN 2025

Professional Level

Strategic Business Reporting

CHAPTER 16

IFRS 13:FAIR VALUE MEASUREMENT

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ICAN 2023

16 IFRS 13: Fair Value Measurement

16.0 Learning objective

This chapter discusses IFRS 13: Fair Value Measurement.

16.1 Learning outcomes

On the successful completion of this chapter, readers should be able to:

a. **Explain the role of IFRS 13 within the wider IFRS framework and the ICAN SBR syllabus.**
b. **Distinguish clearly between entry price and exit price, and between transaction costs, transport costs and fair value.**
c. **Identify the correct unit of account and describe how this affects the measurement of an asset, a liability or a net position.**
d. **Select the relevant market (principal or most advantageous) when more than one market exists.**
e. **Apply the highest and best use principle to non-financial assets, including the stand-alone and in-combination premises.**
f. **Choose and justify an appropriate valuation technique – market, cost or income – in a Nigerian context.**
g. **Categorise inputs into Levels 1, 2 and 3, and explain the impact of the hierarchy on disclosure.**
h. **Measure the fair value of liabilities and own equity instruments, including net risk positions permitted by IFRS 13.**
i. **Incorporate non-performance risk and demand features into liability valuations.**
j. **Prepare IFRS 13-compliant disclosures, differentiating between recurring and non-recurring measurements.**

16.2 Introduction to IFRS 13

16.2.1 Background

International Financial Reporting Standards frequently require or permit entities to measure or disclose the fair value of assets, liabilities, or their own equity instruments. Examples include:

Standard	Requirement linked to fair value
IAS 16/IAS 38	The revaluation model bases an asset's carrying amount on its fair value at the revaluation date.
IAS 40	Under the fair value model, investment property is valued at fair value at every reporting date.
IAS 19	Defined benefit obligations are presented as the fair value of plan assets less the present value of plan liabilities.
IFRS 9	All financial instruments are initially measured at fair value. Subsequent measurement is at amortised cost when strict conditions are met; otherwise measurement continues at fair value. Certain financial liabilities are also remeasured at fair value.
IFRS 7	When a financial instrument is not measured at fair value in the statement of financial position, its fair value must be disclosed.

Standard	Requirement linked to fair value
IFRS 3	Determining goodwill involves measuring: • the acquisition-date fair value of the consideration transferred • the fair value of identifiable assets acquired and liabilities assumed, subject to limited exceptions.
IFRS 2	Equity-settled share-based payments are accounted for using the grant-date fair value of the equity instruments awarded.
IAS 36	Recoverable amount is the lower of value in use and fair value less costs of disposal.
IFRS 5	A non-current asset held for sale is measured at the lower of its carrying amount and fair value less costs of disposal.

In many of these Standards the guidance on fair value was brief or had evolved piecemeal over time, leading to inconsistency.

16.2.2 Purpose of IFRS 13

IFRS 13 was introduced to create a single, coherent framework for fair value across all Standards. The objectives are to:

a. Provide a precise definition of fair value.
b. Set out a unified measurement framework that applies whenever another IFRS requires or allows fair value.
c. Prescribe consistent disclosures that explain how fair values have been determined.

Note that IFRS 13 does not decide *which* items must be fair valued or *when* fair value is required; those decisions remain within the individual IFRSs that refer to fair value. The measurement framework applies both at initial recognition and at subsequent measurement dates.

16.2.3 Scope of IFRS 13

The Standard applies wherever another IFRS:

a) requires fair value measurement or
b) permits fair value measurement or disclosures that are based on fair value (such as fair value less costs to sell).

Main exclusions

IFRS 13 does not apply to:

a) Share-based payment transactions governed by IFRS 2.
b) Measurements similar to fair value but defined differently, for example:
   (i) net realisable value in IAS 2 Inventories
   (ii) value in use in IAS 36 Impairment of Assets.

Disclosure exemptions

The disclosure requirements of IFRS 13 do not extend to:

- **plan assets measured at fair value under IAS 19**
- **investments held by retirement benefit plans under IAS 26**
- **assets whose recoverable amount has been determined as fair value less costs of disposal under IAS 36.**

16.2.4 Fair value – The core idea

Fair value reflects how the market would price an item today, not how the reporting entity views it. When two businesses hold identical assets, each asset should carry the same fair value so long as market conditions are identical. Entity-specific intentions, such as keeping an asset in use or planning to sell it next year, do not influence the figure.

Although IFRS 13 words the definition in terms of assets and liabilities, the same principles apply when valuing an entity's own equity instruments (for example, in a share-for-share acquisition).

Remember: fair value is an exit price – the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction at the measurement date.

Definition: Exit price and entry price

(a) Exit price: The price that would be received to sell an asset or paid to transfer a liability.

(b) Entry price: The price paid to acquire an asset or received to assume a liability in an exchange transaction.

16.2.5 Identifying the Asset or Liability to be Measured

Fair value is always determined for a specific item. The fair value guidance in IFRS 13 is applied to the unit of account specified by the relevant standard, whether that unit is a single asset or liability, a portfolio of assets, a portfolio of liabilities, or a combined group of assets and liabilities.

Unit of account: The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.

The relevant IFRS will state the *unit of account*:

a) a stand-alone asset or liability
b) a group of assets
c) a group of liabilities
d) a net position comprising both assets and liabilities.

When estimating fair value, incorporate the assumptions that knowledgeable, willing buyers and sellers would make in current market conditions. Key characteristics include:

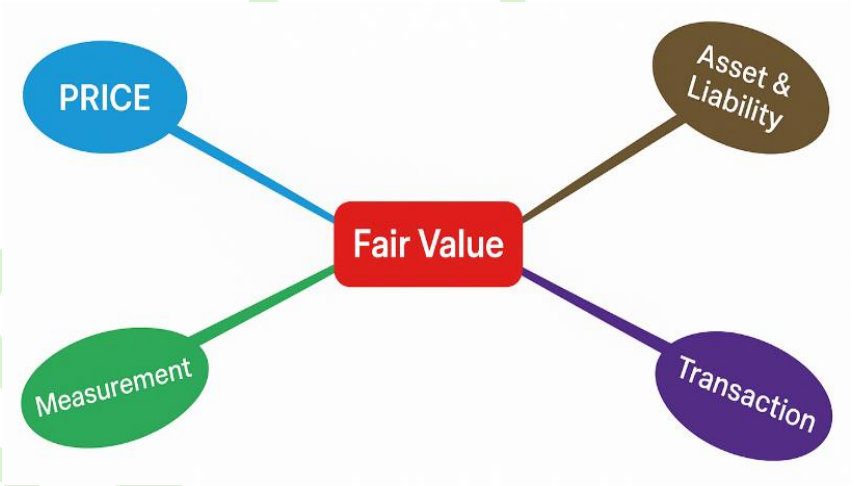
a) the item's condition and location
b) any legal or contractual restrictions on its sale or use.

16.2.6 Who are "market participants"?

A market participant must have all of the following attributes:

a) Independent of the reporting entity and of each other.
b) Informed, with a sound understanding of the item and the transaction, supported by customary due-diligence.
c) Able to transact, meaning they have the legal and financial capacity to buy or sell.
d) Willing to transact, acting without compulsion.

Visualise these parties when selecting valuation inputs; their perspective drives a credible fair value measurement as shown below.



16.3 Measurement

16.3.1 How to measure fair value

Fair value represents the price that would be received to sell an asset – or paid to transfer a liability – in an orderly, arm's-length transaction between market participants on the measurement date and under present market conditions.

Two broad situations arise:

SITUATION	APPROACH
Observable market data available	Use the quoted price directly. For example, an equity share listed on the Nigerian Exchange provides a quoted exit price.
No observable market data	Apply a suitable valuation technique that estimates the price at which an orderly sale (or transfer) would occur. Examples include discounted cash-flow models or market multiples.

Active markets

- A quoted price from an active market is the most reliable evidence and must be used when available.
- Active markets for non-financial assets (for example, specialised plant) are rare, so valuation techniques are usually required in such cases.

16.3.2 Principal market versus most advantageous market

Fair value must reflect a hypothetical sale or transfer in one of two markets:

MARKET	DEFINITION	FAIR VALUE RULE
Principal market	The market with the greatest volume and level of activity for the asset or liability.	Use the price in this market.
Most advantageous market	The market that maximises the amount received (or minimises the amount paid) after transaction costs, when no principal market exists.	Use the price in this market.

Locating the relevant market

a) An exhaustive search is not required. Use information that is reasonably available.
b) In practice, the market in which the entity normally transacts is assumed to be the principal market unless evidence shows otherwise.
c) If a principal market exists, that price is applied even if another market quotes a better price on the measurement date.

Transaction costs

a) Transaction costs are ignored when measuring fair value, because fair value is distinct from net realisable value or fair value less costs of disposal.
b) The decision to base fair value on an exit price does not imply an intention to sell.

Transport costs

If location affects value, adjust the quoted price for the costs of moving the asset from its current location to the principal (or most advantageous) market.

Illustrative fair-value examples set in the Nigerian Market Environment

Example 1 – Quoted Federal Government Bonds held by Zuma Capital Plc

	NGX Debt Board	FMDQ Exchange
Quoted clean price (₦ per ₦100 nominal)	₦103.20	₦102.75
Transaction fee (broker, regulatory & settlement)*	₦0.15	₦0.10
Net proceeds per ₦100	₦103.05	₦102.65
Daily trading volume (nominal ₦' Billion)	1.2	6.4

**Shown here only to identify the most advantageous market. Under IFRS 13 transaction costs are not deducted from the fair-value figure itself.*

Assessment

a) The principal market is FMDQ because it has the highest level of activity.

b) Even though NGX would yield a slightly higher net amount after costs, IFRS 13 requires Zuma Capital to use the FMDQ quoted price of ₦102.75 per ₦100 nominal as fair value, without adjusting for transaction fees.

Example 2 – Surplus Drilling Rig Owned by Niger Delta Services Ltd

	Port Harcourt Auction Hub (Market A)	Lagos Industrial Yard (Market B)
Indicative sale price (₦' million)	₦650	₦625
Transport cost to market	₦45	₦25
Net amount after transport	₦605	₦600
Average annual units traded	3 rigs	18 rigs

Assessment

a. Principal market — Market B, because it has the greatest volume of activity.

b. Most advantageous market — Market A, because it gives the higher net return (₦605 million versus ₦600 million).

Fair-value conclusion

IFRS 13 mandates use of the price in the principal market even if another market is more advantageous.

Therefore, the fair value of the rig is the Lagos Industrial Yard price ₦625 m, adjusted for transport because location affects value:

Fair value = ₦625 million − ₦25 million = <u>₦600 million</u>

Transaction costs are ignored in the measurement, but they were considered when identifying the principal versus most advantageous market.

These examples show how Nigerian entities should apply IFRS 13 when multiple domestic markets, such as NGX and FMDQ for securities, or regional hubs for specialised equipment are available.

16.3.3 Fair Value of Non-Financial Assets – "Highest and Best Use"

Key Concept
For any non-financial asset, fair value must reflect the highest and best use (HBU) that market participants would adopt on the measurement date. In other words, assume the asset is employed in the way that maximises its value to typical buyers, not necessarily how the reporting entity currently uses it.

Definition: Highest and Best Use
Highest and best use is the use of a non-financial asset that maximises the value of the asset itself, or of the cash-generating unit in which the asset would be deployed, from the standpoint of market participants.

HBU is considered only if the following conditions are simultaneously satisfied:

CONDITION	EXPLANATION
Physically possible	The existing size, design, condition, and location of the asset allow the proposed use.
Legally permissible	The use complies with zoning rules, environmental laws, covenants, or other legal constraints.
Financially feasible	The use generates a return acceptable to market participants after considering conversion costs.

The present use of land or equipment is presumed to be the HBU unless market evidence indicates a superior alternative.

Valuation premise

Premise	When applied	Valuation basis
Stand-alone	Asset would be used on its own.	Fair value equals the price a market participant would pay today to use the asset independently.
In-combination	Maximum value arises only when the asset is combined with complementary assets or liabilities that are also available to market participants.	Fair value equals the price a market participant would pay today, assuming the set of complementary items is available.

Nigerian illustration – Repurposing an Industrial Property

Scenario

a) ***Eko Manufacturing Plc*** **owns a 4-hectare industrial site with ageing warehouses in Apapa, Lagos.**
b) **The site is currently used as a logistics depot and was last revalued at ₦3.6 billion based on comparable industrial sales.**
c) **Recent transactions show high-rise residential towers in the same corridor selling out quickly to expatriate tenants.**

Management assessment

Criterion	Industrial use	Residential redevelopment
Physically possible	Yes	Yes, subject to demolition and piling.
Legally permissible	Current zoning is industrial; a change-of-use permit is needed.	Lagos State Planning Authority indicates that a mixed-use permit is obtainable for ₦25 million and typically granted within six months.
Financially feasible	Annual net cash flows of ₦350 million, implying a value of ₦3.6 billion at a 10% yield.	A feasibility study shows demolition and permit costs of ₦400 million and a projected exit value of ₦5.2 billion, producing an acceptable development margin.

Comparison

Valuation path	Amount (₦ billion)
Current industrial use	3.6
Residential redevelopment (*exit value 5.2 less conversion costs 0.4*)	4.8

Conclusion

Residential redevelopment is the highest and best use. The fair value of the site is therefore ₦4.8 billion, even though Eko Manufacturing currently runs a depot on the land. If the entity reports the site at fair value, that figure – not the lower industrial-use valuation – must appear in the financial statements, together with appropriate IFRS 13 disclosures.

Exam tip for ICAN SBR candidates

When faced with a valuation question:

a. **Identify potential uses and test each against the three HBU criteria.**
b. **Select the superior use and determine whether valuation is stand-alone or in-combination.**
c. **Support your choice with clear, market-based evidence and quantify conversion or demolition costs where relevant.**

16.4 Valuation techniques

16.4.1 Why valuation techniques are used

Your goal is to estimate the price at which a normal, arm's-length sale of an asset (or transfer of a liability) would occur between informed market participants on the measurement date. IFRS 13 recognises three acceptable techniques:

Technique	Core idea	Typical applications	Common Nigerian data sources
Market approach	Uses prices from recent market transactions in identical or similar items.	Listed equities, quoted corporate bonds, actively-traded commodities.	NGX, FMDQ, AFEX.
Cost approach	Measures the amount needed to replace the asset's service capacity, often called current replacement cost.	Specialised plant, internally-developed software.	Manufacturers' price lists, engineering studies.
Income approach	Converts future cash flows or earnings into a present value through discounting.	Unquoted subsidiaries, licences, long-term service concessions.	Management projections, independent economic data.

Choose the technique that fits the circumstances and for which sufficient data are available. Always prioritise observable inputs and keep unobservable estimates to a minimum.

16.4.2 Selecting and weighting inputs

a) Maximise observable inputs. Examples include quoted prices, observable yields, and published rental indices.

b) Minimise unobservable inputs. These are judgments such as internally-generated cash-flow forecasts or entity-specific risk adjustments.

c) If a quoted price in an active market exists, you must use it. It is the strongest evidence of fair value.

16.4.3 The IFRS 13 fair-value hierarchy

Level	Nature of inputs	Examples
1	Quoted prices in active markets for identical items.	Equity shares of Zenith Bank Plc traded on NGX at close of business.
2	Observable inputs other than Level 1, directly or indirectly.	Quoted price for a similar property in the same district; interpolated yield curve derived from FMDQ bond quotations.

Level	Nature of inputs	Examples
3	Unobservable inputs.	Long-term cash-flow projections for a start-up in Abuja; appraisal of a unique oil-service vessel.

Disclose both the hierarchy level and any transfers between levels during the period.

16.4.4 Bid and offer prices

Some markets quote different prices for sellers and buyers:

Term	Meaning
Bid price	Amount the market is ready to pay when you sell.
Ask (offer) price	Amount the market demands when you buy.

Select the point within the bid-ask spread that best reflects fair value in the circumstances. IFRS 13 no longer insists on using bid price for assets and ask price for liabilities; professional judgment is required.

Examination guidance

a. Identify the most relevant technique and justify your choice by reference to available data.
b. Map each input to the hierarchy and explain any Level 3 assumptions.
c. Comment on the bid-ask spread only if the item trades in such a market, for example, quoted Treasury bills on FMDQ.

16.5 Liabilities and own equity instruments

16.5.1 Core principles

Topic	Application at the measurement date
Liabilities	Assume the liability is transferred, not settled, so the market participant transferee must continue to honour the obligation.
Own equity instruments	Assume the instrument remains outstanding. The transferee accepts all associated rights and duties.

When measuring fair value:

- Prioritise observable inputs and use quoted prices whenever an active market exists.
- If no active market is available, look for evidence from parties that hold identical or similar items as assets.
- Never introduce an input that reflects a legal restriction on transferring the instrument; that effect is already embedded in other inputs.

16.5.2 Liability or equity instrument held by another party as an asset

Evidence available	Valuation method
Quoted price in an active market	Use this price without adjustment, unless the asset's characteristics differ from the liability or equity instrument being measured.
Observable inputs in an inactive market	Apply these inputs after adjusting for differences between the asset and the liability or equity instrument.
No observable inputs	Use another technique, for example the market approach with similar instruments or an income approach.

Adjust any third-party asset price only for features that are not relevant to the liability or equity instrument itself. Ignore restrictions that simply prevent sale of the asset.

16.5.3 Liability or Equity Instrument Not Held by Another Party as an Asset

Measure fair value from the standpoint of a market participant that:

(a) Owes the liability, or

(b) Has issued the claim on equity.

An income approach is common. Forecast the cash outflows that a transferee would expect to incur, then discount them at a rate that reflects:

a) Time value of money.

b) Non-performance risk, including the entity's own credit risk.

c) Any credit enhancements attached to the instrument.

16.5.4 Net Presentation for Certain Financial Instruments

When a reporting entity manages financial assets and financial liabilities on a net risk basis, IFRS 13 permits a single fair value for the net position, but only when all the conditions below are satisfied:

a. The group is managed to a documented net exposure to a particular market or credit risk.
b. Internal reporting to key management is prepared on the same net basis.
c. Each instrument in the group is already carried at fair value in the statement of financial position.

This practical relief applies only to items within IFRS - 9 Financial Instruments.

16.5.5 Other important points

Issue	Practical implication
Restrictions preventing transfer	Do not add a separate deduction. The restriction is assumed to be reflected in other inputs.
Demand liabilities (e.g. demand deposits)	Fair value cannot be lower than the amount payable on demand, discounted from the earliest date that payment could be required.
Non-performance risk (NPR)	NPR is always considered. It equals the entity's own credit risk plus any factors that affect the likelihood of payment or performance. NPR is assumed unchanged before and after transfer.

Quick revision checklist for SBR candidates

a. Identify whether an active market price exists for an identical liability or equity instrument.
b. Where none exists, look for market evidence from holders of identical or similar items.
c. Distinguish clearly between observable and unobservable inputs.
d. Incorporate non-performance risk in every liability valuation.
e. Apply the netting exception only when the IFRS 9 conditions are fully met.

16.6 Other considerations in fair value measurement

16.6.1 Financial assets and liabilities managed on a net-risk basis

When an entity manages a portfolio of financial assets and financial liabilities so that the net exposure to either market risk or counterparty credit risk is the key focus, IFRS 13 permits a practical relief (often called the *offsetting exemption*).

Requirement	What must be demonstrated?
Documented risk strategy	The entity's policy – approved by senior management – shows that the portfolio is monitored and reported on a net-risk basis.
Internal reporting	Key decision-makers receive information that aggregates the instruments into a single net position.
Fair-value basis	Every instrument in the portfolio is already measured at fair value in the statement of financial position.

If all three conditions are met, the entity may measure the net long position (treated as a single asset) or the net short position (treated as a single liability) at the amount that an informed market participant would pay or receive to extinguish that net risk in one orderly transaction. This mirrors how dealers quote prices for, say, a matched book of interest-rate swaps.

16.6.2 Fair value at initial recognition

a) Transaction price is the entry price – the amount paid to acquire an asset or received to assume a liability.
b) Fair value is the exit price – the amount that would be received to sell the asset or paid to transfer the liability.
c) The two figures often coincide at acquisition, yet IFRS 13 still requires you to consider any factors that might create a difference, for example off-market terms or transaction-specific restrictions.

16.6.3 Fair-value hierarchy (refresh)

Level	Description	Nigerian illustration
1	Observable quoted prices in active markets for identical items.	Closing price of MTN Nigeria shares on NGX.
2	Other observable data, including quoted prices for similar items or market-derived inputs.	Implied forward FX rates taken from FMDQ spot and swap quotations.
3	Unobservable inputs, used only when relevant Level 1 or Level 2 data are unavailable.	Long-term cash-flow forecast for a power purchase agreement in a captive-generation project.

Always categorise each significant input and disclose transfers between levels.

16.6.4 Recurring versus non-recurring fair value measurements

Classification	Trigger	Example
Recurring (RFVM)	Required at each reporting date by another Standard.	Investment property under IAS 40 fair-value model.
Non-recurring (NRFVM)	Only required when a specific event occurs.	IFRS 5 measurement of assets held for sale; IAS 36 impairment test following an indicator of loss.

Disclose separately the fair value hierarchy level, valuation technique, and key inputs for RFVM and NRFVM items.

16.6.5 Unit of account

IFRS 13 itself rarely defines the unit of account. Instead, refer to the Standard that mandates fair value. For example:

a) IFRS 9 measures each derivative contract individually.
b) IAS 41 measures biological assets crop by crop or herd by herd.

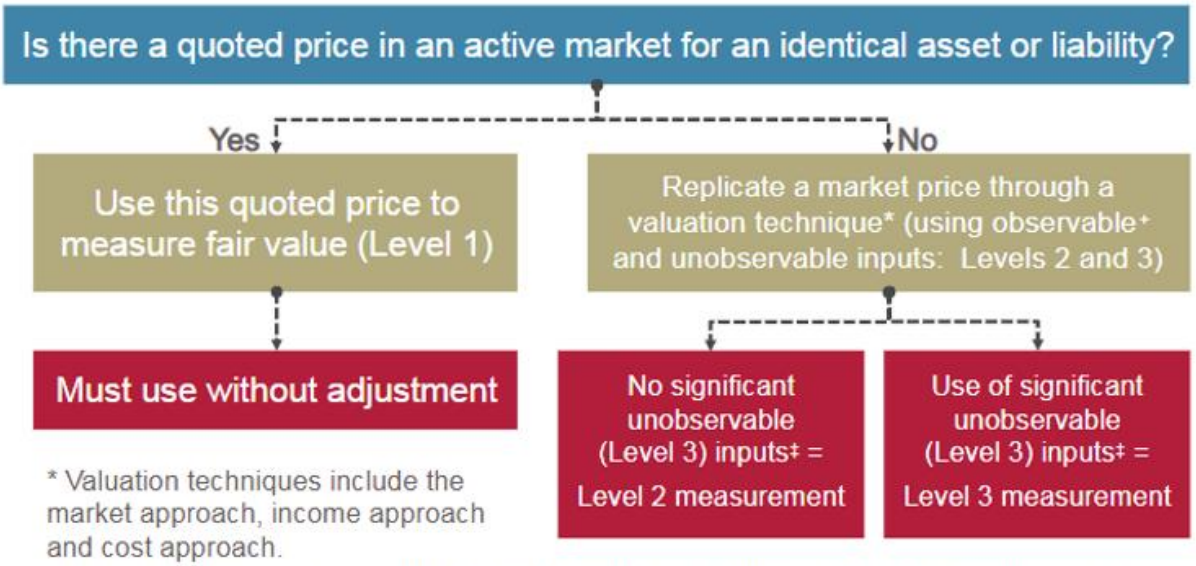
Select the valuation technique that fits that unit and make clear disclosures.

16.6.6 Valuation reminders

Topic	IFRS 13 position
Valuation technique	Choose the method that suits the facts and for which reliable data exist; switch methods only when it improves relevance and reliability, treating the switch as a change in estimate under IAS 8.
Input selection	Maximise relevant observable inputs; keep unobservable inputs to a minimum.
Bid-ask spread	Use the price within the spread that best represents fair value, regardless of whether the input is Level 1, 2, or 3.
Restrictions on transfer	Do not deduct a separate adjustment; the constraint is presumed to be captured within other inputs.
Liabilities with a demand feature	Fair value is at least the present value of the amount payable on demand, discounted from the earliest possible settlement date.
Non-performance risk (NPR)	Always reflected in liability fair values and includes own credit risk; assumed unchanged by transfer.

ICAN 2025

How Is Market-Based Measurement Arrived At?



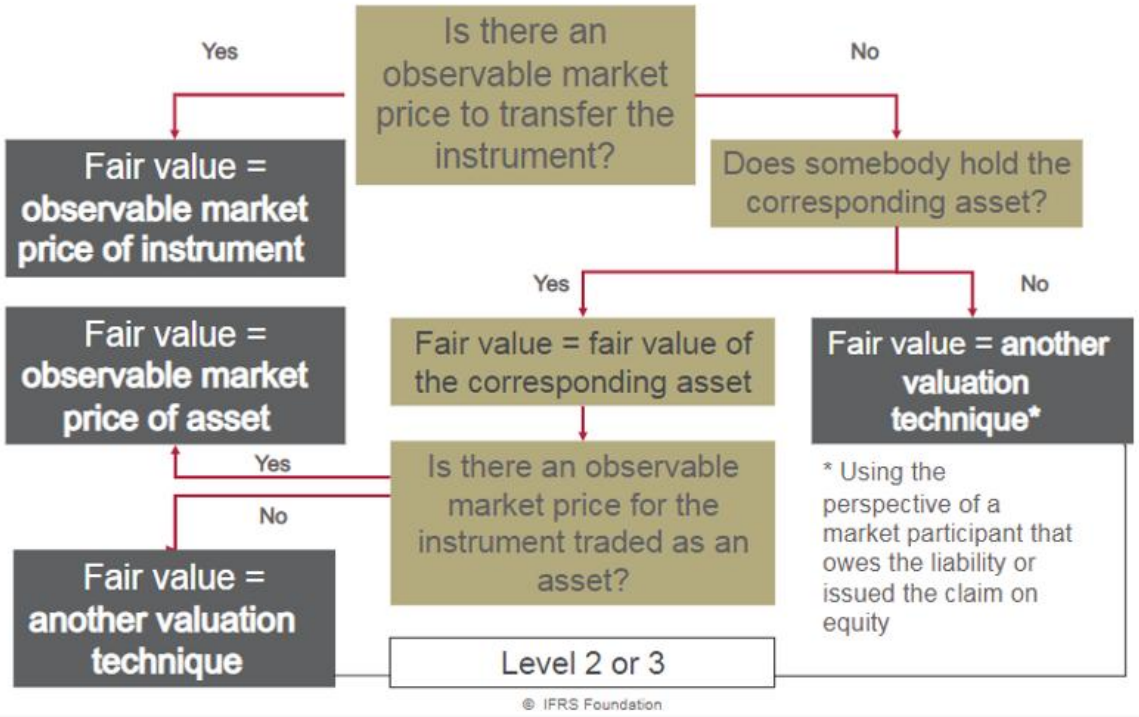
* Valuation techniques include the market approach, income approach and cost approach.

+ Maximise the use of *relevant* observable inputs and minimise the use of unobservable inputs. Observable inputs include market data (prices and other information that is publicly available).

‡ Unobservable inputs include the entity's own data (budgets, forecasts), which must be adjusted if market participants would use different assumptions.

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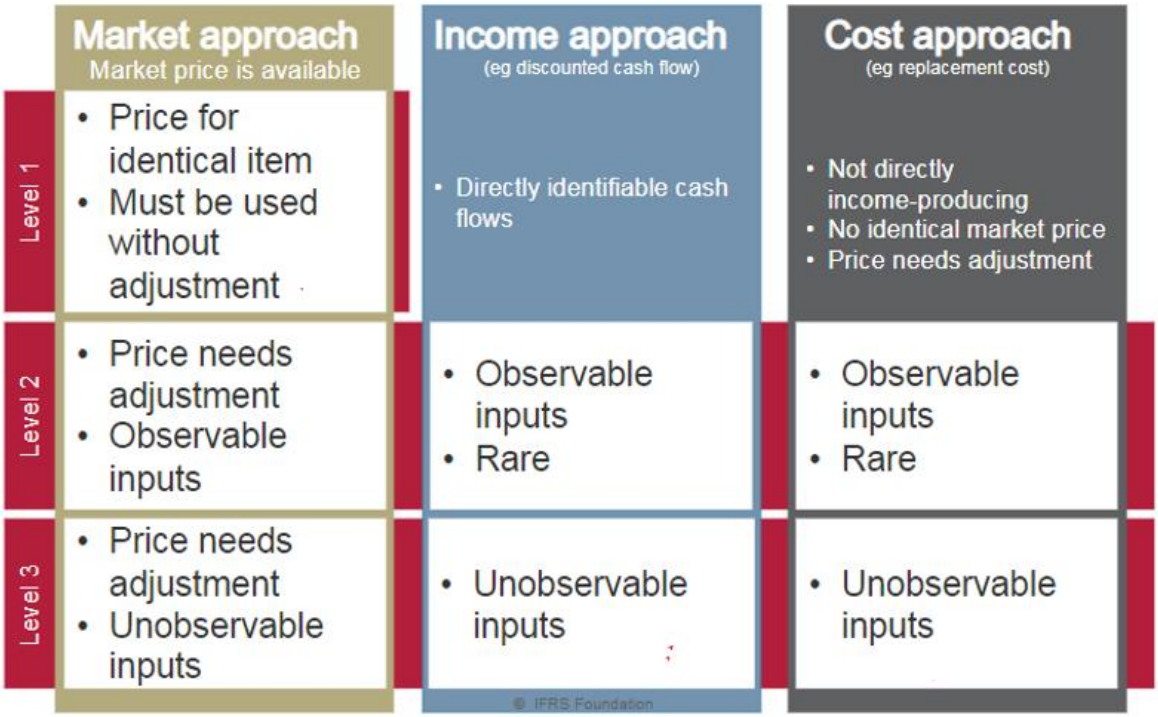
Decision Tree – Liability Measurement At Fair Value!



* Using the perspective of a market participant that owes the liability or issued the claim on equity

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VALUATION TECHNIQUES



VALUATION TECHNIQUES

Valuation approaches	Valuation techniques
Market approach	Transaction price paid for an identical or a similar instrument of an investee Comparable company valuation multiples
Income approach	Discounted cash flow (DCF) method Dividend discount model (DDM) Constant-growth DDM Capitalisation model
A combination of approaches may be used	Adjusted net asset method

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Examination Tip

When presented with a fair-value scenario in Strategic Business Reporting:

a) **Identify the unit of account mandated by the relevant IFRS.**
b) **Pick the valuation technique that matches both the unit and the quality of data.**
c) **Classify inputs into Level 1, 2, or 3, justifying any unobservable estimates.**
d) **Address special cases – offset portfolios, demand features, own credit risk – with clear, concise references to IFRS 13 rules.**

16.7 Disclosure Requirements Under IFRS 13

16.7.1 Recurring *versus* Non-recurring Measurements

Measurement type	Typical trigger	Example	Disclosure needed?
Recurring fair value measurement (RFVM)	Required at every reporting date	IAS 40 investment property when the fair-value model is chosen	Yes, each period
Non-recurring fair value measurement (NRFVM)	Arises only when a specific event occurs	IFRS 5 asset held for sale measured at fair value less costs to sell	Yes, only in the period of the event

16.7.2 Overall disclosure objective

Users must receive sufficient information to evaluate:

a. **The valuation techniques and inputs used for both recurring and non-recurring measurements.**
b. **The impact of measurements that rely on significant unobservable inputs, for example Level 3, on profit or loss and other comprehensive income.**

Judgement is needed to decide the appropriate level of detail, the extent of aggregation or disaggregation and whether additional explanations are necessary.

16.7.3 Determining classes of assets and liabilities

Define classes with reference to:

a) **Nature, characteristics and risks of the item, and**
b) **The level of the fair value hierarchy in which the measurement falls, namely Level 1, Level 2 or Level 3.**

These classes form the basis for the quantitative disclosures that follow.

16.7.4 Minimum disclosures by class

Item to Disclose	RFVM	NRFVM	Items where fair value is disclosed but not used for measurement*
Fair value at the reporting date	✓	✓	–
Reason for NRFVM	–	✓	–
Hierarchy level (1, 2 or 3)	✓	✓	✓
Transfers between Levels 1 and 2 with reasons and policy	✓	–	–
Valuation technique, key inputs, and any changes, Levels 2 and 3	✓	✓	–
Level 3 valuation processes or policies	✓	✓	–
Quantitative information about Level 3 unobservable inputs	✓	✓	–
Reconciliation of Level 3 opening to closing balances**	✓	–	–
Sensitivity of Level 3 fair value to unobservable inputs	✓	–	–
Explanation when a non-financial asset is used below highest and best use	✓	✓	–

* Disclosure-only items are measured on a different basis, for example amortised cost, but another IFRS still requires the entity to publish their fair values.

** Reconciliation details must include gains or losses in profit or loss, gains or losses in other comprehensive income, purchases, sales, issues, settlements and transfers in or out of Level 3.

16.7.5 Practical notes for candidates

a. Link each disclosure to the fair-value hierarchy level, giving most attention to Level 3.
b. Separate recurring and non-recurring disclosures clearly.
c. Explain any inter-level transfers and quote the policy that determines their timing.
d. Avoid boilerplate text, tailor descriptions of unobservable inputs and technique changes.
e. Cross-reference gains and losses to the relevant line items in the statement of profit or loss and other comprehensive income.

16.8 Chapter review

Key takeaways

a. Fair value is an exit price from the perspective of market participants at the measurement date.
b. The principal market price overrides a more advantageous price in an alternative market.
c. Highest and best use must satisfy physical possibility, legal permissibility and financial feasibility.
d. Valuation techniques must maximise observable inputs; Level 3 estimates require transparent disclosure.
e. Non-performance risk is always included in liability fair values.
f. IFRS 13 demands separate disclosure regimes for recurring and non-recurring measurements.

Executive recap:

Area	Core takeaway
Definition	Fair value is an exit price from the viewpoint of market participants on the measurement date, always under current market conditions.
Unit of account	Determined by the IFRS that calls for fair value, not by IFRS 13 itself.
Market selection	Use the principal market. If none exists, use the most advantageous market. Transaction costs are ignored, transport costs are included only when location drives value.
Highest and best use	Applies to non-financial assets. It must be physically possible, legally permissible and financially feasible.
Valuation techniques	Market, cost or income. Choose the one that best fits the item and uses the most observable inputs.
Inputs hierarchy	Level 1: quoted prices. Level 2: other observable inputs. Level 3: unobservable inputs. Disclosure becomes more extensive as you move down the hierarchy.
Liabilities and own equity	Measure from the perspective of a market participant that owes the liability or holds the equity claim, adjusting for non-performance risk.
Netting exception	A net fair value may be used for a group of financial assets and liabilities only when the portfolio is managed and reported on a net-risk basis and all instruments are at fair value.
Disclosures	Split between recurring and non-recurring measurements. Level 3 requires reconciliations and sensitivity analysis.

16.9 Worked example questions and suggested solutions

Question 1 – Quoted equity with multiple domestic markets

Background
Falcon Holdings Plc owns 4 million ordinary shares in DigiCom Nigeria Plc. The shares are listed on both the Nigerian Exchange (NGX Main Board) and the FMDQ Securities Exchange Growth Board. At 31 December 20X5:

Exchange	Closing Bid	Closing Ask	Average Daily Volume (last 30 days)
NGX	₦23.90	₦24.10	220 000
FMDQ	₦23.65	₦23.95	610 000

Transaction costs on either market are ₦0.05 per share. Falcon normally trades its investments through NGX but can access either exchange without restriction.

Required:

(a) **Identify the principal market for DigiCom shares and justify your decision under IFRS 13.**

(b) **Determine the fair value of the 4 million-share holding at 31 December 20X5, explaining any adjustments for transaction or transport costs.**

(c) **State the fair-value hierarchy level and outline the minimum disclosures that Falcon Holdings must provide.**

Question 2 – Highest and best use of a non-financial asset

Background
Rio Textiles Ltd owns five hectares of waterfront land in Port Harcourt currently occupied by disused warehouses. Key data:

Option	Physical feasibility	Legal status	Net cash outcome
A. Refurbish warehouses and lease to third-party logistics firms	Minor structural work only	Existing industrial zoning	Net present value (NPV) ₦480 million
B. Redevelop as a mixed-use residential-commercial complex	Demolish warehouses; new piling required	Planning permission obtainable for a ₦30 million fee	Completed value ₦1.05 billion; development cost ₦520 million

Assume a risk-adjusted discount rate of 12%.

Required:

(a) Evaluate which option represents the highest and best use (HBU) of the land, citing the physical, legal and financial tests.

(b) Calculate the fair value of the property at December 31, 20X5 and classify the key valuation inputs into the IFRS 13 hierarchy.

(c) Draft two concise disclosure notes: one if HBU equals current use, and one if it differs.

Question 3. Background

Sterling Bank Plc actively manages interest-rate risk through over-the-counter (OTC) NGN interest-rate swaps. At December 31, 20X5 the portfolio shows:

Position	Fair Value before CVA/DVA (₦m)	Credit-Valuation Adjustment (CVA) (₦m)	Debit-Valuation Adjustment (DVA) (₦m)
Receivable legs (asset)	1 540	(25)	n/a
Payable legs (liability)	(1 465)	n/a	18

The treasury function measures and reports risk on a net basis, in line with board-approved policy. All swaps are measured at fair value through profit or loss.

Required:

(a) Explain the conditions under which IFRS 13 permits Sterling Bank to present a single net fair value for this portfolio.

(b) Compute the net fair value to be disclosed if the offsetting exemption is available.

(c) Identify the Level 2 and Level 3 inputs in your calculation, and draft the key recurring-measurement disclosures, including sensitivity to a 50 basis-point change in the unobservable credit-spread input.

19.9.2 Suggested solutions

Solution 1: Quoted equity traded on NGX and FMDQ

Step	Analysis	Guidance note
1 Principal Market	Both exchanges are accessible. FMDQ shows the highest volume (610 000 shares), therefore it is the principal market under IFRS 13.	If more than one market is accessible, volume & level-of-activity determine the principal market – habitual dealing alone is not decisive.
2 Exit Price	For an asset, the exit price can be any point in the bid-ask spread that is most representative of fair value (IFRS 13). Using the bid price ₦23.65 is acceptable and conservative.	Using the bid for assets remains common exam practice; justify the choice briefly.

Step	Analysis	Guidance note
3 Fair Value	4 000 000 × ₦23.65 = ₦94.6 million. Transaction costs (₦0.05) are ignored; they do not form part of fair value.	State explicitly that transport costs are irrelevant for financial instruments.
4 Hierarchy & Disclosure	This is a Level 1 measurement (quoted price in an active market). Disclose: fair value, level, valuation premise, and any transfers between levels (none).	Level 1 items need no technique description; still disclose the level and fair value amount.

Solutions to 2: Highest & Best Use of Waterfront Land

Item	Option A (Refurbish)	Option B (Redevelop)
NPV/Net amount	₦480 million	Completed value 1,050 million − costs (520 + 30) million = ₦500 m

HBU assessment

a) *Physically possible* – both options meet this test.
b) *Legally permissible* – mixed-use permit is obtainable (fee ₦30 m).
c) *Financially feasible* – Option B yields the higher net amount (₦500 m).
HBU = mixed-use redevelopment.

Fair value (stand-alone premise)

Fair value = ₦500 million.

Hierarchy of inputs

a) Completed value based on comparable sales of similar mixed-use projects → Level 2.
b) Demolition and development cost estimates → Level 3.

Disclosure sketches

(a) *If HBU = current use* – note that valuation is based on continuing industrial use; no adjustment required.
(b) *If HBU differs (as above)* – disclose that current use differs from HBU; show technique (residual method), key Level 3 inputs (cost estimates) and sensitivity (e.g. ±10% change in development cost changes value by ±₦52 m).

Guidance – Always compare value in current use versus alternative uses net of conversion costs; pick the higher figure and disclose rationale.

Solution 3 – Net Valuation of Interest-Rate Swap Portfolio

Component	Pre-CVA/DVA	Adjustment	Post-adjustment
Receivable legs	+1 540 m	CVA −25 m	+1 515 m
Payable legs	−1 465 m	DVA +18 m	−1 447 m
Net position			+68 m asset

Eligibility for net presentation (IFRS 13, paragraphs 48–52):

a) Managed on a net risk basis under documented treasury policy ✔
b) Internal reporting to ALCO on net basis ✔
c) All swaps already at fair value through P&L ✔
Conditions met ⇒ net presentation allowed.

Fair value of net position
= ₦1 515 m − ₦1 447 m = ₦68 million (asset).

Hierarchy of inputs

a. Discount curves and observable swap rates → Level 2.
b. Credit spreads used in CVA/DVA (+18 m/−25 m) derived from internal models → Level 3.

Key recurring-measurement disclosures

a) Classify the portfolio as Level 2 overall with Level 3 adjustments disclosed separately.
b) Reconcile opening to closing balances of Level 3 adjustments.
c) Sensitivity: a 50 bp widening of own or counterparty credit spread would decrease net fair value by approximately (0.5% × notional exposure) – show quantified effect.

Guidance – Mention each of the three IFRS 13 netting prerequisites; present the arithmetic transparently; identify mixed-level inputs and give the required Level 3 sensitivity narrative.

Common examiner expectations (concise guidance notes)

Area	Examiner look-for
Market selection	Clear reference to rules in IFRS 13; ignore "better" prices outside principal market.
HBU	Application of the three-part test; net value-maximising use selected.
Technique justification	Link to data availability; maximise observable inputs.
Net portfolio	State and test IFRS 13 offsetting criteria before netting numbers.
Disclosure	Align with hierarchy level; give at least method, inputs, transfers, sensitivity for Level 3.

Meeting these points secures technical and professional-marks in the ICAN Strategic Business Reporting paper.

ICAN 2025

Professional Level

Strategic Business Reporting

CHAPTER 17

FINANCIAL INSTRUMENTS: IFRS 9

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ICAN 2025

17 Financial Instruments: IFRS 9

17.0 Learning objective

Equip candidates with the knowledge and professional judgement required to recognise, measure, present and disclose financial instruments and related risks in accordance with IFRS 9, IAS 32, IFRS 7 and supporting guidance, so they can prepare, analyse and audit complex financial statements confidently.

17.1 Learning outcomes

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

a. Explain and apply the recognition principles for financial instruments.
b. Explain derecognition rules for financial assets and apply them in straightforward situations.
c. Classify financial assets at initial recognition and determine their subsequent measurement.
d. Account for permitted reclassifications of financial assets.
e. Explain and apply the impairment model for financial assets.
f. Explain and apply the accounting treatment for financial liabilities.
g. Identify transactions that may contain embedded derivatives.
h. Explain and apply the principles of hedge accounting.

17.2 GAAP for Financial Instruments

17.2.1 Background

The accounting rules for financial instruments originate from three core standards:

Standard	Primary focus	Quick reminder for the exam
IAS 32	Classification and presentation	Distinguish liability, equity and compound instruments clearly.
IFRS 7	Disclosures	Know the qualitative versus quantitative disclosure requirements.
IFRS 9	Recognition, measurement, impairment and hedge accounting	Master the business-model test and the SPPI test, together with the expected-credit-loss model.

17.2.2 Definitions

Term	Summary definition	examiner's watch-point
Financial instrument	Any contract that creates a financial asset for one entity and a financial liability or equity instrument for another entity.	Identify both sides of the contract.
Financial asset	Cash, an equity instrument of another entity or a contractual right either to receive cash or another financial asset or to exchange financial assets or liabilities on favourable terms.	Apply the SPPI test where relevant.
Financial liability	A contractual obligation to deliver cash or another financial asset or to exchange financial assets or liabilities on unfavourable terms.	Do not confuse with constructive obligations.

Typical financial instruments include cash, shares, loans, trade receivables or payables and a wide range of derivatives (see below).

17.2.3 Derivatives

A derivative must:

a. Change value in response to an underlying variable such as an interest rate, commodity price or exchange rate.
b. Require little or no initial net investment.
c. Settle at a future date.

Derivatives fall into two broad groups:

Category	Main Products	Key Exam Issues
Forward Arrangements/Commitments (parties commit to a course of action)	• Forward contracts • Futures contracts • Swaps contracts	Fair-value movements go to profit or loss unless hedge-accounting criteria are met.
Contingent Claims: Options Contracts (*buyer chooses whether to act*)	• Call options • Put options	Measure at fair value. Premium paid is an asset until exercised, lapsed or sold.

Forward contracts

A tailor-made agreement to buy or sell a specified amount of a commodity or financial item on a stated future date at an agreed price.

Initial fair value is nil. Subsequent measurement reflects movements in the spot rate versus the contract rate.

Illustration – Six-month forward to buy USD 1,000 at ₦3,500 per USD

Spot Rate at Valuation Date	Cost Under Forward	Cost on Open Market	Difference	Balance-Sheet Impact
₦4,000 = USD 1	₦3,500,000	₦4,000,000	₦500,000	Asset
₦3,200 = USD 1	₦3,500,000	₦3,200,000	(₦300,000)	Liability

(In practice a present-value adjustment for the remaining term is also required.)

Futures
Exchange-traded contracts that are standardised by amount, date, currency and underlying item.
Daily margining means gains and losses are recognised through profit or loss each day.

Swaps
Agreements to exchange cash flows linked to an underlying obligation.
The most common type is an interest rate swap, where one party pays a variable rate and receives a fixed rate, or vice versa.
Fair-value changes are recognised as assets or liabilities depending on the net position at each reporting date.

Options
Provide the holder with a right, not an obligation, to buy (call) or sell (put) a specified amount of an underlying item at an agreed price.
The holder pays a premium at inception which is recorded as an asset.
The option is exercised only if it is advantageous. Consequently, at any date it cannot create a liability for the holder.

Exam application tips
Always identify the contract's two parties and analyse both perspectives.
Apply the business-model test and the SPPI test to classify financial assets correctly on initial recognition.

For derivatives embedded in host contracts, decide whether to separate them using the guidance in IFRS 9.

Demonstrate clear logic when measuring fair values and when deciding whether hedge accounting criteria are met.
Link disclosures back to IFRS 7 requirements: nature of risk, risk management strategy and quantitative data.

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Structure your answers logically, reference the relevant standard and show workings neatly. Clarity and

17.2.4 Using derivatives

Purpose of derivative activity
Entities use derivatives for two clear reasons:

Speculation: entering positions to profit from favourable price or rate movements.
Hedging: offsetting exposure to an unfavourable movement in a specific risk factor such as exchange rates, interest rates or commodity prices.

Speculation and its consequences
Exchange-traded derivatives are widely available, so non-specialist entities can build positions quickly.
Profit is earned only if the market moves in the anticipated direction; expectations can be wrong.
The 1995 collapse of Barings Bank illustrates this risk. Substantial speculative trades in Japanese futures led to losses that exceeded the bank's capital.

Hedging with derivatives
Hedging seeks protection, not profit.
Example: A chocolate manufacturer fears a rise in cocoa prices. It fixes the future purchase price with a forward contract, locking in today's cost and eliminating uncertainty.

Common derivative contracts

Contract	Key features	Statement of financial position impact
Forward contract	Tailor-made; one future delivery date; and no initial cash flow.	Initially nil value. Subsequent fair value recognised as asset or liability.
Futures contract	Exchange-traded standardised forwards; and daily margining.	Net gain or loss recognised daily in profit or loss.
Swap contract	Exchange of cash flows (e.g., fixed for floating interest).	Fair value asset or liability at each reporting date.
Option contract	Right but not obligation to buy (call) or sell (put). Premium paid upfront.	Premium is an asset. Option re-measured to fair value each period.

Options give the holder a choice and therefore can be recognised only as an asset; the seller recognises a liability if obliged to perform.

17.2.5 Scoping issues under IFRS 9

IFRS 9 applies to all financial assets and liabilities **unless** another Standard requires different treatment. Key scope exclusions are summarised below.

Area Excluded from IFRS 9	Where Accounted	Practical Implication
Subsidiaries, Associates, Joint Ventures	IFRS 10, IAS 27, IAS 28	Investments follow consolidation, or equity method requirements.
Own Equity Instruments	IAS 32	An entity does not fair-value its own shares.
Lease Receivables and Payables	IFRS 16	IFRS 9 impairment applies to lease receivables, and derecognition applies to lease liabilities.
Insurance Contracts and Financial Guarantee Contracts Treated as Insurance	IFRS 17	Insurers use IFRS 17 unless they have elected IFRS 9.
Contracts to Buy or Sell Non-Financial Items for Own Use	Not in IFRS 9 unless net-settled	Most commodity purchase agreements remain outside IFRS 9 if physical delivery is expected and occurs.

Financial guarantees

A guarantee given for another entity's borrowing is within IFRS 9 unless the guarantor has previously accounted for such contracts as insurance. Initial measurement is at fair value; after that the liability is the higher of:

the expected credit loss allowance, and
the amount initially recognised less cumulative income recognised under IFRS 15.

Contracts to Buy or Sell Non-Financial Items

A forward to purchase oil is **outside** IFRS 9 if the entity intends to take delivery to meet its production needs.
The same contract is **inside** IFRS 9 if it can be settled net in cash or if the entity routinely sells the oil shortly after delivery for trading profit.

Net settlement is broad: it exists whenever contractual terms allow cash settlement, or the entity has a past practice of settling similar contracts net, or the commodity is readily convertible to cash.

Illustrative Example: Net Settlement Concept

X Ltd agrees to buy a barrel of crude oil in three months for US$100. At maturity the spot price is US$110. If the contract permits net cash settlement, X Ltd may pay only US$10 and forego physical delivery. Such a contract falls within IFRS 9 because it can be settled net.

Financial Assets and Liabilities Exceptions

Loan commitments: Generally excluded, but a commitment that can be net-settled or is designated at fair value through profit or loss is within IFRS 9.
Own-use renewable electricity contracts: IFRS 9 includes application guidance allowing own-use where unavoidable excess supply is sold back to the grid without defeating own-use intent.
Practical Tips for SBR Candidates:

Identify purpose first: Decide whether a derivative is speculative or hedging; the accounting follows the intent and documentation.
Check scope exclusions: Always test whether another Standard overrides IFRS 9.
Analyse settlement terms: Physical delivery normally implies own-use; net-settlement capability usually brings the contract into IFRS 9.
Disclose appropriately: IFRS 7 requires qualitative and quantitative disclosures of risk exposures and hedging strategies.

17.2.6 Initial Recognition and Measurement of Financial Instruments

Core Recognition Principle
A financial asset or liability appears in the statement of financial position **only** when the entity becomes a party to the contract's provisions. This is a contract-based trigger rather than the usual Framework test of probable economic inflow or outflow.

Initial Measurement Rule
Measure at **fair value** on the recognition date.
For most transactions fair value equals the **transaction price** paid for an asset or received for a liability.
Two notable exceptions exist:

Trade receivables without a significant financing component are recorded at their invoice amount in line with IFRS 15.

If the transaction price differs from observable fair value a **day one gain or loss** is recognised in profit or loss unless another Standard prohibits immediate recognition.

Illustrative Example – Lending below market rate

Fact Pattern	Calculation	Accounting entry
An entity lends ₦1,000,000 at 0% interest, repayable in twelve months. A market rate of 10% is appropriate.	Present value factor at 10% for one year = 1 / 1.1 = 0.909 Fair value at initial recognition = ₦1,000,000 × 0.909 = ₦909,000 (rounded)	Debit: Financial asset ₦909,000 Debit: Profit or loss (*loss*) ₦91,000 Credit: Cash ₦1,000,000

The ₦91,000 represents a day one loss because the asset is recognised at below the cash advanced. Subsequent measurement at amortised cost will unwind this discount as interest income using the effective interest method.

Transaction costs

Definition

Costs that are directly attributable to acquiring, issuing or disposing of a financial asset or liability. If the transaction had not occurred, the entity would not have incurred these costs.

Treatment Depends on the Subsequent Measurement Category

Subsequent Measurement	Treatment of Transaction Costs
Fair value through profit or loss (FVTPL)	Expense immediately in profit or loss.
Other categories (amortised cost or fair value through other comprehensive income)	Add to the initial carrying amount. Amortise over the life of the instrument where relevant.

Practical point: Brokerage fees on listed share purchases go straight to profit or loss if the shares are classified at FVTPL. The same fees are capitalised if the shares are designated at FVOCI.

Initial recognition of derivatives

Forward contracts, futures and swaps normally have **zero fair value** at inception because the contractual price equals the prevailing market price.

Despite the nil value they must be recorded in the accounting system. Subsequent fair value changes are captured at each reporting date.
Options are different: the holder pays a premium that represents an asset on initial recognition.

Effective date and settlement conventions

Instrument Type	Recognition date	Key points for the exam
Regular way purchase or sale of listed equity	Trade date for FVTPL assets. Choice of trade or settlement date for other categories (policy applied consistently).	A policy choice exists under IFRS 9.
Derivatives	Trade date.	Fair value usually zero at this date.
Loans and borrowings	When cash is advanced or received.	Include origination fees in the effective interest rate.

Examination strategy tips

a. **Compare transaction price with observable market data.** If different, decide whether day one profit or loss is permitted.
b. **Classify the instrument first.** Subsequent measurement category drives both transaction cost treatment and recognition of fair value changes.
c. **Demonstrate the double entry.** Marks are available for clear presentation of debits and credits, even when the numbers are rounded.
d. **Explain judgement.** Briefly justify discount rates, fair value sources and why an item is or is not within the scope of IFRS 9.
e. **Highlight disclosure links.** IFRS 7 requires entities to explain valuation techniques, inputs and sensitivity where fair value is not based on quoted prices.

17.3 Measurement methods

17.3.1 Introduction to amortised cost

Amortised cost is a present-value technique that can be applied to both financial assets and financial liabilities. It starts with the amount recognised initially, adds interest calculated at the effective interest rate and deducts contractual cash flows received or paid. The closing figure therefore represents the present value of the future contractual cash flows discounted at the original effective rate.

IFRS 9 Definitions – Complete set for SBR candidates

Term	IFRS 9 Definition	Examination insight
Amortised Cost (AC)	The amount at which a financial asset or financial liability is measured on 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,	Think “present value of remaining contractual cash flows, discounted at the original EIR, after adjusting for impairment”.

Term	IFRS 9 Definition	Examination insight
	and for financial assets, adjusted for any loss allowance.	
Effective Interest Rate (EIR)	The rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial asset or financial liability to the gross carrying amount of the financial asset or the amortised cost of a financial liability.	Determined once at inception and unchanged unless the instrument is re-established on renegotiation or modification.
Effective Interest Method (EIM)	The method of calculating the amortised cost of a financial asset or liability (and of allocating the interest income or expense) by applying the effective interest rate to the gross carrying amount of a financial asset or, for credit-impaired assets in Stage 3, to the amortised cost net of the loss allowance.	Use the EIR each period to:
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).	Level 1 quoted prices first; if unavailable, apply observable inputs (Level 2) or valuation techniques using unobservable inputs (Level 3) and disclose the hierarchy level.

** Accrue interest income or expense in profit or loss.*
*** Update the carrying amount for cash receipts or payments.*

Note for lenders:
The EIR is calculated using contractual cash flows to which the lender is legally entitled. Expected credit losses are accounted for separately through the loss allowance, avoiding double counting in the EIR calculation.

Illustration of Amortised Cost	Carrying Amount
Amount at initial recognition	X
Plus: interest at the effective rate (income for an asset or expense for a liability)	X
Less: contractual cash flows	(X)
Amortised cost	**X**

IFRS 9 specifies that the effective rate is set when the instrument is first recognised. It is the internal rate of return that exactly discounts the expected cash flows over the life of the instrument to the amount recognised on day one.

17.3.2 IFRS 9 Requirements for Amortised Cost

Requirement	Practical meaning	Key exam point
Business-model test (BMT)	The asset is held to collect contractual cash flows.	If sales are more than insignificant, the test may fail.
SPPI test	Cash flows consist solely of payments of principal and interest on the principal outstanding.	Embedded leverage or exotic indexation normally fails the test.
Effective Interest Method (EIM)	Apply the original discount rate to the opening carrying amount each period.	Interest recognised need not equal the coupon paid.

Worked example on a stepped-coupon bond

Facts:

a. Issue proceeds: ₦1,000,000.
b. Coupon: 5% for years 1 and 2, then 7 percent for years 3 and 4.
c. Redemption: par in year 4.
d. Calculated effective rate: 5.942%

Year	Opening amortised cost	Interest @ 5.942%	Cash flow	Closing amortised cost
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

Total interest recognised, ₦240,000, equals the total coupon payments, yet the timing differs. The amortised cost shown each year is the present value of remaining contractual cash flows at the original effective rate.

How is effective interest rate of 5.942% determined?
Effective interest rate (EIR) for the stepped-coupon bond: *Cash-flow profile (issuer's perspective):*

Year	Cash flow (₦)	Description
0	**+1,000,000**	Issue proceeds received
1	**(50,000)**	5 percent coupon **<= *5% x ₦1,000,000***
2	**(50,000)**	5 percent coupon **<= *5% x ₦1,000,000***
3	**(70,000)**	7 percent coupon **<= *7% x ₦1,000,000***
4	**(1,070,000)**	7 percent coupon plus redemption at par

EIR is the single annual discount rate, *r*, that equates the present value of the future outflows with the proceeds received at inception.
$$1{,}000{,}000 = 50{,}000(1+r)^{-1} + 50{,}000(1+r)^{-2} + 70{,}000(1+r)^{-3} + 1{,}070{,}000(1+r)^{-4}$$

Solving the equation (*by goal-seek, IRR function or a simple iterative tool*) gives
EIR (r) ≈ *5.942% per annum*

Interpretation:
The issuer will recognise interest expense each year by applying 5.942% to the opening amortised cost of the bond, ensuring that the carrying amount always equals the present value of remaining contractual cash flows.

Amortised cost and credit-impaired assets

Stage	Condition	Interest recognition	Impairment allowance
Stage 1	Performing; no significant increase in credit risk since origination.	On gross carrying amount.	12-month expected credit losses (ECL).
Stage 2	Significant increase in credit risk but not credit-impaired.	On gross carrying amount.	Lifetime ECL.
Stage 3	Credit-impaired (default).	On net carrying amount (gross less loss allowance).	Lifetime ECL; interest recognised on recovered basis only.

Write-offs reduce both the gross amount and the allowance. Reversals of impairment are recognised immediately in profit or loss but never above what amortised cost would have been if no loss had been recognised.

17.3.3 Fair value measurement

When a financial instrument is not measured at amortised cost, IFRS 9 requires fair value either through profit or loss (FVTPL) or through other comprehensive income (FVOCI).

Category	Typical instruments	Where gains and losses go	Notes
FVTPL	Derivatives, trading portfolios, instruments failing the SPPI test.	Profit or loss.	Transaction costs expensed immediately.
FVOCI (Debt)	Debt assets held both to collect cash flows and for sale.	Expected interest in profit or loss; fair-value changes in OCI; recycling on disposal.	Impairment still applies.
FVOCI (Equity)	Non-trading equity investments elected irrevocably.	All fair-value changes in OCI; no recycling.	Dividends in profit or loss if they represent a return on investment.

Fair value follows IFRS 13 hierarchy. Level 1 quoted prices are preferred. Level 2 uses observable inputs such as market yields. Level 3 relies on unobservable inputs, which trigger additional disclosures about methods and sensitivity.

Examination Guidance

Classify first: Apply the business-model and SPPI tests before deciding on amortised cost, FVOCI or FVTPL.
State your rate: Show how you derived the effective rate and apply it consistently.
Show workings clearly: Present tables of amortised cost or fair-value changes; label each step.
Discuss impairment early: Identify the correct stage and compute the ECL where required.
Link to disclosure: Briefly refer to IFRS 7 requirements on valuation techniques, credit risk management and sensitivity where relevant.

17.3.4 Amortised cost: Further considerations - IFRS 9 perspective

Under IFRS 9 the mechanics of amortised cost are identical for assets and liabilities, yet the terminology differs slightly. Candidates must be comfortable switching viewpoint between borrower and lender.

Borrower's view – Financial liability

Year	Opening amortised cost	Interest expense @ 5.942%	Cash outflow	Closing amortised cost
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

Financial statements

Year-end		Interest Expense (P/L)	Liability in SoFP
1		59,424	1,009,424
2		59,983	1,019,407
3		60,577	1,009,984
4		60,016	Nil

Lender's view – Financial asset

The lender applies the **same effective rate** and the same amortisation schedule, but IFRS 9 labels balances differently:

Gross carrying amount: amortised cost before any loss allowance.
Loss allowance: expected credit losses (ECL) recognised under the impairment model.
Net amortised cost: figure reported in the statement of financial position.

Year-End	Interest Income (P/L)	Gross carrying amount	Loss allowance (example)	Net amortised cost
1	59,424	1,009,424	(1,000)	1,008,424
2	59,983	1,019,407	(1,000)	1,018,407
3	60,577	1,009,984	(1,000)	1,008,984
4	60,016	Nil	Nil	Nil

*A loss allowance lowers the asset's carrying value in the lender's books but does **not** affect the effective rate calculation.*

Comparison summary

Step	Financial Asset Terminology	Financial Liability Terminology
Initial recognition	Transaction price (fair value)	Transaction price (fair value)
Add	Interest recognised **as income** at the effective rate	Interest recognised **as expense** at the effective rate
Less	Receipts	Payments
Result	**Gross carrying amount**	**Amortised cost**
Less (assets only)	Loss allowance	Not Applicable
Reported amount	**Amortised cost of the asset**	**Amortised cost of the liability**

Key examination insights

Same numbers, different labels
Borrower reports a liability at amortised cost.
Lender reports an asset at gross carrying amount, then deducts the loss allowance to arrive at net amortised cost.

Impairment does not alter the effective rate
The ECL allowance is an accounting estimate recorded separately.
Interest continues to accrue on the gross amount (Stage 1 and Stage 2 assets).

Symmetry only breaks when credit risk changes
Without a loss allowance, the borrower's liability and lender's asset carry identical amortised cost figures throughout the life of the instrument.

Disclosure linkage
IFRS 7 requires lenders to explain the basis for ECL measurement, credit risk grading and movements in the allowance.
Borrowers focus disclosures on liquidity risk management and maturity analysis.

Practical Checklist for SBR Answers:

Task	What to Show	Marks Available For
Identify effective rate	State the calculation or IRR function result	Correct rate with brief workings
Produce amortisation table	Opening balance, interest, cash flow, closing balance each year	Logical structure, accuracy, rounding clarity
Distinguish borrower vs lender	Use correct labels (interest expense vs income, gross carrying amount, loss allowance)	Precise terminology

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Task	What to Show	Marks Available For
Explain ECL impact	Show separate allowance, confirm no change to interest calculation	Conceptual understanding
Reference standards	Cite IFRS 9 for measurement, IFRS 7 for disclosure	Professional competence

17.3.5 Amortised cost and credit-impaired assets

Aspect	Financial assets that are not credit-impaired	Credit-impaired financial assets
Effective rate applied	Effective interest rate	Credit-adjusted effective interest rate
Cash-flow base for EIR	Contractual cash flows to which the lender is entitled, **excluding** expected credit losses	Cash flows the entity **expects** to receive, therefore **including** expected credit losses
Initial recognition	Recorded at gross carrying amount with a separate loss allowance based on expected credit losses	Recorded at net amount (gross less expected credit losses) because the impairment event has already occurred
Measurement each period	Gross carrying amount less loss allowance equals amortised cost	Net amortised cost already reflects expected future losses
Interest recognition	Apply EIR to gross carrying amount (Stages 1 and 2)	Apply credit-adjusted EIR to net carrying amount (Stage 3)
Revenue recognition	Interest income for the period, impairment charge shown separately	Interest income based on credit-adjusted rate already reflects credit risk

Key revision points

Stage transfer triggers
Significant increase in credit risk moves an asset from Stage 1 to Stage 2 and shifts the allowance from 12-month ECL to lifetime ECL.
Actual default moves the asset to Stage 3 where interest accrues on the net basis.

No double counting
The EIR ignores expected credit losses.
Those losses are recognised through the allowance, not built into the rate.

Symmetry breaks down
Borrower and lender balances match only when no impairment exists.
A loss allowance reduces the asset but not the liability.

17.3.6 Fair value measurement

Concept	Summary	Examination focus
Definition (IFRS 13)	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.	Exit price, market participant perspective, current conditions.
Quoted Prices	Level 1 inputs provide the most reliable evidence. Use them whenever available.	Bid price for assets, ask price for liabilities is no longer mandatory; the price within the spread that best represents fair value is used.
Valuation Techniques	***Market Approach*** (observable prices). ***Income Approach*** (discounted cash flows). ***Cost Approach*** (replacement cost) or ***Net Assets Approach***.	Choose the technique appropriate to the circumstances and maximise observable inputs.
Fair Value Hierarchy	***Level 1***: quoted prices in active markets for identical items. ***Level 2***: observable inputs other than Level 1 quotes. ***Level 3***: unobservable inputs (entity estimates).	Disclose methodology, inputs and sensitivity for Level 3 measurements.

IFRS 13 Fair value hierarchy – *Refreshed table for SBR Revision*

Level	Definition	Illustrative examples
Level 1	Quoted prices in active markets for **identical** assets or liabilities that the entity can access on the measurement date.	Closing share price on the Nigerian Exchange or London Stock Exchange. Quoted settlement price of a listed futures contract. Market price of a government treasury bill published by FMDQ.
Level 2	Inputs other than quoted Level 1 prices that are **observable** for the asset or liability, either directly	Quoted price of a similar bond with an observable yield curve adjustment.

Level	Definition	Illustrative examples
	(prices) or indirectly (derived from prices).	Spot and forward foreign-exchange rates published by an authorised dealer. Interest-rate swap curves sourced from Reuters or Bloomberg.
Level 3	**Unobservable** inputs for the asset or liability, used when relevant observable data are unavailable.	Discounted cash-flow valuation of a private equity holding. Long-term commodity price forecasts used to value an unlisted mining right. Projected EBITDA multiples for a bespoke contingent consideration.

Practical checklist

a. **Identify unit of account** – determine what is being valued.
b. **Choose valuation technique** – market, cost or income.
c. **Classify inputs** – assign Levels 1, 2 or 3.
d. **Adjust for liquidity and restrictions** – if relevant and market participants would do so.
e. **Disclose under IFRS 7** – include hierarchy level, valuation techniques, key inputs and sensitivity for Level 3.

Exam Preparation Tips:

Task	What markers expect
Calculate credit-adjusted EIR	Show how expected cash flows were adjusted for credit loss and state the resulting rate.
Segregate interest and impairment	Present interest income or expense separately from ECL movements.
Apply fair-value hierarchy accurately	Label each input level and justify why higher level evidence is unavailable.
Explain judgement	Briefly state why the chosen valuation technique and inputs are appropriate for the item being measured.

17.4 Classification and Measurement of Financial Assets

17.4.1 Introduction

On initial recognition every financial asset must be placed in one of three measurement categories. The category chosen drives how the asset is measured afterwards and where gains or losses are reported. The three categories are:
Amortised cost
Fair value through other comprehensive income (FVOCI)
Fair value through profit or loss (FVTPL)

The correct category is identified by applying **Two Tests**:

Test	Purpose	Key Question	Result if the Test Fails
Business-Model Test	Understand why the asset is held.	Is the objective to collect contractual cash flows, to collect and sell, or something else.	Asset moves to FVTPL.
Cash-flow Characteristics Test (SPPI test)	Review the nature of the cash flows.	Are cash flows solely payments of principal and interest on principal outstanding.	Asset moves to FVTPL.

Different portfolios can satisfy different business models within the same entity.

17.4.2 Classification criteria

Category	Conditions	Typical Examples	Measurement Features
Amortised Cost	Business model: hold to collect. Cash flows: SPPI compliant.	Trade receivables, fixed-rate loans intended to be kept to maturity.	Measured at amortised cost with ECL impairment.
FVOCI	Business model: collect and sell. Cash flows: SPPI compliant.	Liquidity bond portfolios managed both for yield and for sale if rates change.	Interest, impairment and foreign exchange in Profit or Loss; fair value changes in OCI; recycling on disposal (debt only).

Category	Conditions	Typical Examples	Measurement Features
FVTPL	Residual category, applied when either test fails or when the entity elects FVTPL to solve an accounting mismatch.	Equity investments not elected to FVOCI. Complex loans with leveraged returns. Trading portfolios and derivatives.	All gains and losses in Profit or Loss; transaction costs expensed at once.

Irrevocable Designations

A loan or receivable that meets amortised cost or FVOCI criteria may be designated at FVTPL at inception if this removes or significantly reduces an accounting mismatch. Equity instruments are by default in FVTPL. The entity may elect irrevocably, at initial recognition, to present subsequent fair value changes in OCI, with no recycling of gains or losses to profit or loss on disposal.

17.4.3 Transaction costs

Subsequent Measurement Category	Treatment of Directly Attributable Transaction Costs
Amortised cost or FVOCI	Capitalise within the initial carrying amount.
FVTPL	Expense immediately in profit or loss.

17.4.4 Overview table for quick revision

Method	Instruments Commonly Captured
Amortised cost	SPPI compliant loans and receivables held to collect cash flows.
FVOCI	SPPI compliant debt assets held both to collect and to sell, equity instruments elected to FVOCI.
FVTPL	Derivatives, equity instruments without FVOCI election, any asset failing the tests, assets designated at FVTPL to avoid mismatches.

17.4.5 Subsequent measurement of financial assets at amortised cost

Core principle

Once a financial asset has been classified at amortised cost, its carrying amount is updated each reporting period using the **Effective Interest Method (EIM)**. The book

value therefore equals the present value of the remaining contractual cash flows discounted at the original effective interest rate (EIR).

Worked illustration

Terms of the Investment:

Description	Amount
Nominal (par) value	₦50 million
Coupon rate	10 percent, paid annually
Purchase price	₦48 million (discount of ₦2 million)
Term to maturity	Three years (redemption at par)
Effective interest rate (IRR)	11.67 percent

The investor classifies the bond at amortised cost on January 1, 2015.

Amortisation schedule

Year	Opening Amortised Cost (₦m)	Interest @ 11.67% (₦m)	Cash Received (₦m)	Closing Amortised Cost (₦m)
20X5	48.00	5.60	(5.00)	48.60
20X6	48.60	5.65	(5.00)	49.25
20X7	49.25	5.75	(55.00)*	Nil

** Includes final coupon of ₦5 million plus principal redemption of ₦50 million.*

Journal entries

Accounting Period	Entry	Cash (₦m)	Financial asset (₦m)	Profit or loss (₦m)
20X5	Purchase	(48.00)	48.00	–
	Interest accrual	–	5.60	(5.60)
	Receipt of coupon	5.00	(5.00)	–
20X6	Interest accrual	–	5.65	(5.65)
	Receipt of coupon	5.00	(5.00)	–
20X7	Interest accrual	–	5.75	(5.75)
	Receipt of coupon	5.00	(5.00)	–
	Redemption	50.00	(50.00)	–

Negative profit or loss
figures represent income.

Analysis and interpretation

Cash coupons total **₦15 million** (₦5 million each year).
Total interest recognised under the effective rate is **₦17 million** (₦5.60 m + ₦5.65 m + ₦5.75 m).
The additional **₦2 million** represents the unwind of the initial discount between purchase price and redemption amount.
The investor's total return is therefore **₦17 million**, matching the internal rate of 11.67 percent applied to the opening carrying amount each year.

17.4.6 Subsequent measurement of financial assets at fair value through OCI

Core principle

A debt asset is measured at fair value through OCI when:

The business model is to collect contractual cash flows **and** sell the asset when advantageous.
The cash flows meet the SPPI test.

Interest income, foreign exchange gains or losses and impairment charges go to profit or loss. **Only** fair value movements are recorded in OCI, with cumulative gains or losses recycled to profit or loss on disposal.

Worked illustration

Initial facts:

Item	Amount
Nominal value	₦50,000,000
Coupon rate	10% (annual)
Purchase price	₦48,000,000
Term to maturity	Three years (redemption at par)
Effective interest rate	11.67%
Fair values	31 Dec 20X5: ₦49,200,000 31 Dec 20X6: ₦49,500,000 31 Dec 20X7: ₦50,000,000

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Amortisation Schedule with Fair Value Layer

Year	Opening Amortised Cost (₦m)	Interest @ 11.67 % (₦m)	Cash Received (₦m)	Closing Amortised cost (₦m)	Fair Value (₦m)	Year-end FV Adjustment (₦m)	Cumulative FV in OCI (₦m)
20X5	48.00	5.60	(5.00)	48.60	49.20	**0.60**	0.60
20X6	48.60	5.65	(5.00)	49.25	49.50	**(0.35)**	0.25
20X7	49.25	5.75	(55.00)*	nil	50.00	**0.25**	nil

** Coupon ₦5,000,000 plus redemption ₦50,000,000.*

Only the annual fair value adjustments appear in OCI. All other effects are recognised in profit or loss.

Journal Entries (20X5 Example)

Entry	Debit (₦m)		Credit (₦m)	
Purchase of bond	Financial asset	48.00	Cash	48.00
Interest accrual	Financial asset	5.60	Interest income (Profit or Loss)	5.60
Receipt of coupon	Cash	5.00	Financial asset	5.00
Fair value gain	Financial asset	0.60	OCI – FV reserve	0.60

Repeat the same pattern in 20X6 and 20X7, adjusting for the fair value movement each year.

Disposal before maturity

Assume the investor sells the bond for ₦50,000,000 on 10 January 20X7 when the amortised cost is ₦49,250,000 and cumulative fair value gain in OCI is ₦250,000.

Disposal entry	Debit (₦m)	Credit (₦m)
Cash proceeds	50.00	–
Financial asset (carrying amount)	–	49.25
Profit on sale (Profit or Loss)	–	0.75
Transfer accumulated OCI to Profit or Loss	OCI reserve 0.25	Profit on sale 0.25

The net profit recognised in profit or loss equals ₦1,000,000 (₦0.75 m realised gain plus ₦0.25 m recycled OCI).

Examination focus

Area	What to show	Why it matters
Split of gains	Interest income in Profit or Loss, fair value movements in OCI.	Demonstrates grasp of category mechanics.
OCI reserve	Track cumulative fair value adjustments separately.	Needed for correct recycling on disposal.
Recycling rule	Reclassify accumulated OCI to Profit or Loss for debt assets, never for equity elected to FVOCI.	Common examiner trap.
Impairment overlay	Debt assets in FVOCI still carry an ECL allowance.	Adjust carrying amount, recognise loss in Profit or Loss, do not touch OCI.
Clear double entries	Show debits and credits for purchase, interest, coupon, fair value and disposal.	Earn method marks even if numbers slip.

Quick comparison with equity FVOCI

Feature	Debt FVOCI	Equity FVOCI (Irrevocable Election)
Interest cash flows	Yes	Dividends only
Impairment	ECL model applies	No impairment testing
OCI recycling	**Yes** on disposal	**No** recycling, reserve remains in equity
Typical use	Liquidity management portfolios	Long-term strategic investments

17.4.7 Interaction of IFRS 9 and IAS 21 for Foreign-Currency Debt Assets Held at FVOCI

Key principles to remember

Standard	Requirement	Practical Effect
IAS 21	Monetary items are re-translated at the **closing rate** each reporting date. The resulting exchange difference is recognised in **profit or loss**.	Every movement in the carrying amount caused by changes in the spot rate must pass through Profit or Loss.
IFRS 9 (FVOCI category)	Fair-value movements (after translation) are taken to **OCI**. Interest income, impairment and foreign-exchange gains or losses stay in **profit or loss**.	Keep the exchange element and the fair-value element separate.

A debt instrument measured at FVOCI is therefore subject to a **dual adjustment** each year:

Exchange re-translation of the amortised cost balance (Profit or Loss).
Fair-value adjustment to arrive at year-end fair value (OCI).

Worked Example (Functional Currency: ₦, Foreign Currency: FC)

Initial facts

Item	Amount
Nominal value	FC 50 million
Coupon	10% (annual)
Purchase price	FC 48 million on 1 Jan 20X5
Term	3 years, redeemable at par
Effective interest rate	11.67%
Spot rates (₦ per FC1)	1 Jan 20X5 = 5 Average 20X5 = 6 31 Dec 20X5 = 7; Average 20X6 = 7.5 31 Dec 20X6 = 8; Average 20X7 = 7 31 Dec 20X7 = 6
Fair values	31 Dec 20X5 = FC 49.20 m 31 Dec 20X6 = FC 49.50 m 31 Dec 20X7 = FC 50.00 m

Amortised-cost schedule (kept in foreign currency)

Year	Opening AC (FC m)	Interest (11.67%)	Coupon Received	Closing AC (FC m)
20X5	48.00	5.60	(5.00)	**48.60**
20X6	48.60	5.65	(5.00)	**49.25**
20X7	49.25	5.75	(55.00*)	**Nil**

** Final coupon FC 5 m plus redemption FC 50 m.*

Translation and Fair-Value Adjustments (Summary)

Year	Naira figures (₦ m)	Exchange difference recognised in profit or loss	Fair-value adjustment recognised in OCI
20X5	Opening AC 240.00 (48 m × 5) Interest accrual 33.60 (5.60 m × 6) Coupon-cash (30.00) (5 m × 6) Closing AC translated 340.20 (48.60 m × 7)	**101.60** (*balancing figure*)	**0.60** to bring 340.20 to fair value 344.40 (49.20 m × 7)
20X6	Opening AC 340.20 Interest accrual 42.38 (5.65 m × 7.5) Coupon-cash (40.00) (5 m × 8) Closing AC translated 394.00 (49.25 m × 8)	**51.42**	**(0.35)** to bring 394.00 to fair value 396.00 (49.50 m × 8)
20X7	Opening AC 396.00 Interest accrual 40.25 (5.75 m × 7) Coupon-cash (35.00) (5 m × 7) Redemption cash (300.00) (50 m × 6)	**(104.25)**	**0.25** to remove remaining OCI balance

Cumulative OCI resets to zero on redemption.

Journal Entry Pattern (₦ m)

Year 20X5 (Extract)

Debit		Credit	
Financial asset (initial)	240.00	Cash	240.00
Financial asset	33.60	Interest income	33.60
Cash	30.00	Financial asset	30.00
Financial asset	101.60	Exchange gain (Profit or Loss)	101.60
Financial asset	0.60	OCI – FV reserve	0.60

The same structure repeats each year:

a. **Interest accrual**: adjust asset and recognise income.
b. **Cash receipt**: reduce asset.
c. **Exchange difference**: balancing figure to align translated amortised cost.
d. **Fair-value adjustment**: debit or credit asset, opposite entry to OCI.

On **redemption** in 2017 the asset is derecognised at its translated amortised cost; cash received equals par in Naira; the residual OCI balance is recycled to profit or loss.

17.4.8 Transaction costs

Key principle
Transaction costs are direct, incremental expenses that an entity would not incur unless it acquired, issued or disposed of a financial asset or liability. The subsequent-measurement category of the instrument drives how those costs are treated.

Subsequent measurement category	Accounting for transaction cost
Fair value through profit or loss	Expense immediately in profit or loss.
Amortised cost or fair value through OCI	Capitalise and include in the initial carrying amount then amortise over the asset's life (amortised cost) or leave embedded in the carrying amount (FVOCI).

IAS 13 once required the use of bid price for assets and ask price for liabilities. IFRS 13 now permits any price within the bid-ask spread that is most representative of fair value in the circumstances. If a policy choice results in using the ask price for an asset or the bid price for a liability, the difference between that price and the instrument's fair value is treated as a transaction cost.

Worked example 1

Equity investment at FVTPL:
1 January 20X6: Purchase price ₦30,000; broker fee 1 percent (₦300).
The equity must be measured at FVTPL so the broker fee is expensed.

Date	Entry	Debit (₦)	Credit (₦)
1 Jan 20X6	Investment Cash	30,000	 30,000
1 Jan 20X6	Profit or loss (expense) Cash	300	 300

December 31, 20X6: Fair value rises to ₦40,000, gain of ₦10,000 recorded in profit or loss.

Accounting entry:
Debit: Investment ₦10,000
Credit: Profit or loss ₦10,000

December 11, 2017: Sale proceeds ₦50,000, gain on disposal ₦10,000 recognised in profit or loss.

Accounting entry:

Debit:	Cash	₦50,000	
Credit:	Investment		₦40,000
Credit:	Profit or loss		₦10,000

Worked example 2

Equity investment designated irrevocably to FVOCI:

Same initial purchase: ₦30,000 plus broker fee ₦300. Fee is capitalised because the asset will be measured at FVOCI.

Date	Entry	Debit (₦)	Credit (₦)
1 Jan 20X6	Investment	30,300	
	Cash		30,300

December 31, 20X6: Fair value ₦40,000 and the Gain of ₦9,700 (₦40,000 less ₦30,300) is recognised in OCI.

Accounting entry:

Debit:	Investment	₦9,700	
Credit:	Other comprehensive income		₦9,700

December 11, 20X7: Sale for ₦50,000. Disposal entry:

Accounting entry:

Debit:	Cash	₦50,000	
Credit:	Investment		₦40,000
Credit:	Profit or loss		₦10,000

The gain previously recognised in OCI remains in equity; it is **NOT recycled to profit or loss because the investment was an equity instrument elected to FVOCI.*

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17.5 Classification and measurement of financial liabilities

17.5 .1 Classification of financial liabilities

All financial liabilities are **initially** classified, and **subsequently** measured, at **amortised cost** unless a specific exception applies. Common exceptions are:

Exception	Typical examples	Measurement basis	Reference
Derivative liabilities	Forward contracts, swaps, written options	Fair value through profit or loss (FVTPL)	IFRS 9.4.3.5
Transferred liabilities that fail derecognition tests	Factoring with recourse, securities lending	FVTPL	IFRS 9.3.2.15

Reclassification after initial recognition is prohibited.

Irrevocable designation at FVTPL

An entity **may** elect to measure a liability at FVTPL on day one **only** when either:

the designation eliminates or significantly reduces an accounting mismatch, or
the liability forms part of a documented risk-management strategy involving derivatives that are accounted for at fair value.

Own credit risk component of a designated liability's fair-value movement is recorded in **OCI**; residual movements remain in profit or loss. This avoids the counter-intuitive result of recognising a profit when the entity's own credit standing worsens.

Illustration – Own credit risk

Situation	Fair Value Change	Debit	Credit
Credit risk improves (*liability increases to ₦1.1 m*)	+₦0.1 m	Profit or Loss expense	Liability
Credit risk deteriorates (*liability falls to ₦0.9 m*)	(₦0.1) m	Liability	Profit or Loss gain

Under IFRS 9 the **own-credit element is routed to OCI, reducing* Profit or Loss *volatility.*

17.5.2 Subsequent measurement at amortised cost

Term	Definition
Amortised cost of a liability	Initial amount minus principal repayments plus or minus cumulative amortisation of any premium, discount, and transaction costs using the effective interest method.
Effective interest rate (EIR)	Discount rate that exactly equates expected future cash payments through the life of the liability to the initial amount.

Worked example

Nominal value = ₦50,000,000
Coupon = 10%
Term = 3 years
Issue proceeds = ₦48,000,000
EIR = 11.67%

Year	Opening AC ₦m	Interest @ 11.67% ₦m	Coupon Paid ₦m	Closing AC ₦m
20X5	48.00	5.60	(5.00)	48.60
20X6	48.60	5.65	(5.00)	49.25
20X7	49.25	5.75	(55.00*)	Nil

** Redemption ₦50 m plus final coupon ₦5 m.*

Journal entries mirror the lender's table but interest is an **expense**, and cash flows are **outflows**.

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17.5.3 Financial guarantee contracts

A financial guarantee within IFRS 9 is a **financial liability**.

Stage	Carrying amount	Income recognition	Guidance
Initial recognition	Fair value of the guarantee	Immediate expense or deferred income based on service pattern	IFRS 9.4.2.1
Subsequent measurement:	*Higher of:*		
(a) Loss allowance under ECL model			
(b) Unearned premium (initial amount amortised)	Release of unearned premium to profit or loss over the term		IFRS 9.4.2.2

Example
Parent P guarantees subsidiary S's four-year loan of ₦50 m. Fair value of guarantee = ₦1.6 m.
If S performs, P releases ₦0.4 m each year to profit or loss, liability reduces to nil.
If S defaults after Year 1, P recognises a loss allowance reflecting the expected payout, for example increasing the liability to ₦37.5 m at Year 2.

17.5.4 Summary of accounting for items measured at fair value

Instrument Category	OCI Treatment	Profit or Loss Treatment	Special Notes
Asset at FVTPL	None	Entire fair-value movement	Transaction costs expensed immediately
Debt asset at FVOCI	Recognise fair-value movement, recycle cumulative OCI on disposal	Interest, FX, impairment, gain or loss on sale	ECL allowance impacts Profit or Loss only
Equity asset at FVOCI (irrevocable election)	Recognise fair-value movement, **no recycling**	Dividends representing return on investment	Transfer within equity on disposal
Liability at FVTPL (own credit elected)	Own credit component only	Remaining movement	Own credit not recycled

Examination focus points

Topic	What examiners test	Revision advice
Classification judgment	Knowledge of exceptions and irrevocable designations	Cite accounting mismatch or risk-management rationale.
Own credit risk	Correct routing to OCI	State that recycling is prohibited.
Effective interest method	Accurate tables and double entries for liabilities	Label interest as an expense, cash as outflow.
Financial guarantees	Dual measurement rule (loss allowance versus deferred income)	Show change when borrower's credit risk increases.
Fair-value hierarchy	Level identification for liabilities at FVTPL	Link to IFRS 13 disclosure requirements.

When presenting answers, begin with the authoritative requirement, apply it logically to the scenario, perform clear calculations, and conclude with the impact on the financial statements and disclosures.

17.6 Other Considerations in Financial Instruments

17.6.1 Embedded Derivatives

Definition:
An embedded derivative is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument.

Examples of embedded derivatives *(within Hybrid Contracts)*:

Host contract type	Possible embedded derivatives
Debt	Foreign currency forward contract, inflation swap, leveraged interest swap
Equity	Equity conversion option, foreign currency option, equity total return swap
Sales	Commodity index future
Insurance, Lease, Service, Purchase	Various types depending on contract specifics

Accounting treatment of embedded derivatives

Financial Asset Host Contract (within IFRS 9 Scope):
The **entire hybrid contract** is subject to classification and **measurement rules of IFRS 9**.

This is a **simplified approach** under IFRS 9 compared to **IAS 39**, especially for **financial liabilities**.

Other host contracts (outside IFRS 9 scope):
Embedded derivative must be **separated and accounted for as a derivative** when:
Economic characteristics and risks of the embedded derivative are **not closely related** to those of the host contract.
A separate instrument with the same terms **meets the definition of a derivative**
The hybrid instrument is **not measured at fair value** through profit or loss.

Note: If the instrument is already measured at fair value through P&L, **separation is not required**.

Hybrid contract concept
A non-derivative host contract may contain a clause that makes part of its cash flows behave like a derivative. The combined instrument is called a *hybrid*. IFRS 9 sometimes requires the embedded derivative to be separated and measured at fair value through profit or loss (FVTPL) while the host follows its own accounting rules.

Decision tree for separation

Step	Question	Action
1	Is the host a financial **asset** within IFRS 9?	**Yes** – do **not** separate. The entire asset fails the SPPI test and is measured at FVTPL.
		No – go to Step 2.
2	Are the economic characteristics and risks of the embedded derivative **closely related** to those of the host?	**Yes** – do **not** separate; account for the hybrid under the relevant Standard for the host.
		No – go to Step 3.
3	Would the embedded feature meet the definition of a derivative if it were freestanding, and is the hybrid not already at FVTPL?	**Yes** – **separate** and measure the embedded derivative at FVTPL.
		No – do **not** separate.

Example
Entity A issues a five-year loan of ₦25 million with interest linked to Brent crude. The host is a financial liability, so Step 1 is not met. Oil price risk is not closely related to the usual interest rate risk of a loan (Step 2 fails). A crude-price swap would qualify as a

derivative if issued separately. The loan is not otherwise at FVTPL. Result: separate the embedded oil derivative, measure it at fair value through profit or loss, and account for the remaining loan at amortised cost.

17.6.2 Derecognition

Derecognition removes a previously recognised financial asset or liability from the statement of financial position. The triggers differ for liabilities and assets.

Financial assets

IFRS 9 uses a sequential **four-step test**. Answer each question in turn; stop when the outcome is clear.

Step	Key Question	Result if "Yes"	If "No", go to…
1	Have contractual rights to the cash flows expired?	Derecognise asset.	Step 2
2	Has the asset been transferred to another party?	Continue to Step 3.	Retain asset.
3	Have **substantially all** risks and rewards been transferred?	Derecognise asset.	Step 4
4	Has control been lost (despite retaining some risk and reward)?	Derecognise; recognise continuing involvement.	Retain asset.

Test	Key Points for Candidates
Contractual rights expire	Straightforward case: derecognise and recognise any gain or loss.
Transfer of rights:	Assess whether the entity has transferred substantially all risks and rewards.
Substantially all transferred	Derecognise the asset.
Substantially none transferred	Continue to recognise the asset.
Partly transferred	Assess control; if control is lost, derecognise and recognise retained interest; if control retained, continue to recognise asset to the extent of continuing involvement.
Pass-through arrangements	Apply the same risk, reward and control analysis.

Exam reminder: show cash-flow diagrams, identify risks such as credit, interest, prepayment, and demonstrate who bears them after the transaction.

Financial Liabilities

Derecognise when, and only when, the obligation is **extinguished** or **substantially modified**.

Trigger	Explanation	Journals
Extinguishment	The obligation is discharged, cancelled or expires.	Debit: Liability, Credit: Cash (or equity if converted). Recognise any difference in profit or loss.
Substantial modification	The net present value (NPV) of the revised cash flows, discounted at the original EIR, changes by **10% or more**.	Derecognise old liability, recognise new liability at fair value, record modification gain or loss in profit or loss. Smaller changes adjust the carrying amount with an immediate gain or loss.

Scenario	Treatment
Cash repayment, equity conversion or legal release	Derecognise the liability, recognise difference between carrying amount and consideration paid in profit or loss.
Modification that results in a 10 percent or greater change in the present value of cash flows (discounted at original EIR)	Treat as an extinguishment; derecognise old liability, recognise new liability, record gain or loss in profit or loss.
Other modifications	Adjust carrying amount, recognise modification gain or loss immediately.

Practical definition of the outcomes

Substantially all risks and rewards transferred: typically > 90 percent transferred.
Substantially none transferred: typically < 10 percent transferred.
Control is deemed lost when the transferee has the practical ability to sell the asset to a third party without restrictions.

Accounting outcomes

Scenario	Asset De-recognised?	What is recognised?
Rights expire (cash collected in full)	Yes	Gain or loss = proceeds – carrying amount
True sale with no recourse	Yes	Proceeds, derecognition gain/loss
Factoring with recourse retaining significant credit risk	No	Continue to show receivable; recognise cash received as liability

Scenario	Asset De-recognised?	What is recognised?
Pass-through arrangement failing control test	Derecognise to extent of transfer; recognise continuing involvement.	

Derecognition under IFRS 9 – Illustrative examples

Section	Scenario	Key facts	Decision	Journal entries (simplified)	Rationale
Financial Assets:	**A1. Contractual rights expire**	Trade receivable of ₦10,000 is settled in cash.	Derecognise asset.	Dr: Cash 10,000, Cr: Trade receivable 10,000	*Rights to cash flows have expired. IFRS 9.3.2.3(a).*
	A2. Non-recourse sale of receivables	Entity sells ₦100,000 receivables for ₦95,000, transfers all credit risk, no repurchase option.	Derecognise asset, recognise gain or loss.	Dr: Cash 95,000, Dr: Loss on sale 5,000, Cr: Receivables 100,000	*Substantially all risks and rewards transferred. IFRS 9.3.2.6.*
	A3. Securitisation with subordinated retention	₦200 m mortgage pool sold, entity retains junior tranche equal to 10 percent of credit risk.	Partial derecognition, recognise continuing involvement.	Dr: Cash 180 m, Dr: Retained interest (asset) 20 m, Cr: Mortgage assets 200 m	*Some risk retained yet control lost, derecognise 90 percent. IFRS 9.3.2.15.*
Financial Liabilities:	**L1. Cash settlement**	Bank loan carrying amount ₦5 m repaid in full.	Derecognise liability.	Dr: Loan payable 5 m, Cr: Cash 5 m	*Obligation extinguished. IFRS 9.3.3.1.*

Section	Scenario	Key facts	Decision	Journal entries (simplified)	Rationale
	L2. Debt for equity swap	Creditor agrees to accept 50,000 ordinary shares in exchange for ₦3 m loan (fair value of shares ₦2.8 m).	Derecognise liability, recognise equity and gain.	Dr: Loan payable 3 m, Cr: Share capital and premium 2.8 m, Cr: Gain on extinguishment 0.2 m	*Liability extinguished, equity issued. IFRIC 19 guidance.*
	L3. Substantial modification (10 percent test)	Bond carrying amount ₦10 m, revised terms reduce PV of cash flows by 12 percent.	Treat as extinguishment, recognise new liability.	Dr: Bond liability 10 m, Cr: New bond liability 8.8 m, Cr: Gain 1.2 m	*NPV change exceeds 10% threshold. IFRS 9.B3.3.6.*

Guidance notes

Financial asset flow chart
Step 1: Have rights to cash flows expired? If yes, derecognise.
Step 2: Has the asset been transferred? If no, retain.
Step 3: Have substantially all risks and rewards moved? If yes, derecognise.
Step 4: Has control been lost? If yes, derecognise while recognising continuing involvement.

Financial liability rule
Derecognise only when the obligation is extinguished, cancelled, expires, or is replaced by a substantially different liability.

Modification test
Compare the PV of revised cash flows, discounted at the original EIR, with the carrying amount. A change of 10% or more signals derecognition.

Disclosure essentials (IFRS 7)
Nature of transferred assets that are not derecognised.
Carrying amounts of recognised assets and associated liabilities.

Gains or losses on derecognition of assets or liabilities.
Details of modifications and resulting gains or losses.

These examples highlight the judgement required when assessing risk transfer, control, and modification thresholds, ensuring compliance with IFRS 9 derecognition principles.

17.6.3 Reclassification

Core rule:
Reclassification is required only when, and only when, the entity changes its business model for managing financial assets.
Such changes are expected to be very rare and must be significant to operations (for example, a wholesale decision by senior management to hold, rather than trade, a debt portfolio).
The switch is accounted for prospectively from the first day of the next reporting period; previously recognised gains, losses, interest and ECL remain untouched.
Financial liabilities cannot be reclassified.

Decision matrix and accounting consequences

From	To	Carry out on reclassification date	Effect on EIR	Impairment treatment	OCI Handling
Amortised Cost	***FVTPL***	Remeasure to fair value; recognise gain or loss in profit or loss.	N/A	Stop recognising ECL.	N/A
FVTPL	***Amortised Cost***	Fair value becomes new gross carrying amount; compute a new EIR based on that amount.	Recalculate using fair value as new "cost".	Start recognising ECL from the reclassification date.	N/A
Amortised Cost	***FVOCI***	Remeasure to fair value; recognise gain or loss in OCI.	No change.	Continue ECL; transfer existing allowance to OCI.	Record initial fair-value uplift in OCI.
FVOCI	***Amortised Cost***	Remeasure to fair value; remove	No change.	Continue ECL; loss allowance transferred	OCI balance set to nil.

From	To	Carry out on reclassification date	Effect on EIR	Impairment treatment	OCI Handling
		cumulative OCI against the asset's fair value.		back from OCI.	
FVTPL	***FVOCI* (Debt)**	Continue at fair value; future changes go to OCI.	No change.	Start recognising ECL prospectively.	From the switch all movements go to OCI.
FVOCI	***FVTPL***	Continue at fair value; recycle cumulative OCI to profit or loss on the reclassification date.	No change.	Stop recognising ECL prospectively.	Cumulative OCI recycled to profit or loss.

Item	IFRS 9 Rule	Measurement Consequences
Financial Assets:	Reclassification is **required** if, and only if, the entity changes its business model for managing financial assets. Such changes are expected to be **very infrequent**.	Re-measure from the first day of the new model:
• *Amortised cost* → *FVOCI*: re-measure to fair value, recognise difference in OCI.		
• *Amortised cost* → *FVTPL*: recognise difference in profit or loss.		
• *FVOCI* → *Amortised cost*: use new effective rate, remove cumulative OCI against fair value of asset.		
• *FVTPL* → *Amortised cost or FVOCI*: fair value on reclassification date becomes new gross carrying amount.		
Financial Liabilities	**No** reclassification permitted after initial recognition.	Not Applicable

Exam technique: Always state that equity instruments irrevocably elected to FVOCI **cannot** be reclassified.

Reclassification – Illustrative Examples Under IFRS 9

Key Rule:
A financial asset is reclassified only when the entity changes its business model for managing that asset. Reclassification is applied prospectively from the first day of the next reporting period; previously recognised gains, losses, interest and ECL are not restated. Financial liabilities cannot be reclassified after initial recognition.

Asset Example 1: Amortised cost ➔ Fair value through profit or loss (FVTPL)

Item	Amount (₦)
Carrying amount on Dec 31, 2016	10,000,000
Fair value on Jan 1, 2017 (reclassification date)	10,800,000

Reason for change: loans previously held to collect are now actively traded.

Journal (Jan 1, 20X7):
Debit: Financial asset (FVTPL) 800,000
Credit: Reclassification gain (P&L) 800,000
The asset is now measured at fair value; expected credit loss (ECL) accounting ceases.

Asset example 2: Amortised cost ➔ Fair value through other comprehensive income (FVOCI)

Item	Amount (₦)
Carrying amount	25,000,000
Fair value	26,000,000
Existing loss allowance (12-month ECL)	200,000

Reason for change: Treasury now manages the bond portfolio for both yield and sale.

Journal:
Debit: Financial asset (FVOCI) 1,000,000
Credit: OCI – FV reserve 1,000,000

Debit: OCI – FV reserve 200,000
Credit: Loss allowance 200,000

Effective interest rate (EIR) is unchanged; ECL continues with movements recorded in OCI.

Asset example 3: FVOCI ➔ Amortised cost

Item	Amount (₦)
Fair value on reclassification date	30,000,000
Cumulative OCI gain	1,000,000
Loss allowance in OCI	300,000

Reason for change: Management intends to hold the bonds to maturity only.

Journal:

Debit: OCI – FV reserve 1,000,000
Credit: Financial asset 1,000,000

Debit: Loss allowance 300,000
Credit: OCI – FV reserve 300,000

Carrying amount now equals fair value. OCI balance is reset to nil. EIR stays the same.

Asset example 4: FVTPL ➔ Amortised cost

Item	Amount (₦)
Fair value on 1 Apr 20X7	15,000,000
Expected undiscounted cash flows	19,000,000

Reason for change: Entity moves from trading strategy to a hold-to-collect model.

Step 1 – The fair value on the reclassification date becomes the new gross carrying amount (no entry because the asset is already at fair value).

Step 2 – A new EIR is calculated using the fair value as the new "cost" and remaining contractual cash flows.

Step 3 – Begin recognising an ECL allowance prospectively.

Asset example 5: FVOCI ➔ FVTPL

Item	Amount (₦)
Fair value	12,000,000
Cumulative OCI loss	400,000

Reason for change: Portfolio is moved to an active trading desk.

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Journal:

Debit: Profit or loss	400,000	
Credit: OCI – FV reserve		400,000

The asset continues at fair value; all future movements are recognised in profit or loss; ECL accounting stops.

Financial Liabilities

Financial liabilities cannot be reclassified after initial recognition.
A liability irrevocably designated at FVTPL on day one remains measured at fair value. Movements attributable to the entity's own credit risk are recorded in OCI; all remaining fair-value changes are presented in profit or loss.

17.7 Impairment of Financial Assets

17.7.1 Introduction

IFRS 9 replaces the incurred-loss model of IAS 39 with an ***forward-looking***

"Expected Credit-Loss (ECL) Model" that is applied to:

Financial assets measured at **amortised cost**.

Debt assets measured at **fair value through other comprehensive income (FVOCI)**.

Loan commitments that are not measured at FVTPL.

Financial guarantee contracts within IFRS 9 (unless at FVTPL).

Lease receivables (IFRS 16) and **contract assets** (IFRS 15).

The objective is to ensure financial statements reflect **deterioration or improvement** in credit quality using reasonable and supportable information that incorporates historical experience, current conditions and forward-looking forecasts.

17.7.2 Key definitions

Term	IFRS 9 definition
Credit loss	Present value of the difference between contractual cash flows and cash flows an entity expects to receive, discounted at the original EIR.
12-month ECL	Expected credit losses that result from default events possible within 12 months after the reporting date.
Lifetime ECL	Expected credit losses that result from all possible default events over the expected life of a financial instrument.
Credit-impaired	One or more events have occurred that have a detrimental impact on the expected future cash flows (e.g. default, breach of covenant, bankruptcy indicators).

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Term	IFRS 9 definition
Purchased or originated credit-impaired (POCI)	Assets that are credit-impaired at the date of acquisition or origination.

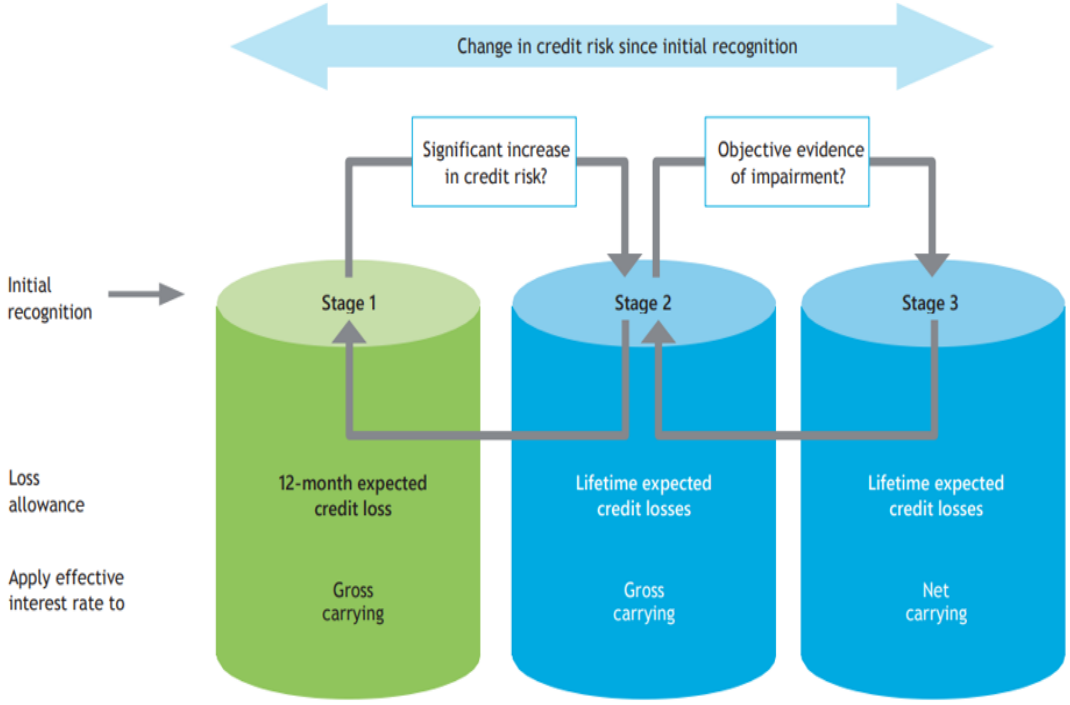
17.7 .3 General three-stage model

Stage	Credit-risk status	Loss allowance	Interest revenue base
Stage 1	Performing – no significant increase in credit risk (SICR) since origination.	12-month ECL	Gross carrying amount
Stage 2	Significant increase in credit risk since origination but asset not credit-impaired.	Lifetime ECL	Gross carrying amount
Stage 3	Credit-impaired (default).	Lifetime ECL	**Net** carrying amount (gross less loss allowance)

Significant increase in credit risk is assessed at each reporting date by comparing the risk of default over the expected life at reporting date with that at initial recognition, using reasonable and supportable forward-looking information.

Measurement principles
ECLs are **probability-weighted** and reflect time value of money.
Entities may use individual or collective assessments.
Collateral and credit enhancements are included if they are integral to the contractual terms and legally enforceable.

The IFRS 9 general impairment model is summarised below.



17.7.4 Simplified approach

For **trade receivables, lease receivables and contract assets** that do not contain a significant financing component, entities may elect (or are required) to recognise **lifetime ECL** from initial recognition. No Stage 1/Stage 2 tracking is required.

17.7.5 Illustrative examples

Example 1 – Stage movement
A three-year amortised-cost loan of ₦1,000,000, EIR 8 percent.
At origination, PD over life = 2 percent (Stage 1).
At Year 1, PD rises to 12 percent; SICR threshold set at 10 percent.

Result: move to **Stage 2**; recognise lifetime ECL.

Example 2 – Default event (Stage 3)
At Year 2, borrower misses two consecutive interest payments; management considers loan credit-impaired.
Lifetime ECL re-measured at ₦120,000.

Journal (Year 2)	Debit	Credit
Loss allowance (Profit or Loss)	120,000	Loss allowance 120,000
Interest income	(apply 8% on net carrying amount)	

Example 3 – Simplified approach for trade receivables

Bucket	Gross ₦	Historical Loss Rate	ECL ₦
0 – 30 days	500,000	0.5%	2500
31 – 60 days	100,000	2.0%	2,000
61 – 90 days	50,000	6.0%	3,000
> 90 days	20,000	20.0%	4,000
Total	**670,000**		**11,500**

Journal:
Debit: Impairment expense 11,500
Credit: Loss allowance 11,500

17.7.6 Disclosure high-lights (IFRS 7)

Reconciliation of opening to closing loss allowance by class of asset.
Explanation of inputs, assumptions and estimation techniques.
Credit-risk management practices, including definitions of default and write-off policy.
Quantitative information about collateral and credit enhancements.

17.7.7 Basis for estimating credit losses under IFRS 9

Definition and core principle:
Credit loss is determined as the **present value** of the difference between:

the **contractual cash flows** that are contractually due to an entity under a financial instrument, and
the **cash flows the entity actually expects to receive**, including amounts arising from collateral.

Expected credit loss (ECL) measurement:
Expected credit losses represent a **probability-weighted estimate** of credit losses (i.e., the present value of all cash shortfalls) over the expected life of the financial asset.

A **cash shortfall** is defined as the shortfall between the contractual cash flows due and the cash flows the entity reasonably expects to recover.
Importantly, a credit loss can arise even when payment in full is anticipated, but expected **later than contractually due**.

The **availability and enforceability of collateral** held by the entity may affect the measurement of expected credit losses.

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Key principles for ECL measurement:
Expected credit losses must be measured based on the following:

a. An **unbiased and probability-weighted assessment**, reflecting a range of possible default scenarios;
b. Incorporation of the **time value of money** using an appropriate discount rate (usually the effective interest rate); and
c. Use of **reasonable and supportable information** that is available without undue cost or effort. This includes historical data, current conditions, and forward-looking macroeconomic forecasts.

Assessment of significant increase in credit risk (SICR):
At each reporting date, entities are required to **assess whether there has been a significant increase in credit risk** (SICR) on a financial instrument since its initial recognition.

This involves comparing:

a. the **current risk of default** over the expected life of the financial asset; and
b. the **risk of default at the time of initial recognition**.

This comparison must be:

a. **forward-looking**, based on relevant quantitative and qualitative information; and
b. supported by data available without undue cost or effort.

If a financial instrument is assessed to have **low credit risk** (e.g., investment grade) at the reporting date, it is presumed that credit risk has not increased significantly.

17.7.8 Initial recognition

On day one, recognise a loss allowance equal to **12-month ECL**.

Formula: $PD_{12\text{-}month} \times LGD \times EAD$ *x Discounted @ the original EIR*

This acts as a proxy for credit risk priced into the instrument.

17.7.9 Subsequent measurement logic

Re-assess credit risk each reporting date using reasonable and supportable forward-looking information.
Upgrade/downgrade stage depending on SICR or credit-impaired status.
Re-measure the allowance; recognise **impairment gain or loss in profit or loss**.
If risk improves so that SICR no longer exists, revert to Stage 1 (12-month ECL).

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17.7.10 Undrawn facilities

The three-stage model also applies to **approved but undrawn** credit lines:

Stage	Portion assessed	Loss allowance
Stage 1	Expected drawdown within next 12 months	12-month ECL
Stage 2	Expected drawdown over remaining life when SICR exists	Lifetime ECL

17.7.11 Purchased or originated credit-impaired (POCI) assets

Recognise a **credit-adjusted effective interest rate** at purchase.
Do **not** recognise a day-one allowance.
Recognise **changes** in lifetime ECL as a loss allowance, with movements in profit or loss (even favourable changes result in an *impairment gain*).

17.7.12 Measurement of expected credit losses

ECL = Present value of weighted cash-shortfall scenarios, reflecting:
Expected value: probability-weighted outcomes, not best/worst case.
Time value: discount using EIR.
Data: historical, current and forward-looking information reasonably available.

17.7.13 Presentation and journals

Loss allowance for financial assets offsets the **gross carrying amount** (contra-asset).
For **loan commitments**/financial guarantees, recognise a **provision**.
Interest income:
Stage 1 & 2 → on gross carrying amount.
Stage 3 → on net carrying amount.

Journal extracts:

Stage 1 – Recognise 12-month ECL at origination

Debit:	Impairment expense	xx	
	Credit: Loss allowance		xx

Stage 2 – move to lifetime ECL

Debit:	Impairment expense	yy	
	Credit: Loss allowance		yy

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Stage 3 – Write-off when no reasonable expectation of recovery

Debit: Loss allowance zz

Credit: Financial asset zz

Illustrative example: Accounting for the loss allowance – Amortised cost example

Scenario:
An entity purchases a three-year bond on 1 Jan 20X5 for ₦48 million (par ₦50 million, 10% coupon, EIR 11.67%) and classifies it at amortised cost. Management estimates loss allowances as follows:

Date	Loss allowance (₦m)
Jan 1, 2015 (day one)	**1.00**
Dec 31, 2015	**1.50**
Dec 31, 2066	**1.20**
Dec 31, 2017	**Nil** (Bond Redeemed in Full)

The loss allowance is a **contra-asset**; it does not alter the effective interest calculation because interest is based on the gross carrying amount.

Amortisation table (Gross amounts)

Year	Opening AC ₦m	Interest 11.67 % ₦m	Coupon cash ₦m	Closing AC ₦m
2015	48.00	5.60	(5.00)	48.60
2016	48.60	5.65	(5.00)	49.25
2017	49.25	5.75	(55.00*)	Nil
** Coupon ₦5 m plus redemption ₦50 m.*				

Journal entries (summary, ₦m)

Date	Cash	Financial Asset	Loss Allowance	Profit or Loss (Impairment + Interest)
1 Jan 20X5	(48.00)	48.00	(1.00)	1.00 (allowance)
31 Dec 20X5	5.00	(5.00)	(0.50)	5.60 interest, 0.50 impairment gain
31 Dec 20X6	5.00	(5.00)	0.30	5.65 interest, (0.30) impairment loss
31 Dec 20X7	55.00	(55.00)	1.20	5.75 interest, (1.20) impairment loss

Insight: When the bond is redeemed in full, the remaining allowance is released to profit or loss, confirming no credit loss occurred.

Credit impairment

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.

Evidence that a financial asset is credit-impaired include (but is not limited to) observable data about the following events:

a. significant financial difficulty of the issuer or the borrower;
b. a breach of contract, such as a default or past due event;
c. the lender has granted to the borrower a concession for economic or contractual reasons relating to the borrower's financial difficulty that the lender would not otherwise have considered:
d. it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
e. the disappearance of an active market for that financial asset because of financial difficulties; or
f. the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

If an entity revises its estimates of receipts it must adjust the gross carrying amount of the financial asset to reflect actual and revised estimated contractual cash flows. The financial asset must be remeasured to the present value of estimated future cash flows from the asset discounted at the original effective rate.

Example: Credit impairment (I)

Company X invests in a bond, as thus:

a. The bond has an issue value of ₦1 million and pays a coupon rate of 5% interest for two years, then 7% interest for two years.
b. Interest is paid annually on the anniversary of the bond issue.
c. The bond will be redeemed at par after four years.
d. The effective rate for this bond is 5.942%.
e. At the end of the second year it becomes apparent that the issuer has financial difficulties and it is estimated that Company X will only receive 60c in the dollar of the future cash flows.

At the end of year 2 the amortised cost is:

Year	Amortised Cost Brought Forward	Interest @ 5.942%	Cash Paid	Amortised Cost Carried Forward
1	1,000,000	59,424	(50,000)	1,009,424
2	1,009,424	59,983	(50,000)	1,019,407

The recoverable amount is calculated as follows:

Year	Future cash flows	Discount factor (@5.942%)	PV (Present value)
3	70,000 @ 60% = 42,000	0.9439	39,644
4	1,070,000 @ 60% = 642,000	0.891	572,022

Recoverable amount: 611,666
Carrying amount: 1,019,407
Impairment **407,741**

Note that the recoverable amount could have been calculated easily as 60% of the carrying amount: 60% of 1,019,407 = **611,644** (*22 difference due to rounding*).
The impairment loss is charged to profit or loss taking into account the balance on the loss allowance account already recognised for the asset.

Example: Credit impairment (II)
Suppose in the above example there was a loss allowance of ₦100,000 recognised on the asset before the impairment event.

The necessary double entries would be as follows:

Account	Debit	Credit
Statement of profit or loss	307,741	
Loss allowance	100,000	
Financial asset		407,741

Future Revenue Recognition
Interest is recognised in the future by applying the effective rate to the new amortised cost (after the recognition of the impairment loss).

Quick-Reference Diagram:
(General Approach Quick-Reference Diagram – General Approach)

	Stage 1	Stage 2	Stage 3
Recognition Trigger	Origination/Low Risk	SICR (*or >30 days past due*)	Objective Evidence of Impairment
Loss Allowance	12-Month ECL	Lifetime ECL	Lifetime ECL
Interest Income	Gross Basis	Gross Basis	Net Basis

Examination pointers
a. **Identify the Stage** and quote evidence (PD movement, days-past-due, credit grade).
b. **Compute ECL** clearly, showing ***PD* × *LGD* × *EAD*** and discounting.
c. **Explain stage movements** – include rebuttable presumption and low-credit-risk option.

d. **Link to disclosures** – IFRS 7 requires narrative and quantitative data.
e. **Differentiate POCI** assets: no day-one allowance; recognise changes only.

17.8 Hedge accounting

Hedge accounting under IFRS 9 – Strategic Business Reporting Guide

17.8.1 What Is hedging?

A hedge is a risk-management action that uses one position (usually a derivative) to offset exposure on another item (hedged item). Example: a Nigerian importer with a $200,000 payable in three months can lock the naira cost by **buying USD forward** for that date.

Economic outcome: gains or losses on the forward contract counterbalance movements in the liability's value.

Financial statements, however, will not naturally show this offset without **hedge accounting**. IFRS 9 therefore offers an elective model that aligns the timing of gains and losses on the hedging instrument with those on the hedged item, reducing profit-or-loss volatility and portraying risk-management strategy faithfully.

17.8.2 Qualifying items

Category	Eligible as Hedged I*tem*?	Eligible as Hedging I*nstrument*?
Recognised asset or liability		If derivative measured at FVTPL or non-derivative financial instrument at FVTPL (for FX risk only)
Unrecognised firm commitment		Derivative
Highly probable forecast transaction		Derivative
Net investment in foreign operation		Derivative or qualifying borrowing

Component hedging: IFRS 9 allows designation of (i) specific risk components (e.g., LIBOR risk in floating debt), (ii) selected contractual cash flows or (iii) a specified proportion of an item, provided the component is separately identifiable and reliably measurable.

Limitations: Only exposures **external to the reporting entity** qualify in consolidated financial statements, except that intra-group FX risk that affects consolidated cash flows may be hedged.

17.8.3 Hedging instruments

Derivatives at FVTPL (forwards, options, swaps) are the most common.
Non-derivative foreign-currency instruments can hedge FX risk.
The instrument must be designated *in its entirety* unless the entity hedges only:

a. the intrinsic value of an option; or
b. the spot component of a forward; or
c. a proportional part (e.g., 50 percent) of nominal.

All changes in fair value of the designated component enter the hedge effectiveness assessment.

17.8.4 Qualifying criteria (IFRS 9.6.4.1)

The objective is to ensure that the hedge relationship remains aligned with the entity's risk management strategy and continues to meet the qualifying criteria throughout its duration.

Before a hedging relationship qualifies for hedge accounting, **all** of the following **conditions** must be met:

a. The hedging relationship consists **only of eligible hedging instruments and eligible hedged items**.
b. There must be **formal documentation** (including identification of the hedged item, the hedging instrument, the nature of the risk that is to be hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk).
c. The hedging relationship meets all of the following hedge effectiveness criteria:
    i. There is an **economic relationship**.
    ii. The **effect of credit risk does not dominate the value**; and
    iii. The **hedge ratio of the hedging relationship**.

In summary, hedge accounting is permitted when *all* of the following are documented at inception:

a. **Formal designation and risk-management objective**.
b. Identification of hedged item, hedging instrument and hedged risk.
c. **Economic relationship** between item and instrument (offsetting changes).
d. Credit risk does not dominate fair-value changes.
e. **Hedge ratio** equals that used for risk management (no deliberate under/over-hedging).

IFRS 9 drops the 80% –125% retrospective effectiveness test of IAS 39, replacing it with this principles-based assessment.

Hedge effectiveness

Hedge effectiveness refers to the extent to which changes in the fair value or cash flows of a hedging instrument successfully offset corresponding changes in the fair value or cash flows of the hedged item, arising specifically from the risk being hedged.

Under **IFRS 9**, entities are not restricted to specific methods for assessing hedge effectiveness. However, the standard mandates that:

Effectiveness **must be assessed at each reporting date** (at a minimum); and
The chosen measurement methodology must be **robust, well-documented, and implemented prior to the application of hedge accounting**.

The objective is to ensure that the hedge relationship remains aligned with the entity's risk management strategy and continues to meet the qualifying criteria throughout its duration.

17.8.5 Types of hedging relationships

Type	Objective	Accounting mechanics
Fair Value Hedge:	Offset exposure to *changes in fair value* of a recognised asset/liability or firm commitment.	Gain/loss on hedging instrument → Profit or Loss.
Gain/loss on hedged item for hedged risk** → **Profit or Loss** **(adjust carrying amount).		
Cash Flow Hedge:	Offset exposure to *variability in cash flows* of a recognised item or highly probable forecast transaction.	Effective portion of hedging instrument → OCI (cash-flow-hedge reserve) then recycled to Profit or Loss in the same period(s) the hedged cash flows affect Profit or Loss.
Ineffective portion** → **Profit or loss** **immediately.		
Hedge of a Net Investment	Protect the FX risk of a foreign subsidiary's net assets.	Similar to cash-flow hedge: effective portion → OCI (translation reserve); recycled on disposal of the foreign operation.

Basis adjustment: For hedged forecast purchases of non-financial items, the accumulated OCI may be added to the cost of the acquired asset (e.g., inventory, PPE) instead of recycling through profit or loss.

17.8.6 Discontinuation and rebalancing

IFRS 9 prohibits voluntary discontinuation. A hedge ends only if:
the hedging instrument expires, is sold, terminated or exercised; or
the qualifying criteria are no longer met *and* rebalancing cannot fix the hedge ratio; or
the risk-management objective changes.

When hedge accounting stops:

a. **Fair value hedge** → the hedged item's basis adjustment remains and is amortised to Profit or Loss if the item is a financial asset/liability.
b. **Cash flow hedge** → amounts in OCI stay until the forecast transaction occurs; if the transaction is no longer expected, OCI is reclassified to Profit or Loss immediately.

Rebalancing realigns the hedge ratio without ending the relationship, treating the adjustment prospectively.

17.8.7 Numerical example – Fair value hedge of fixed-rate debt

Set-up:
Entity X has a ₦10 million fixed-rate loan payable (coupon 4 percent) maturing in three years. To hedge exposure to rises in market rates, X enters a **receive-fixed, pay-floating interest-rate swap** with matching notional.

Designation
Hedged item: fair-value risk of fixed-rate loan attributable to changes in benchmark rate (NIBOR).
Hedging instrument: swap.

Year 1 fair-value movements (₦):
Swap fair-value gain = **120,000** (recognised at FVTPL).
Present-value loss on hedged loan attributable to NIBOR change = **118,000**.

Journal

Debit:	Swap asset	120,000	
	Credit: Profit or loss – FV hedge gain		120,000
Debit:	Profit or loss – FV hedge loss	118,000	
	Credit: Loan liability (basis adj.)		118,000

Net impact on profit or loss: ***Gain 2,000*** *(ineffectiveness).*

The loan's carrying amount is now **₦10,118,000** and will unwind to par using the effective interest method.

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17.8.8 Fair value hedge

A **fair value hedge** is a hedging relationship designed to mitigate the risk of changes in the fair value of a recognised asset, liability, or an unrecognised firm commitment - or a specific component thereof, where such changes are attributable to an identified risk and could materially impact profit or loss.

Illustrative examples:
A company holding **oil inventory** may hedge against a decline in market prices by entering into an **oil forward contract**, thereby stabilising the value of its physical stock.

The **interest rate risk** associated with a fixed-rate debt instrument may be hedged using an **interest rate swap**, converting fixed payments into floating and managing valuation volatility.

accounting treatment for fair value hedges

Under IFRS 9, the accounting for a fair value hedge involves symmetrical recognition of gains or losses in profit or loss for both the hedging instrument and the hedged item:

Any **gain or loss on the hedging instrument** (typically a derivative) is **recognised directly in profit or loss** in the period in which it arises—this follows the standard derivative accounting treatment.

Simultaneously, the **carrying amount of the hedged item** is **adjusted for changes in its fair value** that are attributable to the hedged risk, and this adjustment is also **recognised in profit or loss**, thereby aligning the economic impact of both instruments.

Note:
There are specific exceptions for certain hedge items, especially where hedge accounting intersects with OCI election options. These are governed by separate IFRS 9 provisions.

This hedge accounting model ensures that the impact of risk management activities is faithfully represented in the financial statements, preserving both the integrity of the hedging relationship and the relevance of reported financial performance.

Fair Value Hedge – Detailed illustration

Scenario 1 – Hedging inventory price risk
X Ltd holds **100 barrels of oil** in inventory at historical cost of **₦**70 per barrel. On **30 Sep 20X1** the spot price is **₦100** and management wishes to lock this value ahead of an expected sale in 12 months. The entity therefore **enters a forward contract** to sell 100 barrels at **₦**100 on 30 Sep 20X2.

At the **Dec 31, 2021** reporting date the spot (and forward) price has fallen to **₦90**.

Suggested Solution:

Item	Change in fair value	Accounting entry
Forward contract (hedging instrument)	Gain ₦10 per barrel × 100 = ₦1,000	***Debit:*** Derivative Asset ₦1,000
		Credit: Profit or Loss (FV hedge gain) ₦1,000
Oil inventory (hedged item)	Loss ₦10 per barrel × 100 = ₦1,000	***Debit:*** Profit or Loss (FV hedge loss) ₦1,000
		Credit: Inventory (basis adjustment) ₦1,000

Net impact on profit or loss = **Nil** except for any small ineffectiveness. The inventory now carries a basis adjustment; on disposal the cumulative adjustment is recognised in cost of sales.

Ledger summary

	Inventory	Derivative	Profit or Loss
30 Sep 20X1	10,000 (cost)	–	–
31 Dec 20X1 FV-adjust	(1,000)	1,000	–
Closing balances	9,000	1,000	0

Scenario 2 – Hedging a debt instrument measured at FVOCI
X Plc purchased a debt asset for **₦1,000,000** and classified it at FVOCI. It designates the asset in a fair-value hedge of benchmark-rate risk using an interest-rate swap.

At year-end:
Asset fair-value increase = **₦50,000** (of which **₦40,000** relates to the hedged risk component).
Swap fair-value **loss** = ₦40,000

The double entries to account for the hedge if the hedge accounting criteria were not met are as follows:

Without hedge accounting (or, hedge accounting criteria not met)

Accounting Entries:	**₦**
Debit: Financial asset	50,000
Credit: Other comprehensive income	50,000
(Being: Recognition of fair value gain on financial asset)	
Debit: Statement of profit or loss	40,000
Credit: Derivative	40,000
(Being: Recognition of fair value loss on derivative)	

The double entries to account for the hedge if the hedge accounting criteria were met are as follows:

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With Hedge Accounting (or, Hedge Accounting Criteria Met)

Accounting Entries:	**₦**
Debit: Financial asset	50,000
Credit: Other comprehensive income	10,000
Credit: Statement of profit or loss	40,000
(Being: Recognition of fair value gain on hedged financial asset)	
Debit: Statement of profit or loss	40,000
Credit: Derivative	40,000
(Being: Recognition of fair value loss on derivative)	

Net Profit and loss effect = Nil** (effective hedge); only the un-hedged portion of the asset's revaluation remains in OCI.*

This rule does not apply to equity instruments for which an election has been made for gains and losses to be recognised in OCI (see below).

Exception

IFRS 9 allows an entity to *may* make an irrevocable election at initial recognition for an investment in equity instruments that would otherwise be measured at fair value through profit or loss to be measured at fair value through other comprehensive income.

If such an asset is a hedged *item*, the fair value hedge accounting rules are different and are as follows:

a. The **gain or loss** on the hedging instrument (the derivative) is taken to OCI.
b. The **fair value difference** on the hedged item (which would include that part attributable to the hedged risk) is recognised in OCI in the usual way.

Equity instruments elected to FVOCI cannot be designated in a fair-value hedge.

Firm commitments

Unrecognised firm commitments can be hedged for fair-value risk. The cumulative fair-value change on the commitment attributable to the hedged risk is recognised as a **separate asset or liability**. When the commitment results in a recognised asset or liability (e.g., purchase of PPE), its carrying amount is **basis-adjusted** for the cumulative change recognised during the hedge period.

These examples reinforce the journal structure: derivative fair-value movements go straight to profit or loss, while the hedged item is fair-value-adjusted for the hedged risk with the offsetting entry also in profit or loss, ensuring symmetrical recognition and minimal volatility.

17.8.9 Cash flow hedge

A **cash flow hedge** is a risk management strategy that aims to mitigate the exposure to variability in future cash flows arising from a specific risk associated with a recognised asset, liability, or a highly probable forecast transaction—particularly where such variability could ultimately impact profit or loss.

Common examples of cash flow hedges include:

A company with **floating rate borrowings** using an **interest rate swap** to convert variable interest payments into fixed payments, thereby protecting against potential increases in interest rates.

A Nigerian airline projecting future **US dollar-denominated ticket sales** may enter into **US$/₦ forward exchange contracts** to hedge against adverse currency movements.

Accounting treatment of cash flow hedges

The accounting for cash flow hedges under IFRS 9 involves a distinction between the effective and ineffective components of the hedge:

The **effective portion** of the change in fair value of the hedging instrument is **recognised in Other Comprehensive Income (OCI)** and accumulated in the **hedging reserve** within equity.

The **ineffective portion** - that is, the part of the hedge that does not effectively offset changes in the hedged cash flows - is **recognised immediately in profit or loss**.

When the **forecasted transaction** (e.g., interest payments or foreign currency receipts) subsequently affects profit or loss, the amount that was initially recognised in OCI is **reclassified** to profit or loss in the **same reporting period**, ensuring a matching of hedging gains or losses with the hedged exposure's impact.

Scenario 1: Cash flow hedge – Foreign currency sales receipts

X-SA, a French airline, expects to sell **$1 million of tickets** for cash in six months.

Functional currency: **euro (€)**.
Spot rate at inception (30 Sep 20X1): **€1 = $1.00**.
Six-month forward contract: sell $1 million for euros to fix exchange rate.

Reporting date Dec 31, 20X1:
Forward contract is an asset of **€80** (gain).
Expected euro cash inflow from ticket sales has **fallen by €75** due to dollar weakness.

Entry (Ineffective Gain = €5)	Debit (€)	Credit (€)
Derivative asset	80	
OCI – cash-flow-hedge reserve		75
Profit or loss (ineffective portion)		5

Settlement Mar 31, 20X2:

Forward contract settled: further gain **€23**

Actual ticket proceeds **€905** (forecast €925)
Effective portion = €20; ineffective = €3

Entry @ Settlement	Debit (€)	Credit (€)
Derivative asset	23	
OCI – reserve		20
Profit or loss (ineffective portion)		3
(Being gain on the derivative – hedge instrument)		
Cash (Sales)	905	
Revenue (Profit or Loss)		905
(Being sale of seat tickets)		
OCI Re-classification:		
OCI – reserve	95	
Profit or loss		95
Forward contract close-out:		
Cash	103	
Derivative		103

Outcome: Total income recognised in *Profit or Loss* for 2022 is **€1,008** (*Sales* ***€905*** + *Effective Hedge Gain* ***€95*** + *Ineffectiveness* ***€8***). The OCI reserve is ***Nil***.

Basis adjustment – Hedged purchase of non-financial asset

Scenario
X-Ltd (functional currency: **₦**) forecasts a **$15,000** machine purchase on 1 Jan 20X3. On **Sep 30, 2022** the exchange rate is **₦350 = $1** (anticipated cost ₦5,250,000). X-Ltd enters a forward contract to buy $15,000 at ₦350 to hedge FX risk.

Dec 31, 2022
Forward contract has accrued a **₦300,000 gain** (₦370/$1 spot). Gain is recorded in OCI.

Jan 1, 2023
Machine purchased for $15,000 at spot ₦370/$1 = ₦5,550,000

Entry – Basis Adjustment	Debit (₦)	Credit (₦)
PPE (Machine)	5,550,000	
OCI (Cash-Flow-Hedge Reserve)		300,000
Basis Adjustment:		
OCI (Cash-Flow-Hedge Reserve)	300,000	
PPE (Machine)		300,000

Carrying amount of PPE on ***initial recognition*** = **₦5,250,000 (being the difference between ₦5,550,000 - ₦300,000)**. Depreciation expense of **₦300,000** reflects this hedge-adjusted cost.

Furthermore, let's say the *remaining useful life* of the *asset* is *10 years*, then as of December 31, 2023, the carrying amount after charging the depreciation of **₦525,000 (i.e. ₦5,250,000/10 years) would stand at ₦4,725,000 (i.e. ₦5,250,000 - ₦525,000).**

Key rule:
For **non-financial items**, the cumulative cash-flow-hedge reserve is **added to or deducted from the asset's cost** *(IAS 2 & IAS 16 link)*. No recycling through *Profit or Loss* occurs on settlement.

17.8.10 Hedge of a net investment in a foreign operation

A **net-investment hedge** protects the parent's equity value of a foreign subsidiary against movements between the subsidiary's functional currency and the parent's functional currency. The mechanics mirror a cash-flow hedge:

Aspect	Treatment
Hedged item	Parent's net assets in the foreign operation (post-translation equity).
Hedging instrument	Foreign-currency borrowing or derivative held **anywhere in the group** (IFRIC 16). Notional must not exceed the net investment.
Effective portion	Recognised in **OCI** (foreign-currency-translation reserve).

Aspect	Treatment
Ineffective portion	Recognised in **profit or loss**.
Disposal of subsidiary	Cumulative OCI relating to both the net investment and the hedge is **recycled to profit or loss**.

Translation of net assets and foreign exchange differences

Under **IAS 21**, the **net assets** of a foreign operation (e.g. a foreign subsidiary) are **translated** at the reporting date using the **closing exchange rate**. Any resulting **foreign exchange differences** are recognised in **Other Comprehensive Income (OCI)** and accumulated in a **foreign currency translation reserve** within equity. These amounts remain in OCI **until the disposal** of the foreign operation, at which point the **cumulative translation reserve is reclassified to profit or loss**.

Hedge accounting under IFRS 9 – Net investment hedges

IFRS 9 permits an entity to apply **hedge accounting** to **net investments in foreign operations**, provided that:

a. The hedging relationship is **formally documented**, and
b. The **hedging instrument** (e.g. a foreign currency loan or derivative) does not exceed the **net investment** in the foreign subsidiary.

This allows for the **foreign exchange gains or losses** on the hedging instrument to be **recognised in OCI**, matching the treatment of the translation differences from the net investment — thereby reducing volatility in profit or loss.

Illustrative example: Hedge of a net investment in a foreign operation

Background
Global Holdings Plc, a Nigerian parent company, has a **wholly owned subsidiary**, **GH Ghana Ltd**, operating in Accra, Ghana. The functional currency of **GH Ghana Ltd** is the **Ghanaian Cedi (GHS)**, while the **parent company's functional and presentation currency is the Nigerian Naira (₦)**.

As of **January 1, 2023**, Global Holdings Plc has a **net investment** in GH Ghana Ltd amounting to **GHS 5,000,000**. Due to concerns about the volatility in the NGN/GHS exchange rate, Global Holdings Plc decides to hedge the foreign exchange risk arising from this net investment.

Hedging instrument:
To mitigate this currency risk, Global Holdings Plc borrows **₦500 million** (a Naira-denominated loan) and **designates it as a hedge** of its **net investment** in GH Ghana Ltd.
The rationale: **If the GHS weakens against the NGN**, the **value of the net investment decreases** in NGN terms, but the loan payable in NGN stays fixed. The hedging relationship works because the NGN liability offsets the FX exposure on consolidation.

Accounting treatment under IFRS 9 / IAS 21
The hedge relationship must be **formally designated and documented**, including:
a. The hedging instrument (₦500m borrowing).
b. The hedged item (net investment in GH Ghana Ltd).
c. The nature of the risk being hedged (foreign exchange risk).
d. How hedge effectiveness will be assessed.

Foreign exchange gains or losses on the **hedging instrument** (i.e. the NGN-denominated borrowing) are recognised in **Other Comprehensive Income (OCI)** and accumulated in a **Foreign Currency Translation Reserve (FCTR)**, **to the extent the hedge is effective**.

Foreign currency translation differences on the **net investment** in GH Ghana Ltd are also recognised in **OCI**.

When the subsidiary is disposed of or derecognised, the cumulative exchange differences on both:
a. the net investment, and
b. the hedging instrument, are **reclassified from equity to profit or loss**.

Illustrative Journal entries:

Recognition of FX loss on the NGN loan (hedging instrument):
Assume exchange rate movement results in **₦25 million FX loss** on the NGN loan.

Debit: Other Comprehensive Income (FCTR - equity reserve) ₦25,000,000
Credit: Borrowings (or Exchange Gain)
₦25,000,000
(Being effective portion of FX loss on borrowing designated as hedge of net investment recognised in OCI)

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Recognition of FX gain on net investment (subsidiary equity increase in NGN terms):
Assume the GHS strengthens, resulting in a **₦25 million increase** in the translated net investment.

Debit: Investment in Subsidiary (equity section) ₦25,000,000
Credit: Other Comprehensive Income (FCTR) ₦25,000,000
(Being foreign exchange gain on net investment in foreign operation)

Summary points:
This hedge accounting treatment aligns the **foreign exchange gains/losses on the hedging instrument** and the **net investment** in **OCI**, thus neutralising P&L volatility from foreign operations.
Hedge effectiveness must be demonstrated and documented regularly.
On **disposal** of the foreign operation, all **accumulated FX gains/losses** in **OCI** are reclassified to **profit or loss**.

Summary of accounting treatment

Component	Without Hedge Accounting	With Hedge Accounting
USD Loan in German Sub	FX gains/losses → P&L	FX gains/losses → OCI
Net Investment in US Sub	FX gains/losses → OCI	FX gains/losses → OCI
Volatility Impact	High (mismatched)	Low (offset in OCI)

IFRIC 16 clarifications

Hedge accounting covers only the exchange difference **between subsidiary's functional currency and the parent's functional currency** (not presentation currency if different).
The hedging instrument can be held by **any entity in the group**.
On **disposal** (partial or full), recycle the cumulative effective-hedge OCI balance to *profit or loss* along with the translation reserve.

Exam note: Clearly identify functional-currency pairs, cap hedge notional to net investment, and state that accounting mirrors a cash-flow hedge with recycling on disposal.

Examination tips:

State the objective – identify risk, hedged item, hedging instrument and type of hedge.
Document hedge ratio – show quantities of item vs instrument.
Assess effectiveness qualitatively under IFRS 9; provide calculations if data are given.

Specify accounting entries – split effective/ineffective portions and their destinations (Profit or Loss vs OCI).
Mention disclosures – IFRS 7 requires risk-management strategy, effects on financial performance and position, and sensitivity analysis.

17.9 Chapter review

Focus area	Key reminder	Quick test
GAAP Sources	IAS 32 (classification), IFRS 7 (disclosures), IFRS 9 (recognition, measurement, impairment, hedge accounting).	List two scope exclusions from IFRS 9 and state where they are accounted for.
Classification	Apply business-model and SPPI tests. Failure sends the asset to FVTPL.	Which test fails if cash flows include leveraged commodity index returns?
Amortised Cost	Carrying amount = PV of future cash flows discounted at original EIR.	In a stepped-coupon bond, does total interest recognised equal total coupons? Explain briefly.
FVOCI Debt	Fair value to OCI, interest and ECL to P & L, recycle on disposal.	Why is impairment still required for FVOCI debt assets?
FVOCI Equity	Election is irrevocable; no recycling.	Can impairment be recognised for an equity instrument elected to FVOCI?
Transaction Costs	Capitalise for amortised cost and FVOCI; expense for FVTPL.	How are broker fees treated when equity shares are classified at FVTPL?
Impairment Model	Stage 1 12-month ECL, Stage 2 and 3 lifetime ECL.	Give one trigger that moves an asset from Stage 1 to Stage 2.
Embedded Derivatives	Separate if host is non-financial or fails SPPI, unless closely related.	What is the treatment of an equity-indexed interest payment in a debt host?
Hedge Accounting	Document risk, item, instrument and hedge ratio; split effective and ineffective parts.	Where is the effective portion of a cash-flow hedge recognised initially?
Net-Investment Hedge	Mirrors cash-flow hedge; recycle cumulative OCI on disposal.	Which currency pair's movement is hedged in a net-investment hedge?

Self-check: You should be able to write the journal entries, quote the correct standard, and discuss disclosures for every item in the table.

17.10 End of chapter questions and suggested solutions

17.10.1 Questions

Question 1: Case Study – Credit-Impaired Bond (bankruptcy scenario)

Background
Arsene Wenger purchased 5% Bond in Jose Mourinho on April 1, 2017 (in the primary market) for ₦1,000,000. The "Indenture" (i.e. term of the Bonds issued) was 5-year maturity with a value of ₦1,305,350. The effective rate of interest (EIR) on the debentures is 10% and the IFRS 9 conditions are satisfied for the investment to be carried at "Amortised Cost".

As of March 31, 2019, Jose Mourinho had filed for bankruptcy and immediately went into liquidation. All interest had been paid until that date. OnMarch 31, 2019, the liquidator of Jose Mourinho had announced a reduction of remaining interests by 40% and that only 80% of the terminal (maturity) value of the Bonds would be paid (upon realization of the assets of Jose Mourinho), which is expected to coincide with the original repayment (cash flows) dates. The market interest rate of a similar bond is 8% on that date.

Required:
a. Determine the "Carrying Amount" of the Bonds just prior to when it is evident that impairment of this investment has set-in.
b. Determine the amount to be recognised post impairment assessment, considering the possible impairment of the investment.
c. (Explain how the impairment loss, if any, will be reported in Arsene Wenger financial statements for the year ended March 31, 2019.

Question 2:

Background
Green-Finance Limited is a service organisation involved in specialized training. The company has the following mix of trade receivables which are outstanding along with different dates (i.e. some receivables are currently due or past due and other not yet due) as at the reporting date 31 December 2019.

The average credit day for every trade receivable is 30 days. The schedule below represents the distribution of the trade receivables from the invoice dates.

Grouping	Invoice Dates	Invoice Amounts (₦)	Outstanding Balance(s) (₦)
A	1 March 2019	1,000,000	120,000
B	4 May 2019	800,000	100,000
C	10 September 2019	500,000	200,000
D	26 November 2019	1,200,000	320,000
E	10 December 2019	600,000	450,000

The loss rate as estimated by the management of the company based on historical data of actual loss on collections is as shown below.

Past Due Days	Current	1–30 Days	31–60 Days	61–90 Days	Above 90 Days
Loss Rate(s)	0%	2%	5%	10%	40%

Required:
Based on a *'Practical Expedient'*, and the adoption of the *'Simplified Approach (i.e. Provision Matrix)'* in accordance with the requirement of IFRS 9 by the management of the company, what will be the amount of allowance for credit losses as at December 31, 2019 to be recognised in the balance sheet and statement of profit or loss, given that the closing balance in the allowance accounts for credit losses (as at December 31, 2018) was **₦124,000**. Please, show the accounting entries. *(Assume 30 Days makes a month)*.

Question 3: Integrated question – amortised cost and fair value measurement

Scenario
On 1 January 20X4, *Delta Investments Ltd* purchased two bond instruments in the primary market:

Bond	Business-model intent	Contract terms	Purchase price	Face / redemption value	Effective interest rate (EIR)
Alpha 5 %	Hold to collect contractual cash flows	4-year maturity, 5 percent annual coupon (31 Dec)	₦980,000	₦1,000,000	6.37%
Beta 7 %	Collect **and** sell for liquidity	3-year maturity, 7 percent annual coupon (31 Dec)	₦1,040,000	₦1,000,000	5.75%

Delta classifies **Alpha** at **amortised cost** and **Beta** at **FVOCI (debt)**.

Additional data:
Transaction costs are immaterial.

Market yields for Beta at each year-end produce the following fair values:
31 Dec 20X4 → ₦1,060,000
31 Dec 20X5 → ₦1,030,000
On 1 July 20X6 Delta sells the entire Beta holding for **₦1,020,000** plus accrued interest.
The credit quality of both issuers remains investment grade (Stage 1) throughout.

Required

a. Prepare an amortisation schedule for Alpha for 20X4 and 20X5 and show journal entries for:
(i) interest accrual,
(ii) coupon receipt, and
(iii) year-end carrying amount

b. For Beta, compute:
(i) interest income (EIR basis),
(ii) fair-value adjustment recognised in OCI for 20X4 and 20X5, and
(iii) the gain or loss recognised in profit or loss and recycled from OCI on disposal 1 July 20X6.

(c) Draft the statement-of-financial-position extract at 31 Dec 20X5 showing Alpha and Beta (separate line items and related reserves).

(d) Provide brief guidance (maximum 120 words) on how the business-model and SPPI tests determined the initial classification of Alpha and Beta.

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Question 4: Embedded derivatives

a. Inflation-linked lease

A retailer signs a ten-year property lease. Annual rentals increase by twice the general inflation rate published by the national statistics bureau.

Required*:*

i. Decide whether an embedded derivative exists and, if so, whether it must be separated.

ii. State the measurement basis after separation.

b. Convertible debt with share price cap

On issue a ₦100 million five-year loan gives the holder an option to convert to 1 million ordinary shares **only if** the share price exceeds ₦150. The current price is ₦120.

Required*:*

i. Identify the host contract and the embedded derivative(s).

ii. Explain the IFRS 9 treatment in the issuer's books on initial recognition.

Question 5: Classification of financial instruments

a. Treasury bill portfolio

A bank buys short-dated government treasury bills and manages them in a liquidity book. Sales before maturity are common when better yielding assets become available. Cash flows meet the SPPI test.

Required*:*

i. State the appropriate measurement category.

ii. Justify your answer with reference to the business-model test.

b. Trade receivable with significant financing component

A manufacturer gives a customer 30-month credit at zero per cent interest. The SPPI test is passed. The business model is hold to collect.

Required*:*

i. Explain why the receivable is initially recognised at fair value below invoice price.

ii. Describe subsequent measurement and any disclosure implications.

c. Structured note linked to commodity prices

An investor purchases a note whose coupon equals 5 percent of par plus an additional return equal to the annual percentage change in the Brent crude oil price. There is no option to separate the commodity link.

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Required:

i. Determine the initial classification and measurement of the note.
ii. Explain how fair-value changes will affect profit or loss.

17.10.2 Suggested solutions

Solution 1

Wenger purchased, on **April 1, 2017**, a 5% bond issued by *Mourinho PLC* for **₦1,000,000** in the primary market.

Coupon rate: **5%**, payable annually on31.
Term: **5 years** (maturity March 31, 2022).
Redemption amount (including premium): **₦1,305,350**.
Calculated effective interest rate (EIR): **10%**.
The bond is classified at **amortised cost**.

On **31 March 2019** (end of Year 2) the issuer filed for bankruptcy:
Future coupons will be reduced **by 40%** (i.e. only **60%** will be paid).
Only **80%** of the maturity amount will be repaid.
Expected timing of cash flows remains unchanged.
Market yield on similar risk at that date: **8%** (used for disclosure only; measurement uses original EIR).

The investment therefore becomes **credit-impaired (Stage 3)** @ March 31, 2019.

Amortised-Cost Schedule to March 31, 2019 (Gross Basis)

Year-End	Opening AC ₦	Interest @10 % ₦	Coupon ₦	Closing AC ₦
Mar 31, 2018	1,000,000	100,014	(50,000)	**1,050,014**
Mar 31, 2019	1,050,014	105,016	(50,000)	**1,105,030**

Gross carrying amount at the point of default = **₦1,105,030**

Expected-credit-loss (ECL) calculation at March 31, 2019
Remaining contractual cash flows (Years 3 – 5): three coupons of ₦50,000 and redemption of ₦1,305,350.

Revised expectations/estimation:
Coupons: 60% of ₦50,000 = ₦30,000 per year
Redemption: 80% of ₦1,305,350 = ₦1,044,280

Year	Contractual cash flow ₦	Expected cash flow ₦	Shortfall ₦	Discount factor @10 %	PV shortfall ₦
3 (Mar 31, 2020)	50,000	30,000	20,000	0.9091	18,182
4 (Mar 31, 2021)	50,000	30,000	20,000	0.8264	16,528
5 (31 Mar 222)	1,355,350	1,074,280	281,070	0.7513	211,164
Total expected credit-Loss (ECL)					**245,874**

Note: figures rounded to nearest naira.

3 Journal entry – Recognition of impairment (Stage 3)

Debit: Impairment expense (profit or loss) 245,874
Credit: Loss allowance (Contra-Asset) 245,874

The bond's **net carrying amount** becomes:	₦
Gross Carrying Amount	1,105,030
Less: Loss Allowance	(245,874)
Net carrying amount	**859,156**

Interest income from 1 April 2019 will be recognised on the **net carrying amount (Stage 3 rule).*

Subsequent measurement and presentation:

Interest income (20X0): 10% applied to net carrying amount until cash flows are revised again.
Cash receipts: when reduced coupons are received, allocate cash between interest and principal using the effective interest method.
Write-off: if later evidence indicates no reasonable expectation of recovery, write off both gross amount and allowance.

Exam observations:

a. Identify the trigger for **credit-impaired classification (Stage 3)** – bankruptcy filing.
b. Discount **cash-shortfall** using the **original EIR**, not the market rate.
c. Present the allowance separately and show the net carrying amount in the SoFP.
d. Explain that future interest accrual shifts to a **net-basis** calculation.
e. Disclose key assumptions and sensitivity in line with IFRS 7.

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Solution 2

Summary of Computation – IFRS 9 Provision Matrix Approach (Simplified)
Entity: Green-Finance Limited
Reporting date: 31 December 2019
Method used: Provision Matrix (Simplified Approach)
Credit days allowed: 30 Days

Loss rate categories:

Past Due Days:	Loss Rate
Current	0%
1 – 30 Days	2%
31 – 60 Days	5%
61 – 90 Days	10%
Above 90 Days	40%

Trade Receivables Ageing & Expected Credit Loss (ECL)

Grouping	Days Past Due	Category	Carrying Amount (₦)	Loss Rate	ECL (₦)
A	275	Above 90 Days	120,000	40%	48,000
B	211	Above 90 Days	100,000	40%	40,000
C	82	61 – 90 Days	200,000	10%	20,000
D	5	1 – 30 Days	320,000	2%	6,400
E	0 (Not Due)	Current	450,000	0%	0
Total			**1,190,000**		**₦114,400**

Journal entries and impairment impact

Description	Amount (₦)
ECL as @ 31 December 2018 (opening balance)	124,000
ECL as @ 31 December 2019 (new provision)	114,400
Impairment Gain for the Year	**9,600**

Accounting Entry:
Debit: Allowance for Expected Credit Loss A/c ₦9,600
Credit: Profit or Loss (Impairment Gain) ₦9,600

Conclusion:
The entity recognised a net **reversal (gain)** on impairment of ₦9,600 in 2019, which is credited to profit or loss. This aligns with the requirement of **IFRS 9: Financial Instruments** under the **Simplified Approach** using a **provision matrix model**.

Solution 3 (*Abbreviated Workings*)

(a) Alpha 5% – amortised cost

EIR 6.37%, coupon ₦50,000.

Year	Opening AC	Interest 6.37%	Coupon	Closing AC
20X4	980,000	62,926	(50,000)	**992,926**
20X5	992,926	63,296	(50,000)	**1,006,222**

Journal – Dec 31, 2014

Debit:	Financial asset (Alpha)	62,926	
	Credit: Interest income (Profit or Loss)		62,926
Debit:	Cash	50,000	
	Credit: Financial asset (Alpha)		50,000

**Similar pattern for 2015.*

(b) Beta 7 % – FVOCI (debt)

Interest recognised in Profit or Loss, fair-value movements in OCI.

Year	Opening AC	Interest 5.75 %	Coupon	Closing AC	Fair value	FV OCI Δ
2014	1,040,000	59,800	(70,000)	1,029,800	1,060,000	**+30,200**
2015	1,029,800	59,214	(70,000)	1,019,014	1,030,000	**+10,986**
****Cumulative FV OCI Dec 31, 2015 = ₦41,186***						

Disposal Jul 1, 2016:

Carrying amount just before sale (assume six months accrual): apply EIR for half-year → interest = ₦29,793; coupon received on sale date = ₦35,000.
Adjust Amortised Cost to **~₦1,013,807** (*i.e. ₦1,019,014 + ₦29,793 - ₦35,000*)
Proceeds ₦1,020,000.
Profit in *Profit or Loss* on sale = **₦6,193** (i.e. ₦1,020,000 - ₦1,013,807)
Recycle cumulative OCI *(₦41,186 Credit*) to Profit or Loss.
Total Profit or Loss Impact = **₦47,379 Gain**

(c) Statement-of-Financial-Position Extract (31 Dec 20X5)

Non-Current Assets:	
Financial assets at amortised cost – Alpha	1,006,222
Financial assets at FVOCI – Beta	1,030,000
Equity:	
FVOCI reserve (debt)	41,186

(d) Guidance note (≤120 words)

Alpha is managed only to collect contractual cash flows; sales are infrequent and incidental. The cash flows – fixed coupons plus principal – meet the **SPPI** test, so the bond is measured at **amortised cost**. In contrast, Beta is held in a liquidity portfolio where management both collects interest and sells bonds to rebalance interest-rate risk. That objective satisfies the **collect-and-sell business model**; the cash flows also pass SPPI, hence Beta is measured at **fair value through OCI**. If either bond contained non-SPPI leverage or exotic indexation, it would default to FVTPL regardless of business model.

Solution 4

Question	Answer and guidance note
Inflation-linked lease	The lease host is a non-financial contract. The rental escalator is an *inflation index*, which is **closely related** to the leased asset because general inflation normally drives market rentals (IFRS 9.B4.3.8). No separation is required; the entire lease is accounted for under IFRS 16.
Convertible debt with price cap	**Host:** liability measured at amortised cost. **Embedded derivative:** a written equity call option (conversion right) because the number of shares is fixed but the exercise condition is linked to the share price. The option is **not closely related** to the host debt, so it is separated and measured at fair value through profit or loss. At issue the proceeds are split: Dr Cash 100 m; Cr Liability (present value of cash flows discounted at market rate) ×; Cr FVPL derivative (residual) ×. Subsequent changes in the option's fair value are recognised in profit or loss.

Solutions 5 - Classification of Financial Instruments

Question	Answer and guidance note
Treasury bill portfolio	Business model = *collect and sell*; cash flows = principal + interest (SPPI passed). The correct category is **fair value through OCI (debt)**. Interest revenue and ECL go to profit or loss; fair-value gains and losses go to OCI and are recycled on sale.
Extended-credit trade receivable	Present value of future cash receipts discounted at a market rate is below invoice amount; the difference is contract interest and is recognised as revenue over 30 months using the effective interest method. Classification = **amortised cost** (hold-to-collect, SPPI passed). IFRS 7 disclosure: significant financing component, carrying amount split between gross receivable and loss allowance.
Commodity-linked structured note	Variable cash flows fail the SPPI test because coupon is leveraged to Brent crude prices. The entire instrument is classified at **fair value through profit or loss** on initial recognition; all subsequent fair-value movements are reported in profit or loss.

These treatments meet IFRS 9, IAS 32 and IFRS 7 requirements and would earn full marks if presented with brief supporting references in the examination.

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Professional Level

Strategic Business Reporting

CHAPTER 18

FINANCIAL INSTRUMENTS: IAS 32 AND IFRS 7

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18 Financial Instruments: IAS 32 and IFRS 7

18.0 Learning objective

This chapter discusses IAS 32 and IFRS 7 and their applications in a manner that clearly distinguishes debt, equity, and compound features, and how to prepare disclosures that convey the scale, nature, and management of financial-instrument risk in line with Strategic Business Reporting (SBR) expectations.

18.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. **Define a financial instrument** and identify which party records an asset, liability, or equity instrument.
b. **Classify financial instruments** as financial assets, financial liabilities, or equity instruments using substance-over-form reasoning.
c. **Apply the fixed-for-fixed test** when assessing instruments settled in an entity's own shares.
d. **Account for compound instruments** by valuing the liability component first and allocating the residual to equity.
e. **Record treasury-share transactions** and explain their impact on equity without affecting profit or loss.
f. **Explain the strict offsetting criteria** and recognise when gross presentation is required.
g. **Determine distributable profit** under Nigerian law and compute group dividend capacity.
h. **Draft IFRS 7 disclosures** that cover significance (carrying values, fair values, reclassification, derecognition, collateral, credit-loss allowances, breaches) and risk (credit, liquidity, market), using both qualitative narratives and quantitative schedules.
i. **Prepare statement-of-profit-or-loss disclosures** for gains, losses, interest, fees, and impairment in line with IFRS 7.
j. **Critically evaluate risk-management information** and explain how it helps users predict future cash flows.

18.2 Financial Instruments: Presentation (IAS 32)

18.2.1 What are Financial Instruments?

A **financial instrument** is any contractual agreement that creates a **financial asset** for one entity and, simultaneously, a **financial liability** or **equity instrument** for another. Understanding this contractual link is critical: when analysing an instrument, always ask who holds the right to receive cash (asset) and who carries the obligation to pay (liability) or provide a residual interest (equity).

Financial Assets

A resource qualifies as a financial asset when it represents one of the following:

a. **Cash**
b. **An equity instrument of another entity**
c. **A contractual right** either
d. to receive cash or another financial asset from another entity, or
e. to exchange financial instruments with another entity under terms that are potentially favourable
f. **A contract settled in the entity's own equity instruments** where the contract is either
g. a non-derivative that entitles the holder to receive a variable number of the issuer's own shares, or
h. a derivative that will be settled other than by delivering a fixed number of the issuer's own shares for a fixed amount of cash or another financial asset.

Illustrative examples

Category	Typical Items
Equity investments	Shareholdings in other companies
Debt investments	Bonds, debentures, commercial papers
Receivables	Trade receivables, notes receivable, loan receivables
Derivatives (assets)	Forward contracts in an asset position, option contracts that are "***in-the-money***"

Financial Liabilities

An obligation is a financial liability when the issuer:

a. **Must deliver CASH** or another financial asset to a counterparty, or
b. **Must exchange financial instruments** under conditions that are potentially unfavourable, or
c. **Holds a contract settled in its own equity instruments** that results in either
    i. delivering a variable number of its own shares, or
    ii. settling a derivative other than by exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset

Illustrative examples

Category	Typical items
Payables	Trade payables, accrued expenses
Interest-bearing debt	Bank loans, debenture stock, corporate bonds
Derivatives (liabilities)	Interest-rate swaps in a liability position, currency forwards that are "***out-of-the-money***"
Other obligations	Written put options over own shares, obligations to repurchase own shares for cash

Equity Instruments

An equity instrument evidences a **residual interest** in the assets of an entity once all liabilities are deducted. Key points:

a. No contractual obligation exists to transfer cash or other assets.
b. Puttable instruments that meet specific IAS 32 criteria may be classified as equity despite a redemption feature.

Illustrative examples

Equity instrument	Why it is equity?
Ordinary shares that cannot be put back to the issuer	No unavoidable obligation to pay cash
Irredeemable, non-cumulative preference shares	No duty to redeem or pay fixed dividends
Warrants or written call options to subscribe for a fixed number of ordinary shares for a fixed amount of cash	"Fixed-for-fixed" criterion met

18.2.2 Derivatives (financial derivatives)

A **Derivative** is a financial instrument or contract that possesses all three of the following characteristics:

a. **Underlying variable**: its value changes in response to movements in a specified rate or price (interest rate, commodity price, FX rate, index, credit rating, and so forth).
b. **Little or no initial net investment**: or an initial investment that is smaller than would be required for direct exposure to the underlying.
c. **Future settlement**: it is settled at a future date, typically net in cash or by exchanging a financial asset.

Why entities use derivatives?

Hedging: managing currency, interest rate, or commodity price risk.

Speculation: taking leveraged positions on price movements.

Market access: gaining exposure to assets or indices that might otherwise be illiquid or costly.

Four headline derivative contracts

Contract	Core features	Common applications
Forward contract	Bespoke agreement to buy or sell an asset at a fixed price on a future date. Executed over-the-counter.	FX forwards for importers and exporters, commodity forwards for producers.
Futures contract	Standardised forward traded on an exchange. Daily "mark-to-market" and margin requirements reduce counterparty risk.	Hedging interest rate exposures, managing commodity inventory price risk.
Swap contract	Two parties exchange cash flows, commonly fixed for floating interest payments or different currencies.	Converting floating-rate debt into fixed-rate obligations, managing cross-currency funding costs.
Option contract	Gives the holder the right, but not the obligation, to buy (call) or sell (put) an underlying asset at a predetermined strike price within a specified period.	Equity portfolio protection via put options, upside participation through call options on commodities.

Key takeaways for SBR candidates:

a. **Substance over form**: always examine contractual terms before assigning an instrument to asset, liability, or equity.

b. **Fixed-for-fixed rule**: crucial for deciding whether an instrument settled in own shares is equity or liability.

c. **Derivative hallmarks**: variability with an underlying, minimal initial investment, and future settlement.

d. **Presentation matters**: income and expenses from liabilities affect profit or loss, whereas distributions on equity bypass profit or loss and are recorded directly in equity.

18.2.3 Compound financial instruments

A **compound financial instrument** has both a debt component and an equity component. The most common example is a **convertible bond** that pays fixed coupons but can be converted into ordinary shares before maturity.

Why classification matters

Debt coupons and redemption amounts affect profit or loss through finance costs. The equity element never affects profit or loss; it sits in equity until conversion or expiry.

Initial Split: Liability first, equity as the residual

On the issue date the proceeds are apportioned as follows:

Step	Action	Rationale
1	**Value the liability component** by discounting future coupons and redemption cash flows at the market yield for a similar non-convertible bond.	Gives the fair value of a straight bond without conversion rights.
2	**Assign the residual to equity**: Equity = Issue proceeds – Fair value of liability.	Captures the value of the holder's conversion option.
3	**Allocate transaction costs** between the two components using the relative fair values.	Ensures consistent measurement of each part.

The split determined on day one is *never* revised for later changes in market yields or share prices.

Illustration example:

Entity A issues two thousand three-year convertible bonds on January 1, 2025. Key terms:

Description	Amount
Face value per bond	₦1,000
Total proceeds	₦2,000,000
Coupon	6% paid annually in arrears
Market yield for equivalent straight debt	9%
Conversion ratio	250 ordinary shares per bond

Split of a Convertible Bond into Liability and Equity Components

(values in Nigerian naira, commas used as thousand separators)

Step	Computation	Amount (₦)
1	Present value (PV) of principal, payable at the end of year 3	1,544,367
2	PV of annual coupons (₦120,000 each year, discounted at 9 %)	303,755
3	**Total liability component** (A + B)	**1,848,122**
4	Proceeds of bond issue	2,000,000
5	**Residual equity component** (D – C)	**151,878**

Working notes:

PV of principal
$2{,}000{,}000/(1.09)^3 = 1{,}544{,}367$

PV of coupons

Year	Cash flow (₦)	Discount factor 9 %	PV (₦)
1	120,000	*1 / 1.09 or* ***(1.09)$^{-1}$***	110,092
2	120,000	*1 / 1.09² or* ***(1.09)$^{-2}$***	101,002
3	120,000	*1 / 1.09³ or* ***(1.09)$^{-3}$***	92,661
	Total PV of coupons		**303,755**

Liability Valuation (discount rate @ 9%)

Cash Flow	Discounted Value (₦)
Principal at year 3	1,544,367
Coupons: ₦120 000 each year	110,092 + 101,002 + 92,661 = 303,755
Total Liability Component	**1,848,122**

Equity Element: Calculation	**₦**
Issue proceeds	2,000,000
Less: Liability component	(1,848,122)
Equity component	**151,878**

Journal entry on 1 January 20X5

Account	Debit (₦)	Credit (₦)
Cash	2,000,000	
Financial Liability		1,848,122
Equity – *Convertible Option*		151,878

* ***Transaction costs*** (*if any*) would be split in the same ratio: ***1,848,122 : 151.878***
** The ***Liability component*** is measured at **amortised cost** in the usual way at each subsequent reporting date (*see Chapter 17 on IFRS 9 – Financial Instruments*).

Subsequent measurement

Liability – follow IFRS 9 amortised-cost rules using the effective interest rate of 9 %.
Equity – no re-measurement.
On conversion – derecognise the liability, credit share capital and share premium, and re-classify the equity component within equity.
If the bond matures without conversion – repay principal, de-recognise the liability, and leave the equity component in reserves.

Examination focus for SBR candidates

Identify hybrid terms that create debt and equity features.
Apply the "liability first" technique using a comparable straight-debt yield.
Draft clear journal entries showing the split.
Explain why subsequent changes in market conditions do not alter the original allocation.

18.2.4 Transactions in own equity

Treasury Shares

An entity may buy back its own shares; once repurchased they become **treasury shares**. The shares remain in the company's possession until they are re-issued, cancelled, or used for a purpose such as an employee share scheme. Treasury shares are shown as a **deduction from equity**. Any gain or loss on their sale, reissue, or cancellation is recorded **directly in equity** and never presented in profit or loss or other comprehensive income.

Principle	Practical implication
When an entity buys back its own shares, the shares become treasury shares.	The cost of the buy-back is deducted from equity, not recorded as an asset.
Gains or losses on subsequent sales or cancellations of treasury shares are not routed through profit or loss.	Record the difference directly in equity.
Disclosure is mandatory.	Show the holding as a separate line that reduces share capital on the face of the statement of financial position, or disclose the amount in the notes, in line with IAS 1.

Interest, dividends, gains, and losses

For financial assets and financial liabilities, recognise all related interest, whether earned or incurred together with any dividend income, and any realised gains or losses in profit or loss for the reporting period. By contrast, for equity instruments, distributions to holders are debited directly to equity, bypassing profit or loss, in line with IAS 32's presentation rules.

Classification of the instrument	Where to record related Income or expense
Financial liability (for example, redeemable preference shares)	Report interest, dividend expense, gains, and losses in profit or loss. These items may appear within finance costs or as separate line items.
Equity instrument	Distributions, such as ordinary share dividends, reduce equity directly. No impact on profit or loss.
Share issues	Deduct incremental transaction costs from equity, net of any tax relief.

Offsetting financial assets and liabilities

Presenting a financial asset and a financial liability as a single net figure can hide useful information from users, so IAS 1 generally **prohibits offset** unless another IFRS expressly allows it. Offset is acceptable only when it mirrors the economic substance of the related balances or transactions.

IAS 32 clarifies the rule for financial instruments. An entity may set a financial asset against a financial liability **only when**:

a. it currently has a **legally enforceable right** to set off the recognised amounts, and
b. it **intends** either to settle the amounts net, or to realise the asset and settle the liability **simultaneously**.

These requirements ensure the statement of financial position reflects the timing and amount of the entity's future cash inflows (from the asset) and outflows (for the liability).

Offset is **rare** and permitted only when both conditions below are met.

Condition	Explanation
The entity has a legally enforceable right to set off the recognised amounts.	The right must exist at all times: during normal business, on default, and on insolvency of any party. It must not depend on a future event.
The entity intends to settle on a net basis, or to receive the asset and settle the liability simultaneously.	Without this intention separate presentation is required, even if a set-off right exists.

Resulting presentation: show a single net amount in the statement of financial position **only** when both tests are satisfied. Otherwise present the gross amounts.

First-time adopters often need to "gross up" balances that were previously offset under local GAAP.

Distributable profit under Nigerian law

Governed by the Companies and Allied Matters Act 2020 (i.e. CAMA 2020).
Dividends are recommended by directors and approved by shareholders. A general meeting may reduce, but not increase, the dividend proposed by the directors.
Interim dividends are permitted if the articles allow.

Dividends may be paid **only** from distributable profits, namely:

a. profits earned through use of company assets, even when the assets are wasting;
b. revenue reserves;
c. realised gains on disposal of fixed assets, tested on a net basis if multiple disposals occur.

Directors must not declare a dividend if there are reasonable grounds to believe the company cannot meet its debts as they fall due.
Amounts in the share premium account or capital redemption reserve cannot fund a cash dividend, although they can support bonus issues of shares.

Illustrative example: Group dividend capacity

Fact Pattern	Amount (₦)
Parent (P) retained profits at year end	400,000
Subsidiary (S) retained profits at acquisition	100,000
Subsidiary (S) retained profits at year end	300,000
Parent (P) interest in Subsidiary (S)	80 %

Consolidated Retained Profits

Component	Amount (₦)
P retained profits	400,000
P share of S post-acquisition profits: 80 % × (300,000 – 100,000)	160,000
Total consolidated retained profits	**560,000**

Maximum group distribution

Only profits held **by P itself** are legally distributable to P shareholders.
Therefore, the maximum dividend to owners of P is **₦400,000**.
Subsidiary (S) could pay its own dividend; eighty percent of any such payment would flow to P and then become distributable by Parent (P).

Key points for SBR candidates:

a. Treasury share transactions bypass profit or loss and always adjust equity.
b. Dividends on liabilities hit profit or loss, whereas dividends on equity reduce equity directly.
c. Offsetting is highly restrictive: both a current, unconditional legal right and a clear intention to settle net are required.

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d. Dividend capacity within a group depends on legally distributable reserves in the parent, not on consolidated figures.

18.3 Financial Instruments: Disclosures (IFRS 7)

18.3.1 Objective

Every entity is exposed to financial risk, yet many of these exposures cannot be detected merely by scanning the statement of financial position. IFRS 7 therefore requires disclosures that allow users to **judge both:**

how important financial instruments are to the entity's financial position and performance, and
the nature and extent of risks arising from those instruments.

In practice IFRS 7 disclosures fall into two broad blocks:

Section	Purpose
Significance of financial instruments	Show how financial assets and liabilities influence performance and position.
Nature and extent of risk	Explain the principal risks (credit, liquidity, market, currency, interest-rate, commodity, etc.) and how management measures and manages them.

18.3.2 Illustration of hidden risks

A United Kingdom entity holds units in a German floating-rate, silver-linked bond denominated in euro:

Feature	Embedded Risk
Floating coupon	Exposure to falling market interest rates.
Euro denomination	Currency risk: sterling movements against the euro affect cash inflows.
Silver-linked bonus	Commodity price risk.
Issuer creditworthiness	Default risk on coupons and principal.

Without narrative and quantitative disclosure, such layered risks remain invisible to users.

18.3.3 Statement of financial position disclosures

An entity must disclose the **carrying amount** for each class of financial instrument, either on the face of the statement of financial position or in the notes, distinguishing at a minimum:

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;
e. financial liabilities measured at amortised cost.

Disclose the **carrying amount** for each class shown below, either on the face of the statement or in the notes:

Financial assets	Financial liabilities
At Fair Value Through Profit or Loss (FVTPL)	at FVTPL
At Amortised Cost	at Amortised Cost
At Fair Value through Other Comprehensive Income (FVOCI)	Not Applcable

Additional line-item information required includes:

Topic	Disclosure requirement
Collateral	Amount of financial assets pledged as security for liabilities or contingencies.
Allowance for expected credit losses	Reconciliation of the opening to closing balance for each asset class with a separate allowance account (for example, trade receivables).
Defaults and breaches	Details of any covenant breaches or payment defaults on borrowings during the period, together with remedial action taken.
Fair value	For each class, disclose fair value and carrying amount side by side unless carrying amount approximates fair value (typically true for short-term receivables and payables).

18.3.4 Why IFRS 7 matters

A set of financial statements often masks crucial risk exposures. IFRS 7 therefore insists on disclosure that lets users:

judge **how important** financial instruments are to performance and position, and understand **the scale and character of the risks** those instruments create.

Consider a UK entity that holds euro-denominated, floating-rate, silver-linked bonds issued by a German counterparty. Hidden within that single investment are:

Embedded feature	Underlying risk
Floating coupon	Interest-rate risk (cash flows fall if market rates drop).
Euro denomination	Currency risk (sterling appreciation reduces income).
Silver price bonus	Commodity price risk.
Issuer credit	Default risk on coupons and principal.

Without IFRS 7, these exposures would remain obscure.

18.3.5 Statement of Profit or Loss and Other Comprehensive Income Disclosures

line item to disclose	Comment
Net gains or losses on instruments at FVTPL	Separate assets from liabilities if helpful.
Net gains or losses on liabilities at amortised cost	Include debt buy-back gains.
Net gains or losses on assets at FVOCI	Show recycling amounts separately.
Net gains or losses on equity instruments designated at FVOCI	No recycling on disposal.
Total interest income and total interest expense (effective interest method)	Exclude instruments already at FVTPL.
Fee income and expense on non-FVTPL instruments	e.g. loan origination fees.
Impairment losses by class of financial asset	Align with IFRS 9 staging.

18.3.6 Other disclosures

Hedge accounting: description of each hedge, the instruments used, year-end fair values, and the risk addressed.
Fair value hierarchy: level 1, level 2, level 3, together with valuation techniques for level 3.

18.3.7 Risk disclosures

Provide both **qualitative narrative** and **quantitative data** for each major risk class.

Risk	Qualitative Requirements	Quantitative Requirements
Credit risk	Exposure sources, risk management objectives, and any changes during the period.	*Maximum exposure* at the reporting date, collateral held, credit quality of assets not past due, age analysis of past-due or impaired assets, and details of collateral obtained.
Liquidity risk	Policies for managing payment obligations.	Contractual maturity analysis of financial liabilities, showing undiscounted cash flows.
Market risk (currency, interest rate, price)	Risk management approach and measurement methods.	Sensitivity analysis showing the impact of reasonably possible changes in each market variable on profit or loss and equity. If a value-at-risk model is used internally, the same model may be disclosed with its assumptions and limitations.

Key point for SBR candidates:

Offsetting of assets and liabilities is not a risk disclosure but a presentation issue governed by IAS 32. Disclose separately unless a current, legally enforceable right of set-off exists and there is an intention to settle net.

18.3.8 How to study this for SBR:

a. **Memorise the two pillars** of IFRS 7: significance and risk.
b. **Link every disclosure** to either the statement of financial position, the statement of profit or loss, or the risk note.
c. **Practise drafting** a credit-risk table, a liquidity maturity ladder, and a market-risk sensitivity analysis.
d. **Explain, not list**: in narrative questions, stress why the information helps users predict future cash flows.

18.4 Chapter review

Key principles recap

Area	Core points to remember
IAS 32 Classification	Substance not legal form. Debt carries an unavoidable obligation. Equity has residual interest only. Hybrid terms create compound instruments.
Compound Instruments	Value liability using a comparable straight-debt yield. Equity is the residual. No subsequent re-measurement of equity.
Treasury Shares	Deduct from equity. Gains and losses stay in equity.
Offsetting	Need current, unconditional legal right **and** intention to settle net/simultaneously.
Distributable Profit (Nigeria)	Parent-only reserves drive dividend limits.
IFRS 7 Pillars	*Significance* of financial instruments. *Nature and extent* of risk.
SOFP Disclosure	Classify by measurement category. Show collateral, ECL roll-forward, breaches, and fair-value hierarchy.
SOPL/OCI Disclosure	Net gains/losses per category. Interest via EIR. Fee income/expense. Impairment by class.
Risk Disclosures	Credit: maximum exposure, quality, ageing, collateral. Liquidity: contractual maturity ladder, policies. Market: sensitivity or VaR with methods and assumptions.

18.5 End of chapter questions and suggested solutions

18.5.1 Questions

Question 1: Puttable Preference Shares (IAS 32)

Background

Sunbeam Plc issues 50,000 irredeemable, non-cumulative preference shares at ₦10 each on April 1, 2025. Holders are entitled to a discretionary dividend of ₦0.75 per share each year. The terms allow holders, after five years, to put the shares back to Sunbeam at fair value **if** Sunbeam's ordinary shares cease to be listed on a recognised stock exchange.

Required:

a. Determine whether the preference shares are classified as equity or a financial liability on initial recognition.
b. Explain the presentation of any dividends and any subsequent buy-back of the shares.

Question 2: Convertible Bond Split (IAS 32)

Background

On January 1, 2025 BrightSky Ltd issues 5,000 three-year convertible bonds at par value of ₦1,000 each, raising ₦5,000,000 in cash. Coupons are 5 % payable annually in arrears. Each bond converts to 120 ordinary shares at the holder's option on maturity. A comparable straight-debt yield is 8 %.

Required:

a. Calculate the liability and equity components on initial recognition (round to the nearest naira).
b. Prepare the journal entry at January 1, 2025.

(Discount factors at 8 %: year 1 = 0.9259, year 2 = 0.8573, year 3 = 0.7938)

Question 3: Risk disclosures for a manufacturing group (IFRS 7)

Background

Falcon Group's year-end balances include:

Item	Carrying amount (₦'000)
Trade receivables (gross)	120,000
Allowance for expected credit losses	(6,000)
Short-term bank loans	55,000
Five-year secured loan (balloon payment at maturity)	80,000

Ageing of receivables:

Current ₦95,000;
31–60 Days ₦18,000;
61–90 Days ₦5,000; and
Over 90 days ₦2,000.

An invoice discounting facility requires Falcon to pledge current-dated invoices as collateral. Management prepares a liquidity ladder that shows the balloon payment falling due in three years.

Required:
Draft the key IFRS 7 disclosures (qualitative and quantitative) that Falcon should provide for:
Credit risk, and
Liquidity risk

18.5.2 Suggested Solutions

Solution 1

The shares grant put rights **only if** listing is lost. Because that contingency may never arise, Sunbeam currently has an unconditional right to avoid paying cash. The instrument meets IAS 32's criteria for a **puttable instrument classified as equity** (all conditions in IAS 32 para 16A are satisfied). It is therefore presented in equity.

Dividends are discretionary; when declared they are debited directly to equity, not recognised as an expense. If the contingency later triggers a put option and Sunbeam buys back the shares, the consideration paid is deducted from equity as treasury shares; no gain or loss is recorded in profit or loss.

Guidance note:

Always test puttable shares against IAS 32 paras 16A–16B. Classification hinges on whether the issuer can **currently** avoid transferring cash or another asset. Equity distributions bypass profit or loss and any later re-purchase adjusts equity only.

Solution 2

Liability and equity components on initial recognition:

Step 1: Present value of coupons
= ₦250,000(0.9259) + 250,000(0.8573) + 250,000(0.7938) = **₦584,575**

Step 2: Present value of principal
= ₦5,000,000 × 0.7938 = **₦3,969,000**

Step 3: Liability component
= ₦584,575 + ₦3,969,000 = **₦4,553,575**

Step 4: Equity component (residual)
Issue Proceeds = ₦5,000,000 – Liability ₦4,553,575 = **₦446,425**

Journal entry at January 1, 2025:

Account	Debit (₦)	Credit (₦)
Cash	5,000,000	
Financial liability		4,553,575
Equity – Conversion option reserve		446,425

Guidance note:

Value the liability first using the market yield for an equivalent non-convertible bond. The equity element is the residual. The split is locked-in at inception; subsequent movements affect only the liability under IFRS 9's amortised-cost rules.

Solution 3

Credit risk

Qualitative
Falcon sells mainly on 60-Day terms to electronics retailers. Credit risk is managed through credit-rating limits, invoice insurance for large customers, and weekly ageing reviews. No significant concentration exists; the largest customer is 6 % of sales.

Quantitative
Maximum exposure equals the gross receivable of ₦120,000 (no other credit enhancements except collateral). Collateral pledged: invoices of ₦40,000 currently under the discounting facility.

Ageing analysis:

Category	Gross (₦'000)	ECL (₦'000)
Current	95,000	1,425
31–60 days	18,000	2,160
61–90 days	5,000	1,000
> 90 days	2,000	1,415
Total	**120,000**	**6,000**

Collateral obtained during the period: nil.

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Liquidity risk

Qualitative

Cash-flow forecasts are prepared monthly. Policy requires undrawn facilities to exceed projected outflows for the next six months by at least ₦10 000. The secured loan breaches no covenants; management plans to refinance the balloon payment one year before maturity.

Quantitative — contractual maturities (undiscounted):

Liability	≤ 3 m	3 m –1 y	1 – 2 y	2 – 3 y
Bank loans	55,650	–	–	–
Secured loan interest	2,400	9,600	9,600	9,600
Secured loan principal	–	–	–	80,000
Total	**58,050**	**9,600**	**9,600**	**89,600**

Management holds cash of ₦30,000 and an unused overdraft facility of ₦40,000 which together cover the earliest time-band.

Guidance note:

IFRS 7 requires risk disclosures that mirror the data reviewed by key management. Provide clear narratives of risk management objectives, then support them with summary quantitative tables such as ageing analyses and maturity ladders. Use undiscounted contractual flows, not carrying amounts, for liquidity tables.

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CHAPTER 19

SUNDRY STANDARDS

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19 Sundry Standards

19.0 Learning objective

This chapter discusses IAS 26, IAS 41, IFRS 6, IFRS 14 and IFRS for SMEs.

19.1 Learning outcomes:

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

a. Explain the main requirements of IAS 26;
b. Explain the main requirements of IAS 41;
c. Explain the main requirements of IFRS 6;
d. Explain the main requirements of IFRS 14;
e. Describe, in overview, the IFRS for SMEs; and
f. Describe and explain the main requirements of SAS 32: On accounting for not-for-profit organisations.

19.2 IAS 26: Retirement Benefit Plans

19.2.1 Chapter 1: Scope of Retirement Benefit Plans

IAS 26 complements IAS 19, Employee Benefits which is concerned with the determination of the cost of retirement benefits in the financial statements of employers.

IAS 26 applies to the reports of retirement benefit plans whether they are:

a. defined contribution plans; or
b. defined benefit plans; and
c. regardless of:
d. whether a fund has a separate legal identity; or
e. whether there are trustees.

All other IFRS apply to the reports of retirement benefit plans to the extent that they are not superseded by IAS 26.

Insured benefits

Retirement benefit plans with assets invested with insurance companies are within the scope of IAS 26 unless the contract with the insurance company is in the name of a specified participant or a group of participants and the retirement benefit obligation is solely the responsibility of the insurance company.

Outside scope

IAS 26 does not deal with other forms of employment benefits such as employment termination indemnities, deferred compensation arrangements, long- service leave benefits, special early retirement or redundancy plans, health and welfare plans or bonus plans. Government social security type arrangements are also excluded from the scope of IAS 26.

19.2.2 Chapter 2: Definition of retirement benefit plans

Definition

Retirement benefit plans are arrangements whereby an entity provides benefits for its employees on or after termination of service (either in the form of an annual income or as a lump sum) when such benefits, or the employer's contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

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A retirement benefit plan is a reporting entity separate from the employers of the participants in the plan. Retirement benefit plans are known by a variety of names, for example, pension schemes, superannuation schemes; or retirement benefit schemes'

Definitions

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service.

Funding is the transfer of assets to an entity (the fund) separate from the employer's entity to meet future obligations for the payment of retirement benefits.

Participants are the members of a retirement benefit plan and others who are entitled to benefits under the plan.

Net assets available for benefits are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.

Actuarial present value of promised retirement benefits is the present value of the expected payments by a retirement benefit plan to existing and past employees, attributable to the service already rendered.

Vested benefits are benefits, the rights to which, under the conditions of a retirement benefit plan, are not conditional on continued employment.

19.2.3 Chapter 3: Valuation of plan assets

Retirement benefit plan investments are carried at fair value. The fair value of marketable securities is market value.

Where an estimate of fair value is not possible for plan asset the reason why this is the case must be disclosed.

Securities that have a fixed redemption value and that have been acquired to match the obligations of the plan may be carried at amounts based on their ultimate redemption value assuming a constant rate of return to maturity.

19.2.4 Chapter 4: Defined contribution plans

Objective of report

The reporting objective is to provide information about the plan and the performance of its investments.

The participants are interested in:

a. the activities of the plan because they directly affect the level of future benefits; and
b. knowing whether contributions have been received and proper control has been exercised to protect the rights of beneficiaries.

An employer is interested in the efficient and fair operation of the plan. The reporting objective is usually achieved by providing a report including:

a. a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
b. statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period; and
c. a description of the investment policies.

Requirement

The report of a defined contribution plan must contain:

a. a statement of net assets available for benefits; and
b. a description of the funding policy.

19.5.5 Chapter 5: Defined benefit plans

Objective of report

The reporting objective is to provide information about the financial resources and activities of the plan that is useful in assessing the relationships between the accumulation of resources and plan benefits over time.

This is usually achieved by providing a report including the following:

a. a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
b. statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period;
c. actuarial information either as part of the statements or by way of a separate report; and
d. a description of the investment policies.

Requirement

The report must contain either:

a statement that shows:

a. the net assets available for benefits;
b. the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; and
c. the resulting excess or deficit; or
d. a statement of net assets available for benefits including either:
e. a note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; or
f. a reference to this information in an accompanying actuarial report. The report should explain:
   i. the relationship between the actuarial present value of promised retirement benefits; and the net assets available for benefits; and
   ii. the policy for the funding of promised benefits.

If an actuarial valuation has not been prepared at the date of the report, the most recent valuation is used as a base and the date of the valuation disclosed.

Actuarial present value of promised retirement benefits

The actuarial present value of promised retirement benefits is based on the benefits promised under the terms of the plan on service rendered to date using either:

current salary levels; or projected salary levels

19.2.6 Chapter 6: Disclosure

Specific requirement

The report of a retirement benefit plan (defined benefit or defined contribution) must contain the following information:

a. a statement of changes in net assets available for benefits;
b. a summary of significant accounting policies; and

c. a description of the plan and the effect of any changes in the plan during the period.

Guidance

Reports provided by retirement benefit plans include the following, if applicable:

a statement of net assets available for benefits disclosing:

a. assets at the end of the period suitably classified;
b. the basis of valuation of assets;
c. details of any single investment exceeding either 5% of the net assets available for benefits or 5% of any class or type of security;
d. details of any investment in the employer; and
e. liabilities other than the actuarial present value of promised retirement benefits;
f. a statement of changes in net assets available for benefits showing the following:
    i. employer contributions;
    ii. employee contributions;
    iii. investment income such as interest and dividends;
    iv. other income;
    v. benefits paid or payable (analysed, for example, as retirement, death and disability benefits, and lump sum payments);
    vi. administrative expenses;
    vii. other expenses;
    viii. taxes on income;
    ix. profits and losses on disposal of investments and changes in value of investments; and
    x. transfers from and to other plans;
g. a description of the funding policy; For defined benefit plans:
    i. the actuarial present value of promised retirement benefits (which may distinguish between vested benefits and non-vested benefits) based on the benefits promised under the terms of the plan on service rendered to date using either:
    ii. current salary levels; or
    iii. projected salary levels;
    iv. a description of the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits.

This information may be included in an accompanying actuarial report to be read in conjunction with the related financial information.

Description of the plan

A description of the plan must be provided either as part of the financial information or in a separate report.

It may contain the following:

a. the names of the employers and the employee groups covered;
b. the number of participants receiving benefits and the number of other participants, classified as appropriate;
c. the type of plan - defined contribution or defined benefit;
d. a note as to whether participants contribute to the plan;
e. a description of the retirement benefits promised to participants;
f. a description of any plan termination terms; and
g. changes in any of the above during the period covered by the report.

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It is not uncommon to refer to other documents that are readily available to users and in which the plan is described, and to include only information on subsequent changes in the report.

19.3 IAS 41: Agriculture

19.3.1 Chapter 1: Scope of Agriculture

IAS 41 *Agriculture* covers the following **agricultural activities**:

a. biological assets, except for bearer plants;
b. agricultural produce at the point of harvest; and
c. government grants for agriculture (in certain situations). IAS 41 does not apply to:
d. the harvested agricultural product (IAS 2 *Inventory* applies);
e. land relating to the agricultural activity (IAS 16 or IAS 40 applies);
f. bearer plants related to agricultural activity (however, IAS 41 does apply to the produce on those bearer plants).
g. intangible assets related to agricultural activity (IAS 38 *Intangible assets* applies).
h. government grants related to bearer plants (see IAS 20 Accounting for Government Grants and Disclosure of Government Assistance).
i. right-of-use assets arising from a lease of land related to agricultural activity (see IFRS 16 Leases)

19.3.2 Chapter 2: Definition of agriculture

Definitions

Agricultural activities – the management by an entity of the biological transformation **and harvest** of biological assets

a. for sale, or
b. **conversion** into agricultural produce, or
c. into additional biological assets.

Biological asset – a living animal or plant, such as sheep, cows, rice, wheat, potatoes and so on.

Biological transformation means the processes of growth, production, degeneration and procreation that cause changes in the quality or the quantity of a biological asset

Agricultural produce is the harvested product of the entity's biological assets.

Harvest – the detachment of produce from a biological asset or the cessation of a biological asset's life.

Illustration: Definitions

A farmer has a field of lambs ('**biological** assets').

As the lambs grow they go through **biological transformation**.

As sheep they are able to procreate and lambs will be born (**additional biological assets**) and the wool from the sheep provides a source of revenue for the farmer ('**agricultural produce').**

Once the wool has been sheared from the sheep ('**harvested**'), IAS 2 requires that it be accounted for as regular inventory.

Definitions

A **bearer plant** is a living plant that:

a. is used in the production or supply of agricultural produce;
b. is expected to bear produce for more than one period; and
c. has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

The following are not bearer plants:

a. plants cultivated to be harvested as agricultural produce (for example, trees grown for use as lumber);
b. annual crops (for example, maize and wheat).

Illustration: Definitions (further examples)

Biological assets	Agricultural produce	Products that result from processiong after harvest sheep
	wool	yarn, carpet etc. trees in a
timber plantation	felled trees	logs, lumber dairy cattle
	milk	cheese
cotton plants	harvested cotton	thread, clothing etc.
sugarcane	harvested cane	sugar
tobacco plants	picked leaves	cured tobacco
tea bushes	picked leaves	tea
fruit tress	picked fruit	processed fruit
oil palm	picked fruit	palm oil
rubber trees	harvested latex	rubber products

Plants such as tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are within the scope of IAS 16 *Property, Plant and equipment*. However, the produce growing on bearer plants, for example, tea leaves, grapes, oil palm fruit and latex, is within the scope of IAS 41.
Note that there is no "animal" equivalent of a bearer plant. Thus, cows kept for milk are within the scope of IAS 41.

19.3.3 Chapter 3: Accounting treatment

Recognition of a biological asset or agricultural produce
An entity should recognise a biological asset or agricultural produce when (and only when):
a. the entity controls the asset as a result of past events
b. it is probable that future benefits **associated with** the asset will flow to the entity, and
c. the fair value or cost of the asset can be measured reliably.

Cost may sometimes approximate fair value,

Measurement
A **biological asset** should be measured initially and subsequently at the end of each reporting period at its **fair value minus ultimate selling costs** (unless the fair value cannot be measured reliably). The gain or loss arising on initial recognition and subsequent revaluation should be included in profit or loss for the period in which it arises.

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Agricultural produce harvested from an entity's biological assets is measured at its **fair value minus estimated ultimate selling costs**. The gain or loss on initial recognition is included in the profit or loss for that period. Ultimate selling costs include commissions to brokers and dealers, levies to regulators, transfer taxes and duties.

Fair value is the quoted price in an active market. It is presumed that fair values can be measured reliably for biological assets. If this is not so, the biological asset should be measured at its cost minus any accumulated depreciation or impairment.

Example: Accounting treatment

Using the earlier example of a sheep farmer, lambs should initially be measured when they are born at their fair value minus costs to sell.

As they grow and their value changes, this gain or loss should be reflected in the biological asset value and also in profit and loss.

The sheep may be used for obtaining wool. Once the wool has been sheared from the sheep, as an agricultural produce the wool should be valued at fair value minus costs to sell.

If the wool is then turned into yarn or carpet its value is then transferred to inventory and IAS 2 will provide any further accounting rules.

Inability to measure fair value reliably

There is a presumption that fair value can be measured reliably for a biological asset.

However, that presumption can be rebutted only on initial recognition for a biological asset if:

a. Quoted market prices are not available, and
b. Alternative fair value measurements are determined to be clearly unreliable.

In such cases, the biological asset shall be measured at:

Cost,

Less any accumulated depreciation, and

Less any accumulated impairment losses.

Once the fair value of the biological asset becomes reliably measurable, the entity shall measure it at:

Fair value,

Less costs to sell.

When a non-current biological asset meets the criteria to be classified as held for sale (or is included in a disposal group classified as held for sale) under IFRS 5, it is presumed that its fair value can be reliably measured.

19.3.4 Chapter 4: Government grants

Agricultural entities (for example, farms) often benefit from government grants in the form of cash payments.

An unconditional government grant related to a biological asset measured at its fair value less costs to sell shall be recognised in profit or loss when, and only when, the government grant becomes receivable.

If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met.

A grant may be dependent on certain conditions being met. For example, the entity may be asked not to engage in a specific agricultural activity. In such cases, the grant should be recognised only when the conditions are met.

If the biological asset has been measured at cost because fair value could not be measured reliably, then the requirements of IAS 20 *Accounting for government grants* should be applied.

19.4 IFRS 6: Exploration for and Evaluation of Mineral Resources

19.4.1 Chapter 1: Objectives of IFRS 6

IFRS 6 specifies the Financial Reporting for the exploration for and evaluation of mineral resources.

In particular, the IFRS requires:

a. limited improvements to existing accounting practices for exploration and evaluation expenditures.
b. entities that recognise exploration and evaluation assets to assess such assets for impairment in accordance with this IFRS and measure any impairment in accordance with IAS 36 Impairment of Assets.
c. disclosures that identify and explain the amounts in the entity's financial statements arising from the exploration for and evaluation of mineral resources and help users of those financial statements understand the amount, timing and certainty of future cash flows from any exploration and evaluation assets recognised.

19.4.2 Chapter 2: Scope of IFRS 6

An entity shall apply the IFRS to exploration and evaluation expenditures that it incurs.

The IFRS does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral resources.

An entity shall not apply the IFRS to expenditures incurred

a. before the exploration for and evaluation of mineral resources (e.g. expenditures incurred before the entity has obtained the legal rights to explore a specific area); or
b. after the technical feasibility and commercial viability of extraction are demonstrable.

Definitions

Exploration for and evaluation of mineral resources means the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

Exploration and evaluation expenditures are expenditures incurred by an entity in connection with the expenditures for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

19.4.3 Chapter 3: Selection of Accounting Policies

IAS 8 sets out criteria which must be applied by a company when needs to develop an accounting policy for a transaction not covered by a specific IFRS.

IFRS 6 exempts companies from applying these criteria in developing an accounting policy for the recognition and measurement of exploration and evaluation assets.

In other words, companies are free to develop an accounting policy (within the broader guidance of IFRS 6) without reference to other parts of IFRS. This is particularly useful when a company involved in this industry adopts IFRS because they may be able to carry on using their pre IFRS accounting policy.

Changes in accounting policies

An entity is allowed to change accounting policies for exploration and evaluation expenditures when the change makes information used as a basis of decision making:

a. more relevant and no less reliable; or
b. more reliable and no less relevant.

To justify a change, the company must demonstrate that the change brings the financial statements closer to meeting the IAS 8 criteria but the change need not achieve full compliance with those criteria.

19.4.4 Chapter 4: Initial recognition and measurement

Exploration and evaluation assets are measured at cost.

An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources.

The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets:

a. acquisition of exploration rights;
b. topographical, geological, geochemical and geophysical studies;
c. exploratory drilling;
d. trenching;
e. sampling; and
f. activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

Expenditures related to the development of mineral resources must not be recognised as exploration and evaluation assets. *The Conceptual Framework* and *IAS 38 Intangible Assets* provide guidance on the recognition of assets arising from development

In accordance with **IAS 37** Provisions, Contingent Liabilities and Contingent Assets an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources.

Elements of cost of exploration and evaluation assets

19.4.5 Chapter 5: Subsequent measurement

A company must apply one of the following to exploration and evaluation assets:

a. cost model; or
b. revaluation model.

If the revaluation model is applied (IAS 16 or IAS 38 model), it must be consistent with the classification of the expenditure as tangible or intangible.

This means that a revaluation model for expenditure classified as an intangible is only possible if there is a fair value that can be measured with reference to an active market.

19.4.6 Chapter 6: Presentation

Exploration and evaluation assets must be classified according to the nature of the assets acquired as:

a. tangible (e.g. vehicles and drilling rigs); or
b. intangible (e.g. drilling rights).

The classification must be applied consistently.

Some exploration and evaluation assets are treated as intangible (for example, drilling rights), whereas

others are tangible (for example, vehicles and drilling rigs). To the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset. However, using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset.

An exploration and evaluation asset is reclassified from this category when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. In such cases they must be assessed for impairment before reclassification.

19.4.7 Chapter 7: Impairment

Exploration and evaluation assets must be:

a. allocated to cash-generating units (CGUs) or groups of CGUs for the purpose of assessing such assets for impairment (the CGU; and
b. assessed for impairment when there are indications that the carrying amount may exceed recoverable amount.

Exploration and evaluation assets are unlikely to generate cash flows independently from other assets so as such they are similar to goodwill. Therefore IFRS 6 requires them to be allocated to CGUs groups for the purpose of impairment testing. They are not tested individually for impairment.

Indicators of impairment include (the list is not exhaustive):

a. expiry of the period of the exploration right without expectation of renewal;
b. expenditure on further exploration/evaluation in the specific area is not budgeted/planned;
c. non discovery of commercially viable quantities of mineral resources;
d. a decision to discontinue activities in the specific area; and
e. indication that the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

19.4.8 Chapter 8: Disclosure

a. Entities must disclose information that identifies and explains the amounts recognised arising from the exploration and evaluation of mineral resources.
b. accounting policies for exploration and evaluation expenditures, and recognition as assets;
c. amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources; and
d. Exploration and evaluation assets must be treated as a separate class of assets (IAS 16 or IAS 38 disclosures apply depending on classification).

19.5 IFRS 14: REGULATORY DEFERRAL ACCOUNTS

19.5.1 Chapter 1: Objectives of IFRS 6

The objective of this Standard is to specify the financial reporting requirements for regulatory deferral account balances that arise when an entity provides goods or services to customers at a price or rate that is subject to rate regulation.

In meeting this objective, the Standard requires:

a. limited changes to the accounting policies that were applied in accordance with previous generally accepted accounting principles (previous GAAP) for regulatory deferral account balances, which are primarily related to the presentation of these accounts; and

b. disclosures that:

i. identify and explain the amounts recognised in the entity's financial statements that arise from rate regulation; and

ii. help users of the financial statements to understand the amount, timing and uncertainty of future cash flows from any regulatory deferral account balances that are recognised.

19.5.2 Chapter 2: Rate regulation

Some countries regulate prices that can be charged for certain goods and services. Such goods and services are said to be “rate regulated”.

19.5.3 Chapter 3: Scope

An entity is permitted to apply the requirements of this Standard in its first IFRS financial statements if and only if it:

a. conducts rate-regulated activities; and
b. recognised amounts that qualify as regulatory deferral account balances in its financial statements in accordance with its previous GAAP.

An entity shall apply the requirements of this Standard in its financial statements for subsequent periods if and only if, in its first IFRS financial statements, it recognised regulatory deferral account balances by electing to apply the requirements of this Standard.

An entity that is within the scope of, and that elects to apply, this Standard shall apply all of its requirements to all regulatory deferral account balances that arise from all of the entity’s rate-regulated activities

19.5.4 Chapter 4: Presentation in financial statement

The impact of regulatory deferral account balances are separately presented in an entity's financial statements. This requirement applies regardless of the entity's previous presentation policies in respect of regulatory deferral balance accounts under its previous GAAP. Accordingly:

a. Separate line items are presented in the statement of financial position for the total of all regulatory deferral account debit balances, and all regulatory deferral account credit balances
b. Regulatory deferral account balances are not classified between current and non-current, but are separately disclosed using subtotals
c. The net movement in regulatory deferral account balances are separately presented in the statement of profit or loss and other comprehensive income using subtotals.

Definitions

Rate-regulated activities: An entity’s activities that are subject to rate regulation.

Rate regulation: A framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a rate regulator.

Regulatory deferral account balance: The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.

19.6 IFRS for Small and Medium-Sized Entities (SMEs)

19.6.1 Chapter 1: Introduction

The IFRS for SMEs Accounting Standard reflects five types of simplifications from full IFRS Accounting Standards:

a. some topics in full IFRS Accounting Standards are omitted because they are not relevant to typical SMEs;
b. some accounting policy options in full IFRS Accounting Standards are not allowed because a more simplified method is available to SMEs;
c. some accounting policy options in full IFRS Accounting Standards are not allowed because a more simplified method is available to SMEs;
d. substantially fewer disclosures are required; and
e. the text is written in 'plain English', so it is easier to understand and translate**.**

International accounting standards are written to meet the needs of investors in international capital markets. Most companies adopting IFRSs are large listed entities. The IASB has not stated that IFRSs are only aimed at quoted companies, but certainly the majority of adopters are large entities. In many countries IFRSs are used as national GAAP which means that unquoted small and medium-sized entities (SMEs) have to apply them.

There is an argument that all entities should apply the same accounting standards in order to give a fair presentation of the affairs of the entity. However, in some cases, many of the IFRSs are complex and can be difficult for SMEs to apply, particularly in areas such as financial instruments. Additionally, not all the information required by IFRSs for disclosure is needed by the users of the SME's financial statements.

Some commentators therefore suggest that SMEs and public entities should be allowed to use simplified or differing standards as the nature of their business is different from large, quoted entities.

The users of financial statements of SMEs are different from the users of the financial statements of quoted companies. The only 'user groups' that use the financial statements of an SME are normally:

a. its shareholders/owners;
b. senior management; and
c. possibly, government departments and agencies.

A SME is often owned and managed by a small number of entrepreneurs, and may be a family-owned and family-run business. Large companies, in contrast, are run by professional boards of directors, who must be held accountable to their shareholders.

Because there are big differences between SMEs and large quoted companies, it is not clear whether there is any reason why SMEs should comply with IFRSs.

There are arguments in favour of using IFRSs for SMEs, and arguments against.

Arguments against the use of IFRSs by SMEs

There are several reasons why SMEs **should not** adopt IFRSs for the preparation of their financial statements.

(a) Some IFRSs deal with subjects that are of little or no relevance to SMEs, such as accounting standards on consolidation, associates, joint ventures, deferred tax, construction contracts and standards that deal with complex issues of fair value measurement.
(b) The costs of complying with IFRSs can be high. Large companies are able to bear the cost, which might not be significant relative to their size. For SMEs, the cost is proportionately much higher, and it is doubtful whether the benefits of complying with IFRSs would justify the costs.

(c) There are not many users of financial statements of SMEs, and they use the financial statements for a smaller range of decisions, compared to investors in international capital markets. So would it be a waste of time (as well as cost) to comply with IFRSs?

Arguments in favour of the use of IFRSs by SMEs

There are also reasons why SMEs **should** adopt IFRSs for the preparation of their financial statements.

a. If SMEs use different accounting rules and requirements to prepare their financial statements, there will be a 'two-tier' system of accounting. This could make it difficult to compare results of larger and smaller companies, should the need arise. Confidence in the quality of Financial Reporting might be affected adversely.
b. If SMEs prepared financial statements in accordance with their national GAAP, it will be impossible to compare financial statements of companies in different countries. If SMEs grow in size and eventually obtain a stock market quotation, they will have some difficulty in the transition from national GAAP to IFRSs.
c. It has also been argued that full statutory accounts for SMEs would be in the public interest, and might help to protect other stakeholders in the company (such as suppliers, customers, lenders and employees).

Considerations in developing standards for SMEs

The aim of developing a set of accounting standards for SMEs is that they allow information to be presented that is relevant, reliable, comparable and understandable. The information presented should be suitable for the uses of the managers and directors and any other interested parties of the SME.

Additionally, many of the detailed disclosures within full IFRSs are not relevant and the accounting standards should be modified for this. The difficulty is getting the right balance of modification, too much and the financial statements will lose their focus and will not be helpful to users.

19.6.2 Chapter 2: IFRS for SMEs

The standard consists of 230 pages of text, arranged into 35 sections that cover all of the recognition, measurement, presentation and disclosure requirements for SMEs. There is no cross reference to other IFRS (with one exception relating to financial instruments).

The IFRS for SMEs imposes a lesser burden on SMEs due to:

a. some topics in IFRSs being omitted because they are not relevant to typical SMEs;
b. the simplification of many of the recognition and measurement requirements available in full IFRSs; and
c. substantially fewer disclosures.

The IFRS for SMEs does not address the following topics:

a. earnings per share (i.e. there is no equivalent to IAS 33);
b. interim accounting (i.e. there is no equivalent to IAS 34);
c. segment reporting (i.e. there is no equivalent to IFRS 8);
d. special accounting for assets held for sale (i.e. there is no equivalent to IFRS 5).
e. The omission of equivalent rules to those in IAS 33, IAS 34 and IFRS 8 is not surprising as they are relevant to listed entities. As the next section explains, such entities cannot be SMEs.

Stand-alone document

The IFRS for SMEs is a stand-alone document. This means that it contains all of the rules to be followed by SMEs without referring to other IFRSs. For example, it sets out rules for property, plant and equipment without specifying that the rules are similar or dissimilar to those found in IAS 16.

In the following pages we provide an overview of the sections of the IFRS for SMEs and often refer to similarity or difference to equivalent other IFRSs. This is not what the IFRS for SMEs does but we adopt the approach to make it easier for you to gain an understanding of the main features of the standard.

The IFRS for SMEs is derived from rules in other IFRS. You will note that it uses the same terminology and that many of the rules are identical. However, in several cases the rules in other IFRSs from which the IFRS for SMEs derives have been changed whereas the equivalent rules in this standard have not been changed. For example, the rules on joint ventures are based on the standard (IAS 31) that preceded IFRS 11 which you covered earlier. You should not interpret this as meaning that the standard is out of date. It simply means that there is a difference between the rules for SMEs and those followed by other entities. Changes to the main body of standards will not necessarily result in a revision to the IFRS for SMEs.

19.6.3 Chapter 3: IFRS for SMEs section by section

Section 1: Small and medium-sized entities

Definition

Small and medium-sized entities are entities that:

do not have public accountability, and

publish general purpose financial statements for external users. Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

An entity has **public accountability** if:

a. its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments; or

b. it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (e.g. banks and insurance companies).

The decision as to which entities are required or permitted to apply the standard will lie with the regulatory and legislative authorities in each jurisdiction.

Section 2: Concepts and pervasive principles

This section is drawn from the *IASB Framework for the preparation and presentation of financial statements*. This was the document that preceded the *IASB Conceptual Framework* with which you are already familiar.

The section states that the objective of financial statements of a small or medium-sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision- making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Financial statements also show the results of the

stewardship of management (the accountability of management for the resources entrusted to it).

The section lists the following qualitative characteristics of information in financial statements:

a. understandability;
b. relevance;
c. materiality;
d. reliability;
e. substance over form;
f. prudence.
g. completeness.
h. comparability; and
i. timeliness.

The section contains guidance on financial position (including the definitions of assets, liabilities and equity) and on financial performance (including the definitions of income and expenses) which is the same as in the conceptual framework. The recognition criteria are also the same.

The IFRS for SMEs contains guidance on measurement that is not found in either the original or the new frameworks.

An entity must measure assets and liabilities at historical cost unless another section in the IFRS for SMEs requires initial measurement on another basis such as fair value.

Most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases. For example:

a. property, plant and equipment is measured at the lower of depreciated cost and recoverable amount.
b. inventories are measured at the lower of cost and net realizable value (selling price less costs to complete and sell); and
c. an entity recognises an impairment loss relating to non-financial assets that are in use or held for sale.

This guidance is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.

Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.

Assets and liabilities, or income and expenses, must not be offset unless required or permitted by another section in the IFRS for SMEs.

Section 3: Financial statement presentation

Financial statements must present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in *Section 2 Concepts and Pervasive Principles*.

The application of the IFRS for SMEs, with additional disclosure, when necessary, is presumed to result in financial statements that achieve a fair presentation of the financial position, financial performance

and cash flows of SMEs.

Application of the IFRS for SMEs by an entity with public accountability cannot result in a fair presentation in accordance with this IFRS.

An entity whose financial statements comply with the IFRS for SMEs must make an explicit and unreserved statement of such compliance in the notes. Financial statements must not be described as complying with the IFRS for SMEs unless they comply with all the requirements of this IFRS.

A complete set of financial statements of an entity reporting under the IFRS for SMEs is similar to that required by full IFRS and comprises:

a. a statement of financial position;
b. either a single statement of profit or loss and other comprehensive income, or a separate statement of profit or loss and a separate statement of other comprehensive income;
c. a statement of changes in equity (or a statement of income and retained earnings);
d. a statement of cash flows;
e. notes including a summary of significant accounting policies; and
f. comparative information.

Section 4: Statement of financial position

The rules in IFRS for SMEs on statements of financial position are very similar to those found in IAS 1.

One difference is that line items required for assets held for sale or liabilities of disposal groups held for sale are not required.

Section 5: Statement of comprehensive income and income statement

The rules in IFRS for SMEs on statements of financial performance are very similar to those found in IAS 1.

An entity must present its total comprehensive income either:

a. in a single statement; or
b. in two statements.

An entity must present its total comprehensive income for a period either:

a. in a single statement of comprehensive income, in which case the statement of comprehensive income presents all items of income and expense recognised in the period;or
b. in two statements (an income statement and a statement of comprehensive income) in which case the income statement presents all items of income and expense recognised in the period except the following three categories of gain or loss that must be recognised in total comprehensive income in accordance with the IFRS for SMEs:
    i. gains and losses arising on translating the financial statements of a foreign operation (*Section 30: Foreign currency translation*).
    ii. some actuarial gains and losses (*Section 28: Employee benefits*).
    iii. some changes in fair values of hedging instruments (*Section 12: Other financial instruments*).

An income statement is what the IFRS for SMEs calls a statement of profit or loss.

Section 6: Statement of changes in equity and statement of income and retained earnings

An SME must present either:

a. a statement of changes in equity (SOCIE); or
b. a statement of income and retained earnings (if the only changes in equity in the period arise from profit or loss, dividends paid, corrections of errors and changes in accounting policy).

The statement of income and retained earnings is an income statement with a closing section which shows the following:

a. retained earnings at the beginning of the reporting period;
b. dividends declared and paid or payable during the period;
c. restatements of retained earnings for corrections of prior period errors;
d. restatements of retained earnings for changes in accounting policy; and retained earnings at the end of the reporting period.

Section 7: Statement of cash flows

There are no significant differences between the rules in section 7 and those in IAS 7.

Section 8: Notes to the financial statements

There are no significant differences between the IFRS for SMEs rules on notes to the financial statements and those found in IAS 1.

Section 9: Consolidated and separate financial statements

This section derives from the standards that were replaced by the project that led to the publication of IFRS 10. However, there are no significant, practical differences between the IFRS for SMEs rules on subsidiaries and consolidation and those found in the other IFRS.

Each set of rules would result in the recognition of the same entities as subsidiaries and result in the same consolidated financial statements in most (but not all) cases. It is possible that the more detailed guidance on control in IFRS 10 would lead to the consolidation of some entities that might not be considered as subsidiaries according to the IFRS for SMEs rules. However, most SMEs are unlikely to be involved in the sort of investment that IFRS 10 would further identify.

Section 10: Accounting policies, estimates and errors

The rules in IFRS for SMEs on accounting policies, estimates and errors are very similar to those found in IAS 8. However, there is no requirement to disclose the impact of a new standard in issue but not yet effective.

Sections 11 and 12: Introduction to IFRS for SMEs in respect of financial instruments

Section 11 and Section 12 together deal with recognising, derecognising, measuring and disclosing financial instruments (financial assets and financial liabilities).

Section 11 applies to basic financial instruments and is relevant to all entities. Section 12 applies to other, more complex financial instruments and transactions. An entity must apply either:

a. the provisions of both Section 11 and Section 12 in full, or
b. the recognition and measurement provisions of IFRS 9.

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Section 11: Basic financial instruments

This section applies to all entities.

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

An entity must recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

Measurement of financial assets and liabilities on initial recognition is at the transaction price (including transaction costs) with the following exceptions:

a. financial assets and liabilities that are measured at fair value through profit or loss) are measured at their fair value (which is usually the transaction price) with transaction costs expensed to profit or loss;
b. financing transactions (for example in connection with the sale of goods if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate) where the financial asset or financial liability is measured at the present value of the future payments.

Subsequent measurement at the end of each reporting period is as follows:

a. Debt instruments are measured at amortised cost using the effective interest method with the following exceptions:
b. Debt instruments that are classified as current assets or current liabilities are measured at the undiscounted amount;
c. If an arrangement constitutes a financing transaction, the debt instrument is measured at the present value of the future payments.

Investments in shares must be measured at fair value with all gains and losses recognised through profit or loss.

Section 12: Other financial instruments issues

This section applies to only to those entities which have complex financial instruments. This includes derivatives and any instrument with an embedded derivative.

An entity must recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

When a financial asset or financial liability is recognised initially, an entity must measure it at its fair value, which is normally the transaction price.

At the end of each reporting period, an entity must measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss.

This section includes a simplified hedge accounting regime which can only be used to account for hedges of the following risks:

a. interest rate risk of a debt instrument measured at amortised cost;
b. foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction;
c. price risk of a commodity that it holds or in a firm commitment or highly probable forecast

transaction to purchase or sell a commodity;

d. foreign exchange risk in a net investment in a foreign operation.

Section 13: Inventories

There are no significant differences between the IFRS for SMEs rules on accounting for inventory and those found in IAS 2.

Section 14: Investments in associates

The section 14 rules on identifying investments in associates are very similar to those found in IAS 28.

Section 14 allows an entity to account for all of its associates using one of the following:

a. cost model;
b. equity method; or
c. fair value model.

Section 15: Investments in joint ventures

Definition

A **joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Joint control is the contractually agreed sharing of control over an economic entity.

Joint control only exists when the strategic financial and operating decisions relating to the economic activity require the unanimous consent of the entities sharing control (the joint venturers).

Joint control is the key factor in deciding whether a joint venture exists. The following characteristics are common to all types of joint venture:

a. two or more joint venturers are bound by a contractual arrangement (usually in writing); and
b. the contractual arrangement establishes joint control.

The IFRS for SMEs identifies three broad types of joint venture:

a. jointly-controlled operations
b. jointly-controlled assets
c. jointly-controlled entities.

An entity with a jointly-controlled operation must recognise:

a. the assets that it controls and the liabilities that it incurs, and
b. the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture.

An entity with an interest in jointly-controlled assets must recognise:

a. its share of the jointly controlled assets, classified according to the nature of the assets;
b. any liabilities that it has incurred;
c. its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;
d. any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
e. any expenses that it has incurred in respect of its interest in the joint venture.

An entity with an interest in jointly-controlled entity must account for all of its jointly-controlled entities using one of the following:

a. cost model;
b. equity method; or
c. fair value model.

Section 16: Investment property

The section 14 rules on identifying investment properties are very similar to those found in IAS 40.

Section 14 requires that investment properties must be measured at fair value (cost model not allowed, unless fair value cannot be measured reliably without undue cost or effort).

Section 17: Property, plant and equipment

This section applies to accounting for property, plant and equipment and investment property whose fair value cannot be measured reliably without undue cost or effort.

Most of the section 17 rules are similar to the IAS 16 rules. However, there are some differences. For example, residual value, useful life and depreciation need to be reviewed only if there is an indication they may have changed since the most recent annual reporting date. (IAS 16 requires an annual review).

Section 18: Intangible assets other than goodwill

The section 18 rules on accounting for intangible assets are similar to the IAS 38 rules. However, there are some differences.

All assets within the scope of this section must be measured subsequently using the cost model. Revaluation is not allowed.

All research and development costs must be expensed as incurred. There is no capitalisation of internally generated intangible assets.

All intangible assets must be amortised over their estimated useful lives. If this cannot be estimated a useful life of 10 years is assumed. This means that there is no requirement to test unamortised intangibles for impairment on an annual basis.

Section 19: Business combinations and goodwill

The section 19 rules on accounting for business combinations and goodwill are similar to the IFRS 3 rules. However, there are some differences.

Acquisition costs are capitalised under this standard whereas they must be expensed under IFRS 3.

Goodwill is amortised over its estimated useful life. If this cannot be estimated a useful life of 10 years is assumed. This means that there is no requirement to test goodwill for impairment on an annual basis.

Section 20: Leases

Lessee accounting is different to that required under IFRS 16. The IFRS for SMEs requires both lessees and lessors to identify operating leases and finance leases. The lessee must recognise a leased asset and lease liability only for finance leases.

Section 21: Provisions and contingencies

There are no significant differences between the IFRS for SMEs rules on provisions and contingencies and those found in IAS 37.

Section 22: Liabilities and equity

The section 22 rules on equity and liabilities are similar to the IAS 32 rules though IAS 32 does envisage more complex scenarios. Both sets of rules would lead to the same classification of an instrument as debt or equity and both sets of rules require split accounting (into debt and equity components) on the initial recognition of an issue of convertible debt.

Both sets of rules require that any gain or loss on transactions involving an entity's own equity must be recognised as a movement in equity. Section 22 applies the same rational to transactions involving a parent's controlling interest in a subsidiary that do not result in a loss of control. The carrying amount of the non-controlling interest is adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between the amount by which the non-controlling interest is so adjusted and the fair value of the consideration paid or received, if any, shall be recognised directly in equity and attributed to equity holders of the parent.

Section 23: Revenue

IFRS 15 has replaced IAS 18 *Revenue* and IAS 11 *Construction contracts* but the revenue recognition rules for SMEs continue to be based on the rules in these superseded standards.

The rules cover revenue from:

a. sale of goods;
b. the rendering of services;
c. construction contracts; and
d. the use of an entity's assets by others (yielding interest, royalties or dividends).

Revenue is measured at the fair value of consideration received or receivable.

Revenue from the sale of goods is recognised when **all** of the following conditions have been met:

a. The entity has transferred to the buyer the 'significant risks and rewards of ownership of the goods. This normally occurs when legal title to the goods or possession of the goods passes to the buyer.
b. The entity does not retain effective control over the goods sold, or retain a continuing management involvement to the degree usually associated with ownership.
c. The amount of revenue can be measured reliably.
d. It is probable that economic benefits associated with the transaction will flow to the entity.
e. The costs incurred (or to be incurred) for the transaction can be measured reliably.

Revenue from rendering a service is recognised with reference to the stage of completion at the reporting date as long as the outcome of the contract can be estimated reliably. This is when **all** of the following conditions are met:

a. The amount of revenue can be measured reliably.
b. It is probable that the economic benefits associated with the transaction will flow to the service provider.
c. The stage of completion of the transaction as at the end of the reporting period can be measured reliably.
d. The costs already incurred for the transaction and the costs that will be incurred to complete the

transaction can be measured reliably.

When these conditions are not met, revenue should be recognised only to the extent of the expenses recognised that are recoverable.

Revenue from construction contracts is measured in a similar way.

Revenue from interest, royalties and dividends is recognised when it is probable that the benefits will flow to the entity and the amount of the revenue can be measured reliably. The following approaches are used:

a. **Interest**. Interest income should be recognised on a time proportion basis that takes into account the effective yield on the interest-earning asset.
b. **Royalties**. Revenue from royalties should be recognised on an accruals basis, in accordance with the terms of the royalty agreement.
c. **Dividends**. Revenue from dividends should be recognised when the right to receive the dividend is established.

Section 24: Government grants

The section 24 rules on accounting for government grants are similar to the IAS 20 rules. However, section 24 does not seem to allow deduction of a capital grant from the asset to which it relates.

Section 25: Borrowing costs

Borrowing costs must be recognised as expenses and cannot be capitalised as required by IAS 23.

Section 26: Share-based payment

The section 26 rules on accounting for share-based payment are similar to the IFRS 2 rules.

One difference is that section 26 allows the directors to make an estimate of the fair value of equity instruments granted when there is no observable market price and a reliable measure of fair value is impracticable.

Section 27: Impairment of assets

The section 27 rules on impairment of assets are similar to those in IAS 2 for inventories and those in IAS 36 for impairment of other non-financial assets.

Section 28: Employee benefits

The section 28 rules on accounting for employee benefits are very similar to those found in IAS 19 with no significant differences worth mentioning.

Section 29: Income tax

The section 29 rules on accounting for income tax are similar to the IAS 12 rules.

Section 30: Foreign currency translation

The section 30 rules on foreign currency translation are similar to the IAS 21 rules.

One difference is that section 30 does not permit recycling of the cumulative translation difference in respect of an investment in a foreign entity when that entity is disposed of.

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Section 31: Hyperinflation

The section 31 rules on hyperinflation are very similar to the IAS 21 rules. This is not relevant to Nigerian companies.

Section 32: Events after the end of the reporting period

There are no significant differences between the IFRS for SMEs rules on events after the end of the reporting period and those found in IAS 10.

Section 33: Related party disclosures

There are no significant differences between the IFRS for SMEs rules for related parties and those found in IAS 24.

Section 34: Specialised activities

IFRS for SMEs provides guidance on:

Agriculture (drawn from IAS 41);

Extractive industries (refers back to the property, plant and equipment, intangibles other than goodwill, and provisions sections of the IFRS);

Service concession arrangements (drawn from, but much simplified, IFRIC 12).

Section 35: Transition to the IFRS for SMEs

The guidance is similar to that provided by IFRS 1 for first time adoption of full IFRS. These rules are not described further in this chapter.

19.7 SAS 32: On Accounting for Not-For-Profit Organisations

19.7.1 Chapter 1: Introduction

SAS 32 establishes measurement and recognition presentation and disclosure standards for financial statements of not for profit organisations.

SAS 32 was published with the aim of developing a uniform and consistent basis of providing financial information for not-for-profit organisations in order to enable meaningful assessment of their performance.

Not-for-profit organisations

Definition: Not-for-profit organisation

A not-for-profit organisation is an entity, normally without transferable ownership interests, organised and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose. Its members, contributors and other resource providers do not, in such capacity, expect pecuniary return directly from the organization.

Types of not-for-profit organisations

Not for profit organisations are basically of two types:

a. public sector not for profit organisations; and
b. private sector not for profit organisations.

SAS 32 applies only to private sector not for profit organisations

19.7.2 Chapter 2: Contributions

Not for profit organisations obtain most of their resources from members of the public, organisations and governments that identify with their mission rather than by commercial transactions.

Definition: Contributions

A contribution is a voluntary non-reciprocal transfer to a not-for-profit organisation of cash or other assets or a non-reciprocal settlement or cancellation of its liabilities.

Government funding provided to a not-for-profit organisation for example is considered to be a contribution.

Contributions are a type of revenue unique to not for profit organisations. The main feature that sets it apart from revenue is the non-reciprocal nature of the transfer. This means that the contributor does not expect to receive anything, and that the not-for-profit recipient does not need to provide anything to the contributor, in exchange for the contribution.

Types of contribution

There are (broadly speaking) three types of contribution that a not for profit organisation might receive:

a. an unrestricted contribution;
b. a restricted contribution; and
c. an endowment contribution.

Restricted contributions

A not for profit organisation might have multiple goals and a supporter of the organisation might chose to support one or another of these goals. Such a supporter might make a contribution and specify that it is to be used for a specific purpose.

In other words, some contributions are restricted as to their use.

Definition: Restricted contributions

A restricted contribution is a contribution subject to externally imposed stipulations that specify the purpose for which the contributed asset is to be used. A contribution restricted for the purchase of a capital asset or a contribution of the capital asset itself is a type of restricted contribution.

Accepting a restricted contribution places an obligation on the not-for-profit organisation to respect the restriction and use the cash received only in accordance with the wishes of the donor.

Example: Restriction on use of a contribution

A health charity has the objective of improving the health of the population in remote, rural areas.

The charity operates educational programmes, an inoculation programme, a neo- natal and post-natal care programme.

The charity requests and receives funding from the WHO of a contribution of $1,000,000 to fund the inoculation programme over the next 3 years. This amount can only be used on the inoculation programme.

Endowment contributions

Definition: Endowment contributions

An endowment contribution is a type of restricted contribution subject to externally imposed stipulations specifying that the resources contributed be maintained permanently, although the constituent assets may change from time to time.

Example: Endowment contributions

A very wealthy individual might leave ₦10,000,000 to a health charity stipulating that the money be invested to earn income that must be applied in supporting students through their medical training.

Note that an organisation might also place a voluntary restriction on the use of resources, setting funds aside for a particular purpose. The difference between internal and external restrictions is that the organisation could change its mind about internally restricted resources and apply them in any way it wishes.

19.7.3 Chapter 3: Financial reporting – background

Stakeholders

Stakeholders of not-for-profit organisations include:

a. contributors:
b. organisations;
c. governments; and
d. members of the public;
e. beneficiaries of the service of the organisation;
f. the government (who might have granted tax exemption to the activities of the organisation);
g. regulators; and
h. others (suppliers/employees etc.).

Each of the above might have differing informational needs but these will include both financial and non-financial information.

Financial reporting issues

The main objective of Financial Reporting of companies subject to IFRS is to provide information that is useful for decision making purposes.
The objective of Financial Reporting by not-for-profit organisations should have a similar aim. In particular, contributors will want to judge whether the contributions provided have been applied in the way expected to the service activities of the organisation.

Statement of financial position

The primary purpose of a statement of financial position is to present the organisation's economic resources, obligations and net assets as at the reporting date.

The statement of financial position, together with the other statements and the notes, provide useful information for assessing whether the organisation will continue to provide services, achieve its

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objectives and meet its obligations.

Total net assets represent the organisation's residual interest in its assets after deducting its liabilities. The net assets balance therefore provides information about the net resources the organisation has available for carrying out its service delivery activities in the future. Net assets are also referred to as fund balances or as accumulated surplus or deficit.

Restrictions on net assets are externally or internally imposed. To fully understand the nature of the organisation's net assets balance, financial statement users require information about the portions of net assets attributable to endowments, capital assets and other restrictions, none of which can readily be used for other purposes.

Statement of activities

The statement of activities is the not-for-profit version of the statement of financial performance and is also known as the statement of income and expenditure.

The primary purpose of a statement of activities is to communicate information about changes in the organisations' economic resources for the period. Specifically, this statement provides information about the costs of the organisation's service delivery activities for the period and the extent to which these expenses were financed all funded by contributions and other revenue.

The information provided is useful in evaluating the organisations performance during the period, including its ability to continue to provide services, and in assessing how the organisations management has discharged its stewardship responsibilities.

Closing comment

Financial reports need to take account of the peculiar nature of the "revenue stream" of not-for-profit organisations and the possible existence of restrictions on how some assets can be used by the organisation. The following section explains certain accounting methods that can be applied in achieving this aim. The subsequent section then specifies the treatment required by SAS 32.

19.7.4 Chapter 4: Financial reporting – accounting methods

Fund accounting

SAS 32 defines fund accounting as follows:

Definition: Fund accounting

Accounting procedures in which a self-balancing group of accounts is provided for each fund established by legal, contractual or voluntary action, especially in governmental units and not for profit organisations.

In essence, the statement of financial position comprises a series of separate funds each with net assets balancing against a fund balance.

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Statements of financial position for a not-for-profit organisation as at 31 December 31, 2021:

	Fund1	Fund 2	Fund 3	Total
	₦m	₦m	₦m	₦m
Current assets	200	300		**500**
Non-current assets			400	**400-**
Total assets	200	300	400	**900**
Current liabilites	80	90		**170**
Non-current liabilities		200		**200**
Fund balances	120	10	400	**530**
	200	300	400	**900**

The statement of activities (being the not-for-profit version of the statement of financial performance) is structured in a similar way to show revenue, expenses and surplus relating to each fund in the period.

An organisation that uses fund accounting in its financial statements usually provides a brief description of the purpose of each fund reported.

Recognition of contributions: Restricted fund method
Fund accounting can be used to highlight resources subject to different restrictions and those which are unrestricted.

SAS 32 defines the restricted fund method as follows

Definition: Restricted fund method
Restricted fund method is a specialized type of fund accounting which involves the reporting of details of financial statement elements by fund in such a way that the organisation reports total general funds, one or more restricted funds, and an endowment fund, if applicable

One of the funds might be specified as a fund relating to capital assets. These assets are not available. Net assets invested in capital assets represent an amount of net assets that is not available for other purposes.

Contributions are recognised as follows when using restricted fund accounting:

Unrestricted contributions: Recognise as revenue relating to the general fund in the period.

Restricted contributions: Recognise as revenue relating to appropriate fund in the period.
Endowment contributions: Recognise as revenue relating to the endowment fund in the period.

Recognition of contributions: Deferral method
SAS 32 defines the deferral method as follows:

Definition: Deferral method
Deferral method is a way of capturing matching concepts by relating revenues with expenses.

The deferral method may be used with or without fund accounting. Contributions are recognised as follows when using fund accounting:

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a. Unrestricted contributions:
b. Restricted contributions:
    i. recognise as deferred contribution in net assets; then
    ii. recognise as revenue when the conditions of the contribution are met.
c. Endowment contributions: Recognise directly in the endowment fund.

Summary of contribution double entry

Type of contribution	Restricted fund method	Deferral method
Unrestricted contribution	Dr Cash/receivables Cr Revenue When received	Dr Cash/receivables Cr Revenue When received
Restricted contribution	Dr Cash/receivables Cr Revenue When received	Dr Cash/receivables Cr Deferred contribution When received and Dr Deferred contribution Cr Revenue When condition is met
Endowment contribution	Dr Cash/receivables Cr Revenue When received	Dr Cash/receivables Cr Endowment fund When received

19.7.5 Chapter 5: SAS 32 requirements

Financial statements for a not-for-profit organisation must include:

a. statement of accounting policies (as a prominent single section);
b. statement of financial position;
c. statement of activities;
d. statement of changes in net assets;
e. statement of cash flows; and
f. notes to the accounts.

General disclosures

The following must be disclosed:

a. the name of the organisation;
b. the period of time covered;
c. a brief, clear and concise description of its purpose and all activities; and
d. its legal form and legal form of other related entities that are expected to register by legislation.

A not-for-profit organisation that uses fund accounting must provide a brief description of the purpose of each fund reported.

Basis of preparation

Where separate funds are reported, contributions may be recognised using either the deferral method or the restricted fund method.

Where separate funds are not reported only the deferral method may be used.

Example: Financial statements: Restricted fund accounting

Example: Financial statements: Deferral method

Statement of financial position

	Unrestricted fund	Capital assets	Restricted fund	Endowment fund	Total
Current assets	2		3	4	9
Investments	5		6	7	18
Non-current assets		8			8
	7	8	9	11	35
Current liabilities	1		1	1	3
Non-current liabilities	2	1	2	2	7
Deferred contribution			6		6
Unrestricted fund	4				4
Capital fund		7			7
Restricted fund			0		0
Endowment fund				8	8
	7	8	9	11	35

Statement of activities

Revenue	6		2		8
Expenses	3		2		5
Surplus	3		0		3

Statement of changes in net assets

Surplus in the year	3		0		3
Transfer	-1	1			
Contribution				5	5
Net assets at start	2	6	0	3	11
Net assets at end	4	7	0	8	19

Notes:

Capital assets have been puchased in the year out of the unrestricted fund. This is shown as a transfer in the statement of changes in net assets.

An endowment contribution of 5 has been received and this has been recognised directly in the endowment fund.

Restricted funds of 2 have been received and recognised in revenue.

There is a balance of 6 recognised as a deferred contribution (the amount recognised in the restricted fund in the previous example).

Professional Level

Strategic Business Reporting

CHAPTER 20

BUSINESS COMBINATIONS AND CONSOLIDATION

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20 Business Combinations and Consolidation

20.0 Learning objective

This chapter explains the provisions of IFRS 3 and IFRS 10 and revises consolidated statements of financial position.

20.1 Learning outcomes

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

a. Explain and discuss in detail the requirements of IFRS 3 with regard to the calculation of goodwill;
b. Define using examples subsidiary, parent and control;
c. Explain the concept of control as set out in IFRS 10;
d. Describe situations when control is presumed to exist;
e. Identify and describe the circumstances in which an entity is required to prepare and present consolidated financial statements;
f. Prepare a consolidated statement of financial position including the fair value exercise and the elimination of inter-company balances and accounting for unrealised profit;
g. Account for goodwill including impairment testing; and
h. Account for gain on a bargain purchase (negative goodwill).

20.2 The nature of a group and consolidated accounts

20.2.1 International accounting standards and group accounts

The following standards relate to accounting for investments:

a) IFRS 10 *Consolidated financial statements;*
b) IAS 27 *Separate financial statements;*
c) IAS 28 *Investments in associates and joint ventures;*
d) IFRS 11 *Joint Arrangements; and*
e) IFRS 3 *Business combinations*.

IAS 1 and group accounts

IAS 1 requires that financial statements distinguish between:

a) profit or loss for the period;
b) other comprehensive income, which consists of gains or losses that are not reported in profit or loss – such as gains on asset revaluations;
c) transactions between the entity and its owners in their capacity as owners, which are called 'equity transactions' and reported in the statement of changes in equity.

This applies to consolidated accounts (group accounts).

20.2.2 Location of accounting rules

IFRS 3 defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses.

IFRS 10 explains that a business under the control of another is a subsidiary and the controlling entity is the parent.

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IFRS 10 defines consolidated financial statements as the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. This means that groups must present their financial statements in the form of consolidated accounts.

Guidance on the process of consolidation is set out in two standards, IFRS 3 *Business Combinations* and IFRS 10 *Consolidated Financial Statements*.

IFRS 3 is largely about the initial accounting for a new investment, setting out the rules on the calculation of goodwill.

IFRS 10 covers the on-going rules related to consolidation. It is IFRS 10 that requires:

(a) that the financial statements of P and S be prepared using uniform accounting policies;

(b) the consolidated assets, liabilities, income and expenses are those of the parent and its subsidiaries added on a line by line basis;

(c) the elimination of unrealised profit on intra group transactions; and

(d) the cancellation of intra group balances.

Changes of ownership

IFRS 3 explains how to account for further investments in a subsidiary after control has been achieved. This is called step acquisitions were control already exist.

IFRS 10 explains how to account for disposals where control is retained or lost.

20.2.3 The nature and purpose of consolidated financial statements

A subsidiary is usually acquired through the purchase of a controlling interest in its equity. The parent makes a long-term investment in the subsidiary. In the statement of financial position of the parent, there is a non-current asset: 'Investment in subsidiary, at cost'

Sometimes, a parent company has no assets at all except shares in the subsidiaries in the group. A parent whose main assets (or only assets) are shares in subsidiaries is sometimes called a **holding company**.

When a large part of the assets of a parent company consists of investments in subsidiaries, it is difficult for the users of the financial statements of the parent to understand anything about its financial position or financial performance. To find out meaningful information about their investment, users of the parent's financial statements need to know about the financial position and performance of the operating subsidiaries.

The purpose of consolidated accounts is to provide financial statements that have meaning and relevance to users.

When a parent acquires a subsidiary, both the parent and the subsidiary remain legally separate entities. However, in practice they operate as if they were one organisation. Consolidated financial statements reflect the reality (or substance) of the situation: the group is a single economic unit.

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

20.3 IFRS 10: Consolidated financial statements

20.3.1 Introduction to IFRS 10

IFRS 10 establishes principles for the presentation of consolidated financial statements when an entity controls one or more other entities

Definitions: Group, parent and subsidiary Group: A parent and its subsidiaries

Parent: An entity that controls one or more entities. **Subsidiary:** An entity that is controlled by another entity.

A group consists of a parent entity and one or more entities that it has control over. These are called subsidiaries.

The entity that ultimately controls all the entities in the group is called the parent.

Some parent companies have no assets at all except shares in the subsidiaries of the group. A parent whose main assets (or only assets) are shares in subsidiaries is sometimes called a **holding company**.

Control

An entity is a subsidiary of another entity if it is controlled by that other entity. IFRS 10 contains a principles based definition of control.

Definition: Control

An investor controls an investee when:

a. it is exposed, or has rights, to variable returns from its involvement with the investee; and

b. it has the ability to affect those returns through its power over the investee.

In other words, an investor controls an investee, if and only if, it has all the following:

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.

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20.3.2 Situations where control exists

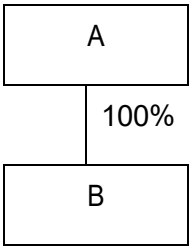
The above definition of control is quite complicated.

In practice, the vast majority of cases involve a company achieving control of another through buying a controlling interest in its shares.

Furthermore, in the vast majority of cases obtaining a controlling interest means buying shares which give the holder more than 50% of the voting rights in the other company.

Illustration: Wholly owned subsidiary

A owns 100% of B's voting share capital.



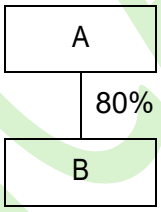
This 100% holding is described as a controlling interest and gives A complete control of B.

B would be described as a wholly owned subsidiary.

A company does not have to own all of the shares in another company in order to control it.

Illustration: Partly owned subsidiary

A owns 80% of B's voting share capital.



This 80% holding is described as a controlling interest and gives A complete control of B.

B would be described as a partly owned subsidiary.

Other parties own the remaining 20% of the shares. They have an ownership interest in B but do not have control.

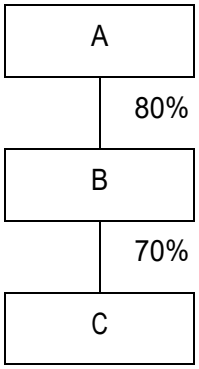
This is described as a non-controlling interest.

Non-controlling interest (NCI) is defined by IFRS 10 as: "the equity in a subsidiary not attributable ... to a parent."

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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.

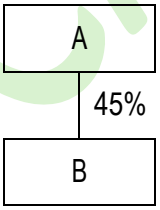
C is described as a sub-subsidiary of A.

In certain circumstances, a company might control another company even if it owns shares which give it less than half of the voting rights. Such a company is said to have ***de facto*** control over the other company. (***De facto*** is a Latin phrase which translates as ***of fact***. It is used to mean **in reality** or to refer to a position held in fact if not by legal right).

Illustration: Wholly owned subsidiary

A owns 45% of B's voting share capital.

The other shares are held by a large number of unrelated investors none of whom individually own more than 1% of B.



This 45% holding probably gives A complete control of B.

It would be unlikely that a sufficient number of the other shareholders would vote together to stop A directing the company as it wishes.

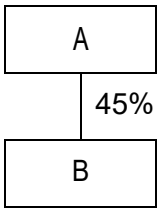
A company might control another company even if it owns shares which give it less than half of the voting rights because it has an agreement with other shareholders which allow it to exercise control.

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Illustration: Wholly owned subsidiary

A owns 45% of B's voting share capital.

A further 10% is held by A's bank who have agreed to use their vote as directed



This 45% holding together with its power to use the votes attached to the banks shares gives A complete control of B.

It was stated above but is worth emphasising that in the vast majority of cases control is achieved through the purchase of shares that give the holder more than 50% of the voting rights in a company.

Two or more investors collectively control an investee when they must act together to direct the relevant activities. If this is the case, no investor can direct the activities without the co-operation of the others so no investor individually controls the investee and it is not a subsidiary. Each investor must account for its interest in accordance with the relevant IFRSs, such as IFRS 11 Joint Arrangements, IAS 28 Investments in Associates and Joint Ventures or IFRS 9 Financial Instruments.

Power

An investor has power over an investee when it has existing rights that give it the current ability to direct the relevant activities (the activities that significantly affect the investee's returns). This power does not necessarily have to be exercised. As long as the rights exist, all other things being equal, the investee is a subsidiary.

Power arises from rights.

a) Assessing power is often straightforward – for example when power arises through holding more than 50% of voting rights; or

b) Assessing power might be more complex, for example:

    a) when power results from one or more contractual arrangements; or

    b) when power is due to a dominant but not majority shareholding.

Only substantive rights are taken into account. Substantive rights are rights that an investor has the *practical ability* to exercise. Usually, suc h rights must be currently exercisable so that the entity is in a position to direct the relevant activities of the entity. However sometimes rights might be substantive, even though they are not currently exercisable.

Example: Substantive rights

S Inc. is an investee company.

Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings. This includes the approval of material sales of assets as well as the making or disposing of significant investments.

S Inc. holds annual shareholder meetings at which decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months.

Shareholders that individually or collectively hold at least 5% of the voting rights can call a special meeting to change the existing policies over the relevant activities with 30 days' notice.

X Plc holds a majority of the voting rights in S Inc. Are these rights substantive?

Answer

The rights are substantive and S Inc. is a subsidiary of X Plc.

X plc is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before it can exercise its voting rights does not stop it from having the current ability to direct the relevant activities.

Example: Substantive rights

B Inc. is an investee company (with the same fact pattern as for S Inc. above).

A Plc holds an option, which if exercised, would give it ownership of shares with more than 50% of the voting rights of B Inc. This option is exercisable in 25 days and is deeply in the money.

Is B Inc. a subsidiary of A Plc?

Answer

The option contract is a substantive right that gives A Plc the current ability to direct the relevant activities of B Inc.

A plc has rights that are essentially equivalent to those of a majority shareholder in that it can make decisions about the direction of the relevant activities when they need to be made.

The fact that it takes 30 days before it can exercise its votes does not stop it from having the current ability to direct the relevant activities.

B Inc. is a subsidiary of A Plc.

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20.3.3 The requirement to prepare consolidated accounts

Definition

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

All parents?

An entity that is a parent must present consolidated financial statements.

There is an exception to this rule. A parent need not present consolidated financial statements if (and only if) it meets all of the following conditions:

(a) The parent itself (X) is a wholly-owned subsidiary, with its own parent (Y).
(b) 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.
(c) The parent's debt or equity instruments are not traded in a public market.
(d) The parent does not file its financial statements with a securities commission for the purpose of issuing financial instruments in a public market.
(e) The parent's own parent, or the ultimate parent company (for example, the parent of the parent's parent), **does** produce consolidated financial statements for public use that comply with International Financial Reporting Standards.

All subsidiaries?

Consolidated financial statements should include all the subsidiaries of the parent from the date at which control is achieved to the date upon which control is lost.

A question might explain that a parent does not wish to consolidate a subsidiary but it would usually have to do so. The following might be given as spurious justification for failing to consolidate a particular subsidiary:

(a) The subsidiary's activities are dissimilar from those of the parent, so that the consolidated financial statements might not present the group's financial performance and position fairly;
(b) Obtaining the information needed would be expensive and time-consuming and might delay the preparation of the consolidated financial statements; and
(c) The subsidiary operates under severe long term restrictions, so that the parent is unable to manage it properly. For example, a subsidiary might be located in a country badly disrupted by a war or a revolution. However, note that if the parent loses control then the investee is no longer a subsidiary and should not be consolidated.

Sometimes a group is acquired and the new parent intends to sell one of the new subsidiaries. In this case the subsidiary is accounted for as discontinued operation according to the rules in IFRS 5. This means that all of its assets and all of its liabilities are included as separate lines on the face of the statement of financial position and the group share of its profit (or loss) is shown as a separate line on the face of the statement of profit or loss.

20.3.4 Investment entities exemption

Under normal rules a parent must consolidate all controlled entities.

There is an exemption that applies to investment entities. These are entities whose business activity is primarily investing activity for example, venture capitalists, unit trusts and mutual funds.

An investment entity might take shares in say, a brewer, in order to make gains through dividends or capital appreciation, not to become involved in brewing.

Furthermore, an investment entity might hold shares in a diverse range of businesses in very different sectors. The investment may result in the investment entity gaining control of the investee.

The usefulness of investment entities consolidating such investments has been called into doubt.

Definition of 'investment entity'

An investment entity is an entity that:

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

An investment entity has the following typical characteristics:

a) it has more than one investment;
b) it has more than one investor;
c) it has investors that are not related parties of the entity; and
d) it has ownership interests in the form of equity or similar interests.

A parent must determine whether it meets the investment entity definition by considering whether it demonstrates the above characteristics. However, the absence of any of the typical characteristics may not necessarily disqualify an entity from being classified as an investment entity. Each case should be judged on its merit.

The exemption

An entity that is an investment entity (as defined) must not consolidate investments over which it has control but must measure these at fair value through profit or loss in accordance with IFRS 9: *Financial Instruments*.

This does not apply to a subsidiary of an investment entity that provides services related to the investment entities activities; such a subsidiary must be consolidated.

Note that this exemption only applies to an investment entity itself. If an investment entity is itself a subsidiary, the ultimate parent would consolidate the investment entity and the entities that the investment entity controls in the usual way.

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20.4 IFRS 3: Business Combinations

20.4.1 Introduction to IFRS 3

Definitions

A **business combination** is a transaction or other event in which an acquirer obtains control of one or more businesses.

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

Objective of IFRS 3

The objective of IFRS 3 is to improve the relevance, reliability and comparability of information reported about business combinations and their effects.

It establishes principles and requirements for:

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.

Transactions under common control are not within the scope of IFRS 3.This means that transfers of ownership of a subsidiary within a group (for example in group reconstructions) are not subject to the rules in this standard. Companies engaging in such transactions must develop accounting policies in accordance with the guidance given in IAS 8.

20.4.2 Acquisition method

All business combinations are accounted for by the acquisition method which 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.
e) dentifying the acquirer

It might be difficult to identify an acquirer:

(i) The acquirer is usually the combining entity whose relative size is significantly greater than that of the other(s).

(ii) 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.

(iii) In a business combinations affected by exchange of equity interests the acquirer is usually the entity that issues equity (however, in a “reverse acquisition” the issuing entity is the acquiree).

Also note that the acquirer is usually the entity:

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;
d) that pays a premium over the pre-combination fair value of the equity interests of the others.

Determining the acquisition date

Acquisition date is the date on which the acquirer effectively obtains control of the acquiree. This generally the closing date (date of transfer of consideration and when net assets are acquired) but might be before or after this date depending on circumstances.

20.4.3 Goodwill

IFRS 3 is largely about the calculation of goodwill.

Definition: Goodwill

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

IFRS 3 sets out the calculation of goodwill as follows:

Illustration: Goodwill

N.B. All balances are as at the date of

	₦
Consideration transferred (cost of the business combination)	
Non-controlling interest	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3)	X
Goodwill recognised	X

The non-controlling interest may be stated as either:

a) a proportionate share of the identifiable assets acquired and liabilities assumed; or
b) at fair value as at the date of acquisition.

Issues to address:

IFRS 3 gives guidance on:

a) cst of a business combination;
b) recognition and measurement of identifiable assets and liabilities assumed; and
c) accounting for goodwill.

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20.4.4 Cost (consideration transferred)

IFRS 3 states that the purchase consideration for an acquisition (business combination) is the sum of:

a) the fair values, at the acquisition date, of the assets transferred by the acquirer, such as cash;
b) the liabilities incurred by the acquirer to the former owners of the acquire;
c) and
d) equity instruments issued by the acquirer in exchange for control of the acquiree.

The purchase consideration may include some deferred and contingent considerations.

When the acquirer issues shares as part of the purchase consideration and the shares are quoted equity instruments, they are normally valued at their market price at the acquisition date for the purpose of measuring the consideration/acquisition cost.

If the consideration includes assets or liabilities of the acquirer carried at amounts that differ from their fair values at the acquisition date, these are revalued with gains and losses taken to P&L.

Consideration includes any asset or liability resulting from a contingent consideration arrangement:

a) recognised at acquisition-date the fair value if it is given at that date, but if it is given at a future date, determine the present value and unwind the interest; and
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.

Costs of acquisition: transaction costs

Transaction costs incurred in making an acquisition, such as the cost of the fees of advisers and lawyers, must not be included in the cost of the acquisition.

These costs must be treated as an expense as incurred and written off to profit or loss.

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The amount of transaction costs associated with an acquisition and written off during the period to profit or loss must be disclosed in a note to the financial statements.

Example: Cost of acquisition

Company P acquired 80% of the shares of Company S when the fair value of the net assets of S was ₦800,000.

The purchase price was ₦300,000 in cash plus 10,000 new shares in Company P.
The new shares were to be issued 1 month after the date of acquisition.

The market value of P's shares at the date of acquisition was ₦40 each. One month later the market value had increased to ₦45.

The costs of making the acquisition were ₦80,000.

₦700,000. The share price at the date of acquisition is used not that at the date of issue.
The costs of making the acquisition should be written off to profit or loss.

		N
Cost of investment (Cash Consideration)		300
Share exchange consideration		400
Total consideration		700
Parent share of net asset at acquisition	800 x 80%	(640)
Positive Goodwill at acquisition		60

Note Parent control subsidiary by 80%, therefore shares 80% of subsidiary net asset at the date of acquisition.

However, if an entity borrows money to finance an acquisition, the costs associated with arranging the borrowing are treated in accordance with the rules of IFRS 9. These costs are deducted from the value of the debt and amortised over the term of the debt using the effective rate of interest (i.e. the amortised cost method).

Deferred consideration

Sometimes all or part of the cost of an acquisition is deferred and does not become payable until a later date.

The amount of any deferred consideration (the amount not payable immediately) is discounted to its present value at the acquisition date and subsequently unwind by charging the interest (finance cost) against earnings.

Contingent consideration

Sometimes the final cost of the combination is contingent on (depends on) a future event. For example, an acquirer could agree to pay an additional amount if the acquired subsidiary's profits exceed a certain level within three years of the acquisition.

In a situation such as this, the contingent payment should be included in the cost of the combination (discounted to present value if the payment will occur more than 12 months in the future).

Under the rules of IFRS 3, contingent consideration must be recognised at fair value at acquisition, even if it is not probable that the consideration will actually have to be paid.

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Example: Contingent consideration

Company X purchased 100% of the issued capital of Company S on 1 January Year 4.

The purchase agreement required Company X to pay ₦300,000 in cash immediately and an additional sum of ₦100,000 on 31 December Year 6 if the earnings of Company S increase at an annual rate of 25% per year in each of the three years following the acquisition.

How should the contingent payment be recognised in calculating the goodwill arising at the date of acquisition?

Answer

The contingent consideration should be included in the cost of investment (the purchase consideration) whether or not it is probable that it will have to be paid. The contingent consideration of ₦100,000 should be measured at fair value.

If it is fairly certain that the contingent consideration will have to be paid, an appropriate measure of fair value might be the present value of the future payment, discounted at an appropriate cost of capital. The purchase consideration is therefore ₦300,000 plus the present value of the contingent (deferred) consideration.

If there is still contingent consideration at the end of an accounting period, it might be necessary to re-measure it.

If the contingent consideration will be payable in cash, it should be re-measured to fair value at the end of the reporting period. Any gain or loss on re- measurement should be taken to profit or loss.

If the contingent consideration will take the form of debt, the amount of the debt is re-measured at fair value at the end of the reporting period and the change in value is recognised in profit or loss in the period.

If the contingent consideration will take the form of equity, it is not re-measured at the end of the reporting period. The eventual settlement of the payment will be accounted for as an equity transaction (i.e. a transaction between the entity and owners of the group in their capacity as owners).

A reason for re-measuring the contingent consideration is that the amount payable might depend on the performance of the subsidiary after its acquisition.

If the profits are higher than expected, the contingent consideration might be re- measured to a higher value, increasing the liability (the contingent payment) and reducing the reported profit for the period.

Similarly if the profits are lower than expected, the contingent consideration might be re-measured to a lower value, reducing the liability (the contingent payment) and increasing the reported profit for the period.

(Note: Under the previous accounting rules, before the introduction of IFRS 3, any increase in the value of contingent consideration was charged to goodwill.).

Share options given to the previous owners

When an entity acquires a subsidiary that was previously managed by its owners, the previous owners might be given share options in the entity as an incentive to stay on and work for the subsidiary after it has been acquired. IFRS 3 states that the award of share options in these circumstances is not a part of the purchase consideration. The options are post-acquisition employment expenses and should be accounted for as share-based payments in accordance with IFRS 2.

20.4.5 Acquisition date, amounts of assets acquired and liabilities assumed

Core principle

An acquirer of a business must recognise assets acquired and liabilities assumed at their acquisition date fair values and disclose information that enables users to evaluate the nature and financial effects of the acquisition.

To support this IFRS 3R sets out:

(a) 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* as at the acquisition date.

This might result in recognition of assets and liabilities not previously recognised by the acquiree.

When a company acquires a subsidiary, it may identify intangible assets of the acquired subsidiary, which are not included in the subsidiary's statement of financial position. If these assets are separately identifiable and can be measured reliably, they should be included in the consolidated statement of financial position as intangible assets, and accounted for as such.

This can result in the recognition of assets and liabilities not previously recognised by the acquiree.

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Illustration: Identifiable asset on acquisition

If a company bought 100% of the Coca-Cola Corporation, they would be buying a lot of assets but part (perhaps the largest part) of the purchase consideration would be to buy the Coca Cola brand.

Coca Cola does not recognise its own brand in its own financial statements because companies are not allowed to recognised internally generated brands.

However, as far as the company buying the Coca-Cola Corporation is concerned the brand is a purchased asset. It would be recognised in the consolidated financial statements and would be taken into account in the goodwill calculation.

Contingent liabilities

Many acquired businesses will contain contingent liabilities such as contingent liabilities for the settlement of legal disputes or for warranty liabilities. IFRS 3 states that contingent liabilities should be recognised at acquisition 'even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.'

The contingent liabilities should be measured at fair value at the acquisition date. (Contingent assets are not recognised).

Restructuring costs

An acquirer should not recognise a liability for the cost of restructuring a subsidiary or for any other costs expected to be incurred as a result of the acquisition (including future losses).

This is because a plan to restructure a subsidiary after an acquisition cannot be a liability at the acquisition date. For there to be a liability (and for a provision to be recognised) there must have been a past obligating event. This can only be the case if the subsidiary was already committed to the restructuring before the acquisition.

This means that the acquirer cannot recognise a provision for restructuring or reorganisation at acquisition and then release it to profit and loss in order to 'smooth profits' or reduce losses after the acquisition.

Measurement principle

Identifiable assets acquired and the liabilities assumed are measured at their acquisition date fair values.

Definition: Fair value

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

The net assets of a newly acquired business are subject to a fair valuation exercise.

The table below shows how different types of asset and liability should be valued.

Item	Fair value
Marketable investments	Current market value
Non-marketable investments	Estimated values that take into consideration features such as: (a) price earnings ratios (b) dividend yield (c) expected growth rates of comparable investments
Trade and other receivables	Present values of the amounts to be received. This is normally the same as the book value. Discounting is not usually required because amounts are expected to be received within a few months.
Inventories: finished goods	Selling price less the sum of: (a) the costs of disposal, and (b) a reasonable profit allowance for the selling effort of the acquirer based on profit for similar finished goods.
Inventories: work in progress	Selling price of finished goods less the sum of: (a) costs to complete, (b) costs of disposal, and (c) a reasonable profit for the completing and selling effort based on profit for similar finished goods.
Inventories: raw materials	Current replacement costs
Land and buildings	Market value
Plant and equipment	Normally market value. Use depreciated replacement cost if market value cannot be used (e.g., because of the specialised nature of the plant and equipment or because the items are rarely sold, except as part of a continuing business).
Intangible assets	Described later.
Trade and other payables; long-term debt and other liabilities.	Present values of amounts to be disbursed in meeting the liability determined at appropriate current interest rates. For current liabilities this is normally the same as book value.

Exceptions

Note that this table only shows the exceptions to the above principles and guidance.

Topic	Recognition principle	Measurement at acquisition	Measurement at later dates
Contingent liability	Defined by IAS 37 and not recognised. Contingent liability due to a present obligation is recognised	Fair value	At the higher of the original amount and the amount that would be reported under IAS 37.
Income taxes	IAS 12 applies	IAS 12 applies	IAS 12 applies
Employee benefits	IAS 19 applies	IAS 19 applies	IAS 19 applies
Indemnification assets	This is a right to be compensated by the seller if a defined contingency occurs Recognition of the asset mirrors the recognition of the liability	Measurement of the asset mirrors the recognition of the liability	Measurement of the asset mirrors the recognition of the liability
Reacquired rights		Recognised as an intangible asset and measured on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value	The asset recognised is amortised over the over the remaining contractual period of the contract in which the right was granted.
Share based payments		IFRS 2 applies	
Assets held for sale		IFRS 5 applies	

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Deferred tax

Deferred income tax assets and liabilities are recognised and measured in accordance with IAS 12 *Income Taxes*, rather than at their acquisition-date fair values.

Measurement period

Initial accounting for goodwill may be determined on a provisional basis and must be finalised by the end of a measurement period.

This ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed at the acquisition date but must not exceed one year from the acquisition date.

During the measurement period new information obtained about facts and circumstances that existed at the acquisition date might lead to the adjustment of provisional amounts or recognition of additional assets or liabilities with a corresponding change to goodwill.

Any adjustment restates the figures as if the accounting for the business combination had been completed at the acquisition date.

Classification guidance

Identifiable assets acquired and liabilities assumed must be classified (designated) as necessary at the acquisition date so as to allow subsequent application of appropriate IFRS.

The classification is based on relevant circumstances as at the acquisition date with two exceptions:

a) classification of a lease contract in accordance with IFRS 16 *Lease*s; and

b) classification of a contract as an insurance contract in accordance with IFRS 17 *Insurance Contracts*.

Classification in these cases is based on circumstances at the inception of the contract or date of a later modification that would change the classification.

20.5 Consolidation technique

20.5.1 The basic approach

Suggested step by step approach to the preparation of consolidated statements of financial position

To prepare a consolidated statement of financial position as at the acquisition date, the following steps should be taken.

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Step 1: Establish the group share (parent company share) in the subsidiary and the percentage owned by non-controlling interests.

Step 2: Perform double entry to record any individual company adjustments that might be necessary. Mark these in the face of the question. The information can be lifted into workings later so that the marker can understand what you have done.

Step 3: Set out a pro-forma (skeleton) statement of financial position and fill in the easy numbers (for example those assets and liabilities that are a straight cross cast and the share capital)

Step 4: Calculate the net assets of the subsidiary S at the acquisition date and at the end of the reporting period taking into account information about the fair value of assets at the acquisition date and the existence of any assets not recognised by the subsidiary that might need to capitalise for consolidation purposes.

Step 5: Calculate the goodwill

Illustration: Goodwill (Full goodwill or FV method)

	₦
Consideration transferred (cost of the business combination)	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3)	X

Step 6: Calculate the non-controlling interest.

Illustration: Consolidated retained

	₦
NCI at the date of acquisition	XX
NCI's share of the post-acquisition retained earnings of S	X
NCI's share of each other post-acquisition reserves of S (if	X

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Step 7: Calculate consolidated retained earnings.

Possible complications

You should be familiar with the following of possible complications that you may need to take into account when answering questions:

- Before consolidation
  - (a) Measuring the cost of acquisition
  - (b) Identifying assets not recognised by the subsidiary which need to be included for consolidation purposes
  - (c) Performing the fair value exercise

    Construct a net assets summary of each subsidiary showing net assets at the date of acquisition and at the reporting date.
- During consolidation
  - (a) Mid-year acquisition – consolidation must be from the date of acquisition so you may need to construct a net assets total for a subsidiary at a point during the previous year.
  - (b) Elimination of inter-company balances
  - (c) Elimination of unrealised profit.
- After consolidation
  - (a) Impairment testing goodwill
  - (b) Accounting for a gain on a bargain purchase.

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20.5.2 Practice questions

Practice question **1**

P acquired 70% of S on January 1, 2021 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 netassets.

The statements of financial position P and S as at 31 December 20X1 were as follows:

Assets:	P (₦)	S(₦)
Investment in S, at cost	450,000	-
Other assets	500,000	350,000
	950,000	350,000
Equity		
Share capital	100,000	100,000
Retained earnings	650,000	100,000
	750,000	200,000
Current liabilities	200,000	150,000
	950,000	350,000

x

Prepare a consolidated statement of financial position as at December 31, 2021.

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Practice question **2**

P acquired 70% of S on 1 January 20X1 for ₦450,000 The

retained earnings of S were ₦50,000 at that date.

It is P's policy to recognise non-controlling interest at the date of acquisition at fair value.

The fair value of the non-controlling interest at the date of acquisition was

₦75,000.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P (₦)	S(₦)
Assets:		
Investment in S, at cost	450,000	-
Other assets	500,000	350,000
	950,000	350,000
Equity		
Share capital	100,000	100,000
	650,000	100,000
Retained earnings		
	750,000	200,000
Current liabilities	200,000	150,000
	950,000	350,000

x

Prepare a consolidated statement of financial position as at December 31, 2021.

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Practice question **3**

P bought 80% of S 2 years ago.

At the date of acquisition S's retained earnings stood at ₦600,000. The fair value of its net assets was not materially different from the book value except for the fact that it had a brand which was not recognised in S's accounts. This had a fair value of 100,000 at this date and an estimated useful life of 20 years.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P	S
	₦	₦
PP and E	1,800,000	1,000,000
Investment in S	1,000,000	
Other assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Liabilities	200,000	200,000
	3,200,000	1,300,000

Prepare a consolidated statement of financial position as at December 31, 2021.

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Practice question **4**

P bought 80% of S 2 years ago.

At the date of acquisition S's retained earnings stood at ₦600,000 and the fair value of its net assets were ₦1,000,000. This was ₦300,000 above the book value of the net assets at this date.

The revaluation was due to an asset that had a remaining useful economic life of 10 years as at the date of acquisition.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P	S
	₦	₦
PP and E	1,800,000	1,000,000
Investment in S	1,000,000	
Other assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Liabilities	200,000	200,000
	3,200,000	1,300,000

Prepare a consolidated statement of financial position as at December 31, 2021.

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Practice question **5**

P acquired 70% of S on 1 January 20X1 for ₦1,000,000 The

retained earnings of S were ₦50,000 at that date.

Also, at the date of acquisition S held an item of plant with a carrying amount of 250,000 less than its fair value. This asset had a remaining useful life of 10 years as from that date.

It is P's policy to recognise non-controlling interest at the date of acquisition as a proportionate share of netassets.

The statements of financial position of P and S as at 31 December 20X1 were as follows:

	P (₦)	S(₦)
Assets:		
Investment in S, at cost	1,000,000	-
Other non-current assets	400,000	200,000
Current assets	500,000	350,000
	1,900,000	550,000
Equity		
Share capital	100,000	100,000
Retained earnings	1,600,000	300,000
	1,700,000	400,000
Current liabilities	200,000	150,000
	1,900,000	550,000

Prepare a consolidated statement of financial position as at December 31, 2021.

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20.6 Accounting for goodwill

20.6.1 Accounting for goodwill

Positive goodwill - Excess of cost of combination over share of net assets

After initial recognition goodwill is measured at cost less any accumulated impairment losses.

(a) Goodwill acquired in a business combination is not amortised.
(b) 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.

20.6.2 Impairment testing of goodwill

Purchased goodwill is not amortised, but must be tested for impairment on an annual basis. It cannot be tested for impairment directly. It is allocated to one or more cash generating unit (IAS 36) and then the carrying amount of the cash generating unit is compared to its recoverable amount.

The following discussion and examples assume that the subsidiary in question is a cash generating unit (CGU).

Partial goodwill method (NCI at acquisition measured as a proportionate share of subsidiary's net assets

Recoverable amount of the CGU is based on the cash flows that its assets are expected to generate (either through use or sale of the unit). These cash flows will be a function of all of the assets of the unit including the NCI's share of the goodwill, but this latter figure has not been recognised.

The carrying amount of the NCI is made up of:

(a) the total net assets of the unit (parent's interest and NCI's); and

(b) the parent's interest in goodwill.

Any comparison of carrying amount to recoverable amount should compare like to like but the cash flows from the NCI's goodwill contribute to the recoverable amount but this goodwill is not in the carrying amount. IAS 36 requires a working that grosses up the carrying amount of the

CGU's assets by the NCI share of goodwill. Note that this is only in a working; it is not part of the double entry.

This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.

Any impairment is charged against the goodwill in the first instance with any balance writing down other assets in the unit.

Only that part of any impairment loss attributable to the parent is recognised by the entity as a goodwill impairment loss.

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Example: Impairment of goodwill

X plc paid ₦1,600 for an 80% interest in Y plc on 01/01/X1.

On this date Y had identifiable net assets with a fair value of ₦1,500.

Goodwill on acquisition:	₦
Cost of acquisition	1,600
Share of net assets (80% × ₦1,500)	(1,200)
Goodwill	400

The following amounts are recognised in the consolidated financial statements at the date of acquisition:

	₦
Goodwill	400
Asset	1,500
NCI (20%× 1,500)	300

This cash-generating unit includes goodwill within its carrying amount, so it must be tested for impairment annually (or more frequently if there is an indication that it may be impaired).

31/12/X1 – Impairment test

X plc estimates that the recoverable amount of Y plc is ₦1,400.

The net assets of Y plc (after fair value adjustments) were still ₦1,520.

Carrying amount of Y plc:	Goodwill	Asset	Total
As at 01/01/X1	400	1,500	1,900
Notional grossing up of goodwill $400 \times {}^{20}/_{80}$	100	-	100
	500	1,500	2,000
Recoverable amount			(1,520)
Impairment loss			480

The whole loss (480) is covered by the goodwill of 500 but only 80% of this is in the financial statements. Therefore only 80% of the loss is recognised

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Allocation of impairment loss	Notional write off	X plc share	X plc write off
Goodwill (notional)	480	80%	384

Allocation of impairment loss	Goodwill	Asset	Total
As at 31/12/X1	400	1,500	1,900
Impairment loss	(384)		(384)
	16	1,500	1,516

Full goodwill method (NCI at acquisition measured at fair value

This is more straightforward.

If there is a NCI in a cash-generating unit to which goodwill has been allocated, the carrying amount of that unit is made up of:

(a) both the parent's interest and the NCI in the net assets of the unit; and

(b) both the parent's interest in goodwill and the NCI's interest in goodwill.

When non-controlling interests are valued by the fair value method, any impairment in the total goodwill after acquisition should be shared between the parent company shareholders and the NCI.

It is tempting to allocate the write off of goodwill between the parent and NCI in proportion to the goodwill attributable to each. However, para C6, Appendix C to IAS 36 says that the impairment should be "allocated between the parent and the NCI on the same basis as that on which profit or loss is allocated".

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Example: Impairment of goodwill

S has 10 million shares of ₦1 each in issue. H acquired 80% of these shares at a price of ₦11.6 million when the net assets of S were ₦10 million. Prior to the acquisition, the shares of S had been trading in the stock market at ₦1.20 per share.

Suppose that subsequently goodwill is impaired in value by ₦1.5 million, so that it is now valued at just ₦2,500,000.

The impairment in the goodwill must be attributed to the parent company and the NCI in the according to the proportions used to allocate profit or loss (80:20).

Goodwill	Total	Parent	NCI
	₦000	₦000	₦000
Purchase consideration	11,600	11,600	
Non-controlling interest (2m shares @ ₦1.2)	2,400		2,400
	14,000		
Fair value of net assets of subsidiary at acquisition	(10,000)	(8,000)	(2,000)
Goodwill	4,000	3,600	400
Impairment of goodwill:	(1,500)	(1,200)	(300)
	2,500	2,400	100

Note that the impairment is allocated 80:20 not 3,600:400 which might have been expected.

Note that the impairment is allocated 80:20 not 3,600:400 which might have been expected.

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20.6.3 Negative goodwill and bargain purchases

A bargain purchase is a business combination in which the calculation of goodwill leads to a negative figure.

When this happens the acquirer must then review the procedures used to measure the amounts recognised at the acquisition date for all of the following:

(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 and share between the parent and the NCI in their percentage holdings where the gain on bargain purchase is arrived based on the Full Goodwill method otherwise it is charged to the parent alone.

This means that in most cases when a bargain purchase occurs, the 'negative goodwill' should be added to the consolidated profit for the group for the year.

20.7 Chapter review

Chapter review

Before moving on to the next chapter, ensure that you can:

a. Explain and discuss in detail the requirements of IFRS 3 with regard to the calculation of goodwill;

b. Define using examples subsidiary, parent and control;

c. Explain the concept of control as set out in IFRS 10;

d. Describe situations when control is presumed to exist;

e. Identify and describe the circumstances in which an entity is required to prepare and present consolidated financial statements;

f. Prepare a consolidated statement of financial position including the fair value exercise and the elimination of inter-company balances and accounting for unrealised profit;

g. Account for goodwill including impairment testing; and

h. Account for gain on a bargain purchase (negative goodwill).

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Solution (continued) **1**

Workings:

W1 Net assetssummary

	At date of consolidation	At date of acquisition	Post acq^{n}
Share capital	100,000	100,000	
Retained earnings	100,000	50,000	50,000
Net assets	200,000*	150,000	

W2 Non-controlling interest

	₦
NCI's share of net assets at the date of acquisition (30% × 150,000 (W1))	45,000
NCI's share of the post-acquisition retained earnings of S (30% of 50,000 (W1))	15,000
NCI's share of net assets at the date of consolidation	60,000

Alternative working

NCI's share of net assets at the date of consolidation (30% × 200,000*)	60,000

W3 Goodwill

	₦
Cost of investment	450,000
Non-controlling interest at acquisition (see W2)	45,000
	495,000
Net assets at acquisition (W1)	(150,000)
	345,000

W4 Consolidated retained profits:

	₦
All of P's retained earnings	650,000
P's share of the post-acquisition retained earnings of S (70% of 50,000 (W1))	35,000
	685,000

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Solution 2

P Group: Consolidated statement of financial position at December 31, 20X1

	₦
Assets	
Goodwill (W3)	375,000
Other assets (500 + 350)	850,000
Total assets	1,225,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	685,000
	785,000
Non-controlling interest (W2)	90,000
	875,000
Current liabilities (200 + 150)	350,000
Total equity and liabilities	1,225,000

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post acqn
Share capital	100,000	100,000	
Retained earnings	100,000	50,000	50,000
Net assets	200,000*	150,000	

W2 Non-controlling interest

	₦
Fair value of NCI at the date of acquisition	75,000
NCI's share of the post-acquisition retained earnings of S (30% of 50,000 (W1))	15,000
NCI's share of net assets at the date of consolidation	90,000

W3 Goodwill

	₦
Cost of investment	450,000
Non-controlling interest at acquisition (given)	75,000
	525,000
Net assets at acquisition (W1)	(150,000)
	375,000

W4 Consolidated retained profits:

	₦
All of P's retained earnings	650,000
P's share of the post-acquisition retained earnings of S (70% of 50,000 (W1))	35,000
	685,000

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Solution 3

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

P Group: Consolidated statement of financial position at 31 December 20X1

	₦
Assets	
Brand (see working)	90,000
Goodwill (see working)	360,000
Property, plant and equipment (1,800 + 1000)	2,800,000
Other assets (400 + 300)	700,000
Total assets	3,950,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (see working)	3,212,000
	3,312,000
Non-controlling interest	238,000
	3,550,000
Current liabilities (200 + 200)	400,000
Total equity and liabilities	3,950,000

Workings:

Net assets summary of S

	At date of consolidation	At date of acquisition	Post 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% × 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

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Solution (continued) **3**

Goodwill	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (20% × 800,000)	160,000
	1,160,000
Net assets at acquisition (see above)	(800,000)
	360,000

Consolidated retained profits:	₦
All of P's retained earnings	2,900,000
P's share of the post-acquisition retained earnings of S (80% of 390,000 (see above))	312,000
	3,212,000

Consolidated retained profits:	~~312,000~~
All of P's retained earnings	~~3,212,000~~
P's share of the post-acquisition retained earnings of S (80% of 390,000 (see above))	

Brand	₦
On initial recognition	100,000
Amortization since acquisition (100,000 × $^{2\ years}/_{20\ years}$)	(10,000)
	90,000

Solution **4**

P Group: Consolidated statement of financial position at December 31, 2021

	₦
Assets	
Goodwill (see working)	200,000
PP and E (see working)	3,040,000
Other assets (400,000 + 300,000)	700,000
Total assets	3,940,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (see working)	3,172,000
	3,272,000
Non-controlling interest	268,000
	3,540,000
Current liabilities (200 + 200)	400,000
Total equity and liabilities	3,940,000

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Solution **4**

	At date of consolidation	At date of acquisition	Post
Share capital	100,000	100,000	
Retained earnings	1,000,000		
Given in the question		600,000	
Extra depreciation on fair value adjustment (300 × 2 years/10 years) – *see explanation on next page*	(60,000)		
Fair value	300,000	300,000	
	940,000	600,000	340,00
	1,000,000	1,000,00 0	

Non-controlling interest ₦200,000

NCI's share of net assets at the date of acquisition (20% × 1,000)	68,000
NCI's share of the post-acquisition retained earnings of S (20% of 340 (see above))	268,000
	₦
	1,000,000

Goodwill

Cost of investment	200,000
Non-controlling interest at acquisition (20% × 1,000)	1,200,000
	(1,000,000

Consolidated retained profits:	₦
All of P's retained earnings	2,900,000
P's share of the post-acquisition retained earnings of S (80% of 340 (see above))	272,000
	3,172,000

Solution (continued) **4**

Property plant and equipment	₦
Parent's	1,800
Subsidiary's	
Given in question	1,000
Fair value adjustment	300
Extra depreciation on fair value adjustment (300 × $^{2\text{ years}}/_{10\text{ years}}$)	(60)
	1,240
To statement of financial position	3,040

Solution **5**

P Group: Consolidated statement of financial position at December 31, 2021

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

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Solution **5**

Workings:

W1 Net assets

	At date of consolidation	At date of acquisition	Postacq^{n}
Share capital	100,000	100,000	
Retained earnings			
Given in the question	300,000	50,000	
Extra depreciation on fair value adjustment (250 × $^{1\ years}/_{10\ years}$)	(25,000)	–	
	275,000	50,000	225,000
Fair value reserve	250,000	250,000	
Net assets	625,000	400,000	

W2 Non-controlling interest

	₦
NCI's share of net assets at the date of acquisition (30% × 400)	120,000
NCI's share of the post-acquisition retained earnings of S (30% of 225 (W1))	67,500
NCI's share of net assets at the date of consolidation	187,500

W3 Goodwill

	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (W2)	120,000
	1,120,000
Net assets at acquisition (see above)	(400,000)
	720,000

W4 Consolidated retained profits:

	₦
All of P's retained earnings	1,600,000
P's share of the post-acquisition retained earnings of S (70% of 225 (W1))	157,500
	1,757,500

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CHAPTER 21

CONSOLIDATED STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Contents

21.0 Learning objective

21.1 Learning outcomes

21.2 Consolidated statement of profit or loss and other comprehensive income

21.3 Chapter review

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21 Consolidated Statement of Profit or Loss and other Comprehensive Income

21.0 Learning objective

This chapter discusses consolidated statements of profit or loss and other comprehensive income..

21.1 Learning outcomes

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

a. Prepare a consolidated statement of comprehensive income;
b. Eliminate the results of inter-company transactions on consolidation;
c. Eliminate unrealised profit on consolidation; and
d. Incorporate fair value adjustments during consolidation.

21.2 Consolidated statement of profit or loss and other comprehensive income

21.2.1 Consolidated statement of profit or loss: the basic rules

A consolidated statement of profit or loss brings together the sales revenue, income and expenses of the parent and the sales revenue, income and expenses of its subsidiaries.

Similarly, a consolidated statement of other comprehensive income brings together the gains and losses of the parent and the gains and losses of its subsidiaries.

In the consolidated statements, all items of income, expenses, gains and losses are a straight cross cast of equivalent items in the individual financial statements of the members of the group.
Non-controlling interest
Consolidated financial statements must also disclose the profit or loss for the period and the total comprehensive income for the period attributable to:

(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 comprehensive income.

he amounts attributable to the owners of the parent and the non-controlling interest are shown as a metric (small table) immediately below the statement of comprehensive income.

Illustration: Amounts attributable to the owners of the parent and the non- controlling interest

	₦
Total comprehensive income attributable	
to: Owners of the parent (balancing	X
figure)	X
	X

Where: x% is the NCI ownership interest

y is the subsidiary's profit for the year that has been included in the consolidated statement of comprehensive income

21.2.2 Inter-company items

Consolidated statements of profit or loss are prepared by combining the information given in the statements of profit or loss of the individual companies.

It is usually necessary to make adjustments to eliminate the results of inter- company trading. This includes adjustments to cancel out inter-company trading balances and unrealised profit.

Inter-company trading

Inter-company trading will be included in revenue of one group company and purchases of another. These are cancelled on consolidation.

Illustration:

	Debit	Credit
Revenue	X	
Cost of sales (actually purchases within cost of sales)		X

Unrealised profits on trading

If any items sold by one group company to another are included in inventory (i.e. have not been sold on outside the group by the year end), their value must be adjusted to lower of cost and net realisable value from the group viewpoint (as for the consolidated statement of financial position). This is an inventory valuation adjustment made in the consolidated financial statements.

Illustration:

	Debit	Credit
Closing inventory – Statement of comprehensive income	X	
Closing inventory – Statement of financial position		X

The adjustment in the statement of comprehensive income reduces gross profit and hence profit for the year. The NCI share in this reduced figure and the balance is added to retained earnings. Thus, the adjustment is shared between both ownership interests.

If the sale is from S to P the unrealised profit adjustment must be shared with the NCI.

Inter-company management fees and interest

All other inter-company amounts must also be cancelled.

Where a group company charges another group company, management fees/interest, there is no external group income or external group expense, and they are cancelled one against the other like inter-company sales and cost of sales.

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Illustration:

	Debit	Credit
Income (management fees)	X	
Expense (management charges)		X

Inter-company dividends

The parent may have accounted for dividend income from a subsidiary. This is cancelled on consolidation.

Dividends received from a subsidiary are ignored in the consolidation of the statement of comprehensive income because the profit out of which they are paid has already been consolidated.

21.2.3 Other adjustments

Fair value adjustments

Depreciation is charged on the carrying amount of assets.

If a depreciable asset is revalued on consolidation the depreciation stream that relates to that asset will also need to be revalued.

This adjustment is carried out in the financial statements of the subsidiary. It will affect the subsidiary's profit after tax figure and therefore will affect the NCI.

Accounting for Impairment of goodwill

When purchased goodwill is impaired, the impairment does not affect the individual financial statements of the parent company or the subsidiary. The effect of the impairment applies exclusively to the consolidated statement of financial position and the consolidated income statement.

If goodwill is impaired:

(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).

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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.

It is the policy of P to include in the distribution costs of S depreciation of an asset which had been subject to a fair value increase of 100,000 on acquisition. This asset is being written off on a straight line basis over 10 years.

The statements of profit or loss for the year to 31 December 20X1 are as follows:

	P	S
	₦(000)	₦(000)
Revenue	1,000	800
Cost of sales	(400)	(250)
Gross profit	600	550
Distribution costs	(120)	(75)
Administrative expenses	(80)	(20)
	400	455
Dividend from S	80	-
Finance cost	(25)	(15)
Profit before tax	455	440
Tax	(45)	(40)
Profit for the period	410	400

Prepare the consolidated income statement for the year ended 31 December.

21.2.4 pre-and post-acquisition profits

A change in ownership in the period will have an impact on the consolidated statement of profit or loss and other comprehensive income.

The financial statements of a subsidiary must be consolidated from the date control is achieved until the date that control is lost. In other words, the pattern of ownership must be reflected in the statement of profit or loss and other comprehensive income.

(a) All of an entity's results are consolidated if it is controlled for the whole year

(b) If an entity is controlled for only part of the year, only those results that relate to that part of the year are consolidated.

For example, if a parent acquires a subsidiary **during** a financial year, the profits of the subsidiary have to be divided into pre-acquisition and post-acquisition and only post acquisition profits are consolidated.

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The following straightforward example is of a type that you have seen in previous papers. Later chapters on step acquisitions and disposals will show more complex applications of the principle.

Example: Consolidated statement of profit or loss (mid-year acquisition)

Entity P acquired 80% of S on October 1, 2021.

	P	S
	₦	₦
Revenue	400,000	260,000
Cost of sales	(200,000)	(60,000)
Gross profit	200,000	200,000
Other income	20,000	-
Distribution costs	(50,000)	(30,000)
Administrative expenses	(90,000)	(95,000)
Profit before tax	80,000	75,000
Income tax expense	(30,000)	(15,000)
Profit for the period	50,000	60,000

A consolidated statement of comprehensive income can be prepared as

	Working		
	P	S (3/12)	Consolidated
	₦	₦	₦
Revenue	400,000	65,000	465,000
Cost of sales	(200,000)	(15,000)	(215,000)
Gross profit	200,000	50,000	250,000
Other income	20,000	–	20,000
Distribution costs	(50,000)	(7,500)	(57,500)
Administrative expenses	(90,000)	(23,750)	(113,750)
Profit before tax	80,000	18,750	98,750
Income tax expense	(30,000)	(3,750)	(33,750)
Profit for the period	50,000	15,000	65,000

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	62,000
Non-controlling interests (20% of 15,000)	3,000
	65,000

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21.3 Chapter review

Chapter review

Before moving on to the next chapter, ensure that you can:

(a) Prepare a basic consolidated statement of comprehensive income

(b) Prepare a basic consolidated statement of comprehensive income

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Solutions to practice questions

Solutions **1**

Consolidated statement of comprehensive income for the year ended 31 December.

	P	S	Dr	Cr	Consol.
	₦(000)	₦(000)	₦(000)	₦(000)	₦(000)
Revenue	1,000	800	(100)		1,700
Cost of sales	(400)	(250)	[3](5)	100	(555)
Gross profit	600	550	(105)	100	1,145
Distribution costs	(120)	(75)			
Fair value adjustment		[1](10)			
	(120)	(85)			(205)
Administrative expenses	(80)	(20)	[2](15)		(115)
	400	445			
Dividend from S	80	-	(80)		
Finance cost	(25)	(15)			(40)
Profit before tax	455	430			785
Tax	(45)	(40)			(85)
Profit for the period	410	390	(200)	100	700

Total comprehensive income attributable to:	₦(000)
Owners of the parent (balancing figure)	633
Non-controlling interests (20% of 390,000) – (20% of [3]5,000)	77
	700

Notes:

1: Extra depreciation on fair value adjustment ($^{100}/_{10\text{ years}}$) 2:

Goodwill impairment

3: Unrealised profit

Alternative approach to determine the NCI post acquisition profit.

S Post acq profit	390,000
Unrealized profit	(5,000)
Adjusted post acq. profit	385,000
NCI's share of post acq.profit	20% of 385,000=77,000.

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Professional Level

Strategic Business Reporting

CHAPTER 22

ASSOCIATESAND JOINT VENTURES

Contents

22.0 Learning objectives

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22.2 IFRS 11: Joint arrangements

22.3 IAS 28: Investments in associates and joint ventures

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22.5 IAS 28: Investments in associates and joint ventures

22.6 Chapter review

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22 Associates and Joint Ventures

22.0 Learning objective

This chapter explains the accounting rules for joint operations, joint ventures and associates.

22.1 Learning outcomes

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

a. Define and explain the differences between a joint operation, a joint ventures and an associate;
b. Account for joint operations;
c. Explain equity accounting;
d. Measure investment in an associate or joint venture for inclusion in the statement of financial position using equity accounting;
e. Measure share of profit of an associate or joint venture for inclusion in the statement of comprehensive income; and
f. Account for unrealised profit on transactions between an associate or joint venture and its parent or a member of the parent's group.

22.2 IFRS 11: Jointarrangements

22.2.1 Introduction

A controlling interest in an investee results in an investment (a subsidiary) which is consolidated.

An interest in the equity shares of another company that gives no influence is accounted for as follows:

(a) The shares are shown in the statement of financial position as long-term assets (an investment) and valued in accordance with 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:

(i) IFRS 11 Joint Arrangements: and
(ii) IAS 28 Investments in Associates and Joint ventures.

This session introduces the rules on accounting for joint arrangements.

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Joint arrangements

Definition

A **joint arrangement** is an arrangement of which two or more parties have joint control.

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Definition

A **joint arrangement** is an arrangement of which two or more parties have joint control.

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A joint arrangement has the following characteristics:

(a) The parties are bound by a contractual arrangement; and

(b) The contractual arrangement gives two or more of those parties joint control of the arrangement.

Definition

A **party to a joint arrangement** is an entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

Definition

A **party to a joint arrangement** is an entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

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Contractual arrangement

Any contractual arrangement will usually be evidenced in writing, usually in the form of a contract or documented discussions between the parties.

A joint arrangement might be structured through a separate vehicle in which case some aspects of the contractual arrangement might be incorporated in its articles, charter or by-laws.

Any contractual arrangement sets out the terms upon which the parties participate in the activity that is the subject of the arrangement and would generally deal with such matters as:

(a) the purpose, activity and duration of the joint arrangement;
(b) how the members of the board of directors, or equivalent governing body, of the joint arrangement, are appointed;
(c) the decision-making process (the matters requiring decisions from the parties, the voting rights of the parties and the required level of support for those matters);
(d) the capital or other contributions required of the parties; and
(e) how the parties share assets, liabilities, revenues, expenses or profit or loss relating to the joint arrangement.

Joint control

IFRS 11 states that decisions about the relevant activities require unanimous consent of all parties that collectively control the arrangement. It is not necessary for every party to the arrangement to agree in order for unanimous consent to exist. This requires agreement by only those parties that collectively control the arrangement.

Day to day decision making might be delegated to a manager or to one of the parties to the arrangement. In such cases, the situation would need to be analysed to decide whether, in fact, decisions require the unanimous agreement of the interested parties. Such an arrangement is still a joint arrangement when the manager executes the policy decisions that have been agreed unanimously by the investors.

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Example: Joint control

In each of the following scenarios three entities A, B and C establish an arrangement.

Example: Joint control

In each of the following scenarios three entities A, B and C establish an arrangement.

Decisions about relevant activities	Scenario 1 Require the unanimous consent of A, B and C	Scenario 2 Require at least 75% of voting rights	Scenario 3 Require at least 75% of voting rights
Ownership interest			
A	50%	50%	50%
B	30%	30%	25%
C	20%	20%	25%
Required			

Decisions about relevant activities	Scenario 1 Require the unanimous consent of A, B and C	Scenario 2 Require at least 75% of voting rights	Scenario 3 Require at least 75% of voting rights

For each scenario analyse whether a joint arrangement exists and which parties have joint control.

For each scenario analyse whether a joint arrangement exists and which parties have joint control.

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Answer Scenario 1

A, B and C have joint control of the arrangement and each must account for its investment according to IFRS 11.

Scenario 2

Although A can block any decision, it does not control the arrangement because it needs the agreement of B.

A and B have joint control of the arrangement. The terms of their contractual arrangement requiring at least 75% of the voting rights to make decisions about the relevant activities imply that A and B have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A and B agreeing.

A and B must each account for its investment according to IFRS 11. C is a party

to a joint arrangement but has no control.

Scenario 3

The arrangement can be controlled by A with B or by A with C. This means that no party can be said to have joint control.

In order for this to be a joint arrangement the contractual terms would have to specify which combination of parties is required to agree about the relevant activities.

IFRS 11 does not apply to this investment.

Answer Scenario 1

A, B and C have joint control of the arrangement and each must account for its investment according to IFRS 11.

Scenario 2

Although A can block any decision, it does not control the arrangement because it needs the agreement of B.

A and B have joint control of the arrangement. The terms of their contractual arrangement requiring at least 75% of the voting rights to make decisions about the relevant activities imply that A and B have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A and B agreeing.

A and B must each account for its investment according to IFRS 11. C is a party

to a joint arrangement but has no control.

Scenario 3

The arrangement can be controlled by A with B or by A with C. This means that no party can be said to have joint control.

In order for this to be a joint arrangement the contractual terms would have to specify which combination of parties is required to agree about the relevant activities.

IFRS 11 does not apply to this investment.

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22.2.2 Types of joint arrangements

There are two types of joint arrangement. A joint arrangement is either a joint operation or a joint venture.

Definition

A **joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.

A joint venture is a joint arrangement where the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

Definition

A **joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.

A joint venture is a joint arrangement where the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

This classification depends on the rights and obligations of the parties to the arrangement.

Investors may or may not establish a joint arrangement as a separate vehicle.

Definition

A **separate vehicle** is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

Definition

A **separate vehicle** is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

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The application guidance to IFRS 11 says that if a joint arrangement **is not** structured through a separate vehicle it must be a joint operation.

If a joint arrangement **is** structured through a separate vehicle it could be a joint operation or a joint venture.

For a joint arrangement to be a joint venture it is the separate vehicle that must have the rights to the assets and the obligations to the liabilities with the investor only having an interest in the net assets of the entity. If an investor has a direct interest in specific assets and direct obligation for specific liabilities of the separate vehicle then the joint arrangement is a joint operation.

22.2.2 Accounting for joint operations and joint ventures

The method of accounting for an interest in a joint arrangement depends on what type of joint arrangement it is.

Joint operations

A joint operator must recognise the following in its own financial statements:

(a) its assets, including its share of any assets held jointly;
(b) its liabilities, including its share of any liabilities incurred jointly;
(c) its revenue from the sale of its share of the output arising from the joint operation;
(d) its share of the revenue from the sale of the output by the joint operation; and
(e) its expenses, including its share of any expenses incurred jointly.

If an entity participates in, but does not have joint control of a joint operation but has rights to the assets, and obligations for the liabilities, relating to the joint operation it must also apply the above accounting treatment.

If an entity participates in, but does not have joint control of a joint operation and also does not have rights to the assets, and obligations for the liabilities, relating to the joint operation it must account for its interest in the joint operation in accordance with the IFRSs applicable to that interest.

When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes a business (as defined in IFRS 3), it must apply the principles on business combinations accounting in IFRS 3.

This applies to the acquisition of both the initial interest and additional interests in a joint operation.

The principles on business combinations include:

(a) the measurement of identifiable assets and liabilities at fair value;
(b) expensing acquisition-related costs;
(c) recognising goodwill; and
(d) impairment testing goodwill.

Joint ventures

A joint venturer must recognise its interest in a joint venture as an investment and account for it using the equity method in accordance with IAS 28 *Investments in*

Associates and Joint Ventures unless the entity is exempted from applying the equity method as specified in that standard.

If an entity participates in, but does not have joint control of a joint operation it must account for its interest in the arrangement in accordance with IFRS 9 Financial Instruments, unless it has significant influence over the joint venture, in which case it must account for it in accordance with IAS 28.

Example – Accounting for a joint operation

On 1 January 20X7, X and Y entered into a joint operation to purchase and operate an oil pipeline.

Both entities contributed equally to the purchase cost of ₦20 million and this was financed by a joint loan of₦20,000,000.

Contract terms

Y carries out all maintenance work on the pipeline but maintenance expenses are shared between B and C in the ratio 40%: 60%.

Both entities use the pipeline for their own operations and share any income from third parties 50%: 50%. Sales to third parties are invoiced by Y.

The full interest on the loan is initially paid by X but the expense is to be shared equally.

During the year ended 31 December 20X7

Y carried out maintenance at a cost of ₦1,200,000. Income from third parties was

₦900,000, all paid to Y.

Interest of ₦1,500,000 was paid for the year on 31 December by X.**Required**

Show the relevant figures that would be recognised in the financial statements of X and Y for the year to 31 December 20X7.

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Both entities use the pipeline for their own operations and share any income from third parties 50%: 50%. Sales to third parties are invoiced by Y.

The full interest on the loan is initially paid by X but the expense is to be shared equally.

During the year ended 31 December 20X7

Y carried out maintenance at a cost of ₦1,200,000. Income from third parties was

₦900,000, all paid to Y.

Interest of ₦1,500,000 was paid for the year on 31 December by X.**Required**

Show the relevant figures that would be recognised in the financial statements of X and Y for the year to 31 December 20X7.

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Answer

Statement of financial position	Total amount	In X financial statements	In Y financial statements
	₦	₦	₦
Jointly-controlled assets			
Property, plant and equipment			
Cost	20,000,000	10,000,000	10,000,000
Share of liabilities incurred			
Bank loan	20,000,000	10,000,000	10,000,000
Current: account with Y (owed by Y) – see workings		720,000	
Current: account with X (owed to X) – see workings			720,000
Share of revenue			
Income from third parties (50:50)	900,000	450,000	450,000
Share of expenses			
Maintenance costs (40:60)	1,200,000	480,000	720,000
Interest on loan (50:50)	1,500,000	750,000	750,000
	2,700,000	1,230,000	1,470,000

Workings

Statement of profit or loss			
Income from third parties (50:50)	900,000	450,000	450,000
Maintenance costs (40:60)	1,200,000	480,000	720,000
Interest on loan (50:50)	1,500,000	750,000	750,000
	(2,700,000)	(1,230,000)	(1,470.000)
	(1,800,000)	(780,000)	(1,020.000)
Cash expense		(1,500,000)	(1,200,000)
Cash collected			900,000
Net cash expense		(1,500,000)	(300,000)
Cash due to X from Y		720,000	(720,000)

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22.3 IAS 28: Investments In Associates And Joint Ventures

22.3.1 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 usually evidenced in one or more of the following ways:

(i) Representation on the board of directors;
(ii) Participation in policy-making processes, including participation in decisions about distributions (dividends);
(iii) Material transactions between the two entities;
(iv) An interchange of management personnel between the two entities; or
(v) The provision of essential technical information by one entity to the other.

22.3.2 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.

Statement of financial position: investment in the associate

In the statement of financial position of the reporting entity (the investor), an investment in an associate is measured at:

Illustration: Equity

	₦
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
	(X)

There is no goodwill-recognised for an investment in an associate.

The accumulated profits of the reporting entity (or the consolidated accumulated reserves when consolidated accounts are prepared) should include the investor's share of the post-acquisition retained profits of the associate (or JV), (**minus** any impairment in the value of the investment since acquisition). This completes the other side of the entry when the investment is remeasured.

Similarly any other reserve of the reporting entity (or any other consolidated reserves when consolidated accounts are prepared) should include the investor's share of the post-acquisition movement in the reserve of the associate (or JV).

Statement of profit or loss and other comprehensive income

In the statement of profit or loss and other comprehensive income, there should be separate lines for:

(a) 'Share of profits of associate (or JV)' in the profit and loss section of the statement; and
(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.

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

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.

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.

Note: ₦75,000 will be included in the accumulated profits of Entity PThe journal to achieve the re-measurement is

Dr Cost ₦75,000 and Cr Accumulated profits ₦75,000

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Dr Cost ₦75,000 and Cr Accumulated profits ₦75,000

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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 31 December Year 5, the net assets of Entity A were ₦400,000.

In the year to 31 December Year 5, the profits of Entity A after tax were

₦50,000.

What figures would be included for the associate in the financial statements of Entity P for the year to 31 December Year 5?

Practice question

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

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Since acquisition of the investment, there has been no change in the issued share capital of Entity A, nor in its share premium reserve or revaluation reserve.

On 31 December Year 5, the net assets of Entity A were ₦400,000.

In the year to 31 December Year 5, the profits of Entity A after tax were

₦50,000.

What figures would be included for the associate in the financial statements of Entity P for the year to 31 December Year 5?

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22.4 Trading with an associate or joint venture

There might be trading between a parent and an associate (or JV). If in addition to the associate (or JV) the parent holds investments in subsidiaries there might also be trading between other members of the group and the associate (or JV).

In such cases there might be:

(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.

Inter-company balances

Inter-company balances between the members of a group (parent and subsidiaries) are cancelled out on consolidation.

Inter-company balances between the members of a group (parent and subsidiaries) and associates (or JVs) ***are not cancelled out*** on consolidation. An associate (or JV) is not a member of the group but is rather an investment made by the group. This means that it is entirely appropriate that consolidated financial statements show amounts owed by the external party as an asset and amount owed to the external party as a liability.

This is also the case if a parent has an associate (or JV) and no subsidiaries. The parent must equity account for the investment. Once again, it is entirely appropriate that consolidated financial statements show amounts owed by the external party as an asset and amount owed to the external party as a liability.

Unrealised inter-group profit

Unrealised inter-company (intra-group) profit between a parent and a member of a group must be eliminated in full on consolidation.

For unrealised profit arising on trade between a parent and associate (or JV***) only the parent's share*** of the unrealised profit is eliminated.

IAS 28 does not specify the double entry to achieve this. The

following are often used in practice

Parent sells to associate (or JV):

(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

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Associate (or JV) sells to parent:

Illustration: Unrealised profit double entry when parent sells to associate

	Debit	Credit
Cost of sales/Retained earning	X	
Investment in associate		
		X

	Debit	Credit

(i) The unrealised profit is held in inventory of the parent and this should be reduced in value by the parent's share of the unrealised profit.

(ii) 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 profitof associate	XInventory	

	Debit	Credit
Share of profitof associate	XInventory	
		X

In both cases, there will also be a reduction in the post-acquisition profits of the associate (or JV), and the investor entity's share of those profits (as reported in profit or loss). This will reduce the accumulated profits in the statement of financial position.

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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.

As at 31 December Year 6 Entity A had made profits of ₦275,000 since the date of acquisition.

In the year to 31 December Year 6, Entity P sold goods to Entity A at a sales price of ₦200,000 at a mark-up of 100% on cost.

The necessary adjustments for unrealised profit, and the double entries are as follows:

Unrealised profit adjustment	₦
Inventory sold by P to A	200,000
Profit on the sale (100%/200%)	100,000
Unrealised profit (₦30,000x100/200	15,000
Entity P's share (40%)	6,000

Double entries:	Dr(₦)	Cr(₦)
Investment in associate	110,000	
Accumulated profits		110,000
Being: Share of post-acquisition profits (40% of ₦275,000)		

	Dr(₦)	Cr(₦)
Cost of sales (hence accumulated profit)	6,000	
Investment in associate		6,000
Being: Elimination of share of unrealised profit (see above)		

Investment in associate (see above for adjustments)	₦
Cost of the investment	205,000
Entity P's share of post-acquisition profits of Entity A	110,000
Minus: Entity P's share of unrealised profit in inventory	(6,000)
	309,000

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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.

As at 31 December Year 6 Entity A had made profits of ₦380,000 since the date of acquisition.

In the year to 31 December Year 6, the reported profits after tax of Entity A were ₦100,000.

In the year to 31 December Year 6, Entity P sold goods to Entity A for

₦180,000 at a mark-up of 20% on cost.

Goods which had cost Entity A ₦60,000 were still held as inventory by Entity A at the year-end.

a) Calculate the unrealised profit adjustment and state the double entry.

b) Calculate the investment in associate balance that would be included in Entity P's statement of fiancial position as at 31 December Year 6.

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 Year6.

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22.5 Chapter review

Chapter review

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

(a) Define and explain the differences between a joint operation, a joint ventures and an associate;

(b) Account for joint operations;

(c) Explain equity accounting;

(d) Measure investment in an associate or joint venture for inclusion in the statement of financial position using equity accounting;

(e) Measure share of profit of an associate or joint venture for inclusion in the statement of comprehensive income; and

(f) Account for unrealised profit on transactions between an associate or joint venture and its parent or a member of the parent's group.

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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.

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Solution **2**

a) **Unrealised profit adjustment**

	₦
Inventory sold by P to A	180,000
Profit on the sale (20%/120%)	30,000
Unrealised profit (₦60,000/₦180,000)	10,000
Entity P's share (30%)	3,000

Double entry	Dr(₦)	Cr(₦)
Cost of sales (hence accumulated profit)	3,000	
Investment in associate		3,000

Being: Elimination of share of unrealised profit (see

b) **Investment in associate (see above for adjustments)**

	₦
Cost of the investment	275,000
Entity P's share of post-acquisition profits of Entity A (30% of	

c) **Statement of profit or loss**

The share of the associate's after-tax profit for the year is shown on a separate line as:

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CHAPTER 23

BUSINESS COMBINATIONS ACHIEVED IN STAGES

Contents

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23.2 Acquisitions Achieved in Stages

23.3 Pattern of Ownership In the Consolidated Statement of Profit or Loss

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23 Business Combinations Achieved in Stages

23.0 Learning Objective

This chapter discusses business combinations carried out in stages, including the re-measurement of any previously held interest, the calculation of goodwill, and the treatment of subsequent share purchases that do not change control, in line with IFRS 3 and IFRS 10.

23.1 Learning Outcomes

On completing this chapter you should be able to:

(a) **Explain when a step acquisition becomes a business combination** and identify the date on which acquisition accounting starts.
(b) **Re-measure and recognise any previously held equity interest** at fair value, compute the gain or loss on deemed disposal, and present it correctly in the consolidated financial statements.
(c) **Determine and calculate goodwill** when control is obtained in stages, using both the proportionate net assets and the full goodwill methods.
(d) **Account for additional share purchases after control is achieved**, treating them as equity transactions, and adjust the parent and non-controlling interests (NCI) appropriately.
(e) **Prepare a consolidated statement of profit or loss that reflects changes in ownership** during the year, including time-apportioned results and split NCI.
(f) **Evaluate disclosure and equity implications** of transfers from IFRS 9 or IAS 28 to control, and of further purchases that leave control unchanged.

23.2 Acquisitions Achieved in Stages

Acquisitions Achieved in Stages

A step acquisition (or acquisition achieved in stages) occurs when the parent entity acquires control over the subsidiary in stages, achieved by buying blocks of shares at different times. ***(These are known as successive share purchases or piecemeal acquisitions)***.

Acquisition accounting is only applied when control is achieved.
The date on which control is achieved is the date on which the acquirer should recognise the acquiree's identifiable net assets and any goodwill acquired (or bargain purchase) in the business combination.

Until control is achieved, any pre-existing interest is accounted for in accordance with:
(a) IFRS 9 in the case of investments in equity instruments
(b) IAS 28 in the case of associates and joint ventures

23.2.1 Types of Business Combination Achieved in Stages

There are three possible types of business combinations achieved in stages:

A previously held investment, say 10% of share capital, with no significant influence (accounted for under IFRS 9), is increased to a controlling holding of 50% or more.
A previously held equity investment, say 35% of share capital, accounted for as an associate under IAS 28, is increased to a controlling holding of 50% or more.
A controlling holding in a subsidiary is increased, say from 60% to 80%.

The first two transactions are treated in the same way, but the third is not. There is a reason for this.

General Principle

Under IFRS 3 a business combination occurs only when one entity obtains control over another, which is generally when 50% or more has been acquired.

When this happens, the original investment – whether an investment in equity instruments with no significant influence, or an associate – is treated as if it were disposed of at fair value (deemed disposal of the original investment). and reacquired at fair value This previously held interest at fair value, together with any consideration transferred, is the 'cost' of the combination used in calculating the goodwill.

If the 50% boundary is not crossed, as when a shareholding in an existing subsidiary is increased, the event is treated as a transaction between owners.

Whenever you cross the 50% boundary, you revalue, and a gain or loss is reported in profit or loss for the year. If you do not cross the 50% boundary, no gain or loss is reported; instead, there is an adjustment to the parent's equity.

Achieving Control

When the subsequent purchase of shares achieves control, then there is a new subsidiary. This represents a radical change in the group structure. A mere investment or perhaps an associate has now become a subsidiary. This is a significant economic event and with this new status of subsidiary, it is necessary to apply acquisition accounting at the date the control is obtained. Achieving control is evidenced by the subsequent purchases of shares taking the cumulative holding to above 50% for the first time and the implication of this is Pursuant to IFRS 3, consolidation can occur and for this purpose, the following steps should be taken:

Calculate Gain on Deemed Disposal of Previously Held Equity

Re-measure the previously held equity to fair value at the date when the investor gains control. Compare this fair value with the carrying amount of previously held equity.

The difference between this fair value and the carrying amount (normally a gain) should be recognised in the statement of profit or loss. That is, it should be added to the group retained earnings.

Note:

The equity interests held by the entity before control was obtained might be an interest in an associate, an interest in a joint venture or simply an investment.

The implication of this is that in substance; it is as if the investor (parent) has disposed of the original equity previously held, recorded the profit or loss arising on this disposal and subsequently re-acquired it.

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Computation of Gain or Loss on Equity Previously Held (Deemed Disposal)

	₦	
Fair value of equity previously held		xx
Less:		
Carrying value of equity previously held	xx	
Gain or loss to be added to group retained earnings	**xx**	

Computation of Goodwill on Gaining Control

IFRS 3 requires the purchase consideration for the purpose of determining goodwill to be recognised and measured at fair value. Following this provision, the purchase consideration of the new investment and the fair value of the equity previously held will be summed up and the goodwill (working 3) can now be calculated as:

	₦	
Purchase Consideration of additional investment	X	
Fair Value of equity previously held on step acquisition	X	
Non-controlling interest		X
		X
Net assets at the date the parent gains control	(X)	
Goodwill at the acquisition date		**X**

Illustrative Example 1: Control in Stages – Previous Holding a Simple Investment

Badagry Ltd has 1 million shares in issue. Peninsula plc acquired 50,000 shares in Badagry Ltd on 1 January 20X6 for ₦100,000. These shares were classified as a financial asset at fair value through other comprehensive income and on 31 December 20X8 their carrying amount was ₦230,000 and increases in fair value of ₦130,000 had been recognised in other comprehensive income and were held in equity. On 1 June 20X9 when the fair value of Badagry Ltd's net assets was ₦4 million, Peninsula plc acquired another 650,000 shares in Badagry Ltd for ₦3.9 million. On 1 June 20X9 the fair value of the 50,000 shares already held was ₦250,000.

Required:

Show the journal entry required in respect of the 50,000 shareholdings on 1 June 20X9 and calculate the goodwill acquired in the business combination on that date assuming that goodwill is valued using the proportion of net assets method.

Solutions:

Journal Entry	₦' 000	₦' 000
Debit Investment in Badagry Ltd (250,000 – 230,000)	20	
Credit Other comprehensive income and equity reserve		20

To recognise the gain on the deemed disposal of the shareholding in Badagry Ltd existing immediately before control being obtained.

Calculation of Goodwill in Respect of 70% (5% + 65%) Holding in Badagry Ltd:

	₦' 000
Consideration transferred	3,900
non-controlling interest (30% × ₦4m)	1,200
Acquisition-date fair value of previously held equity	250
	5,350
Net assets acquired	(4,000)
Goodwill	**1,350**

Illustrative Example 2: Control in Stages – No Previous Significant Influence

Barricade company, whose year-end is 30 June 20X9 has a subsidiary, Pillar company, which it acquired in stages. The details of the acquisition are as follows.

Date	% Holding	Retained at Acquisition	Purchase Consideration
		₦' m	₦' m
1 July 20X7	20	270	120
1 July 20X8	60	450	480

The share capital of Pillar company has remained unchanged since its incorporation at N300 million. The fair values of the net assets of Pillar company were the same as their carrying amounts at the date of the acquisition. Barricade company did not have significant influence over Pillar company at any time before gaining control of Pillar company. The group policy is to measure non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required:

(a) Calculate the goodwill on the acquisition of Pillar company that will appear in the consolidated statement of financial position at 30 June 20X9.
(b) Calculate the profit on the derecognition of any previously held investment in Pillar company to be reported in group profit or loss for the year ended 30 June 20X9.

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Solutions:

(a) Goodwill (at Date Control Obtained)

	₦' m	₦' m
Consideration transferred		480
NCI (20% × 750)		150
Fair value of previously held equity interest (N480m × 20/60)		160
Fair value of identifiable assets acquired and liabilities assumed		
Share capital		300
Retained earnings	450	
	(750)	
	40	

(b) Profit on Derecognition of Investment

	₦' m
Fair value at date control obtained (see part 1)	
160	
Original Cost of investment	
(120)	
	40

23.2.2 Increased Stake in Subsidiary (Control Maintained)

Control to Control (Purchase of Additional Equity Interest After Control Is Achieved)

Where an investor (parent entity) owns a controlling shareholding in the investee (subsidiary entity) and subsequently purchases additional shares, it is simply purchasing the shares from the non-controlling shareholders. This is just a transaction between the owners of the group, which is parent and non-controlling interest. The effect of this additional shares purchased is that the parent's interest will be increasing while the non-controlling interest will be decreasing.

For example, if the parent holds 70% of the shares in a subsidiary and buys 10% more, there is still parent/subsidiary relationship. In this situation, the subsidiary will be consolidated in the group accounts following the normal procedures. The parent is now having 80% interest (i.e. 70% plus 10%) in the subsidiary company while the non-controlling interest has decreased from 30% to 20%.

Accounting for Step Acquisition Where Control is Maintained

Consolidated Statement of Financial position:

The assets and liabilities will still be consolidated line by line
There should be no change in the goodwill to the extent that is has not been impaired.

Non-controlling interest will be reduced

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Post acquisition non-controlling interest will be computed in two steps (post-acquisition NCI based on the former% holding and post-acquisition NCI based on the latter% holding) and these should be summed up.
Cash book will be reduced by the amount of consideration paid to acquire the additional shares (if cash is paid) or share capital and share premium of the parent will be increased if consideration is paid through share exchange.

The other component of equity will be increased or decreased by the difference in the cost incurred to buy additional shares in the subsidiary and the proportion of non-controlling interest that is now acquired by the parent.

The difference that will be taken to equity can be determined as follows:

	₦
Cash paid	x
Transfer from NCI to reduce NCI	(x)
Difference to equity	**(x)**

The transfer from NCI will represent the proportionate reduction in the NCI's equity figure (i.e. the NCI's share of net assets and goodwill under full goodwill) as at the date of the step acquisition which the parent is effectively purchasing from the NCI.

The group equity is adjusted as follows:

Debit:	Non-controlling interests (NCI)
Credit:	Cash/Shares
Debit/Credit:	Reserves (other component of equity)

Illustrative Example 3

On 1 June 20X6, Abuja acquired 70% of the equity of Lokoja in exchange for **N**760,000 cash and 100,000 Abuja shares. At this date the fair value of the identifiable net assets of Lokoja was **N**850,000 and the market value of Abuja shares was **N**2.50. On 31 December 20X8, Abuja acquired a further 10% of the equity of Lokoja at a cost of **N**105,000. On this date the identifiable net assets of Lokoja were **N**970,000. Abuja measures the non-controlling interest using the proportion of net assets method.

Required

(a) What goodwill is recorded in the consolidated statement of financial position at 31 December 20X8, assuming that there is no impairment?
(b) What journal adjustment is required on the acquisition of the further 10% of shares?

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Solutions:

The goodwill included in the statement of financial position at 31 December 20X8 is that goodwill calculated on the initial acquisition in June 20X6:

	₦' 000
Consideration (₦760,000 + (100,000 × ₦2.50))	1,010
Non-controlling interest (30% × ₦850,000)	255
	1,265
Net assets of acquiree	(850)
Goodwill	**415**

The adjustment required is based on the change in the non-controlling interest at the acquisition date:

	₦	₦
NCI on 31 December 20X8 based on old interest (30% × ₦970,000)	291,000	
NCI on 31 December 20X8 based on new interest (20% × ₦970,000)		194,000
Adjustment required		**97,000**

Therefore: the double entry for this is as follows:

Debit:	Non-controlling interest	₦97,000	
Debit:	Shareholders' equity (bal fig)	₦8,000	
Credit:	Cash		₦105,000

Note: Reduction in NCI can be simply calculated as 10% of the Net Asset of Subsidiary (10% of ₦970,000) at 31 December when further acquisition of 10% occurred.

23.2.3 Non-Controlling Interest (NCI)

The NCI in the statement of financial position at the reporting date is based on the percentage holdings at that date.

Group policy might be to measure NCI as a proportionate share of net assets at the acquisition date. In this case the NCI at the reporting date can be easily measured as the NCI share of assets at that date.

If group policy is to measure NCI at fair value at the acquisition date the calculation can be quite tricky. In this case, you have to start with the NCI at the acquisition date and adjust it by the appropriate NCI share of profits since that date. This must be adjusted by NCI share of profits sold at the date of the second purchase by the parent.

Reduction in Non-Controlling Interest During the Financial Year

When parent company buys additional shares in the subsidiary company during the accounting period, the non-controlling interest to be recognised in the statement of financial position and the statement of comprehensive income will be time apportioned as the non-controlling interest percentage will vary over the accounting period that the reduction occurs.

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Illustrative Example 4:

Race course, the parent company owns 80% of a subsidiary company and the non-controlling interest in the subsidiary is currently ₦2,000,000.

(a) Race course, the parent has just acquired the remaining 20% interest of subsidiary paying ₦1,800,000.
(b) Race course has acquired 5% of the subsidiary reducing the non-controlling interest to 15% paying ₦1,600,000.
(c) Race course acquired 80% of the subsidiary at the beginning of the year and at that time the non-controlling interest of the company was ₦1,920,000. On the 1st of October, Race course acquired additional 6% of the subsidiary reducing the non-controlling interest to 14%. The subsidiary company made a profit of ₦800,000 for the year ended on 31 December.

Required:

(a) Calculate the differences that will be recognised in the equity in (a) and (b) above.
(b) Compute the amount of the non-controlling interest to be recognised in the statement of financial position and the statement of profit or loss at the end of the year.

Solutions

(i)

Cash paid	₦1,800,000
Reduction in NCI (20/20 x ₦2,000,000)	₦2,000,000
Difference to equity (increase)	₦200,000

Therefore: the double entry for this is as follows:

Debit:	Non-controlling interest	₦2,000,000	
Credit:	Cash		₦1,800,000
Credit:	Shareholders' equity (difference)		₦200,000

Cash paid	₦1,600,000
Reduction in NCI (5/20 x ₦2,000,000)	₦500,000
Difference to equity (decrease)	₦1,100,000

Therefore: the double entry for this is as follows:

Debit:	Non-controlling interest	₦500,000	
Debit:	Shareholders' equity	₦1,100,000	
Credit:	Shareholders' equity (difference)		₦1,600,000

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(ii)

Non-Controlling Interest (For the Statement of Financial Position)

		₦
Non-controlling interest at acquisition date 1st of January		1,920,000
NCI% of the post-acquisition period (9 months)		
(20% of ₦800,000 x 9/12)	120,000	
Balance of the non-controlling interest before reduction	**2,040,000**	
Reduction in non-controlling interest (6/20 x ₦2,040,000)		(612,000)
Balance of non-controlling interest after reduction		**1,428,000**
Non-controlling in the profit for the year interest after the reduction		
(14% of ₦800,000 x 3/12)		28,000
Non-controlling interest at the year-end 31st December	**1,456,000**	

Profit for the Year Attributable To Non-Controlling Interest (Statement of Profit or Loss and Other Comprehensive Income)

NCI% of the post-acquisition period (9 months) before reduction		
(20% of ₦800,000 x 9/12)	120,000	
NCI% of the post-acquisition period (3 months) after reduction		
(14% of ₦800,000 x 3/12)	28,000	
		148,000

23.2.4 Consolidated Retained Earnings

This must be calculated in the usual way by adding the parent's share of the subsidiary's post-acquisition retained profits to those of the parent but remembering to make the equity adjustment.

23.2.5 Effect of IFRS 9 on Previously Held Equity That Is Accounted for at Fair Value Through Other Comprehensive Income

The previously held equity can be associate, joint venture or financial assets. No problem arises if the previously held equity is either associate or joint venture.

However, where the previously held investment has been classified and accounted for as a fair value through other comprehensive income, gains or losses arising on the fair value at the end of every reporting period must have been recognised in reserves and so reported in the other comprehensive income.

When there is a step acquisition, the previously recognised gain in reserves should be transferred to retained earnings as a movement on reserves and should not be recycled to the statement of profit or loss

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23.3 Pattern of ownership in the consolidated statement of profit or loss

23.3.1 Introduction

The pattern of ownership must be reflected in the statement of profit or loss and other comprehensive income.

A change in ownership in the period will have an impact on the consolidated statement of profit or loss and other comprehensive income

Illustration on pattern of ownership

Situation	Approach
Lump sum acquisition i.e., acquisition made once to gain control with no subsequent acquisition	Consolidate from the acquisition date Note: If the subsidiary is acquired before the financial year under consideration or at the beginning of the financial year, the operating results of the subsidiary should be consolidated with that of the parent in full. If the subsidiary company is acquired during the financial year, the operating results of the subsidiary should be time-apportioned and therefore be consolidated with that of the parent.
Step acquisition achieving control for the first time	The approach is similar to full acquisition.
Step acquisition after control has been achieved	Consolidate the statement of profit or loss for the whole year. Calculate NCI in 2 steps: NCI using the old% interest and NCI using the new% interest. The two NCIs will be summed up.
Step acquisition changing the significant influence to control	Here, equity method and acquisition method will be applied to the different period: Calculate share of the investor's profit in associate from the beginning of the year to the date when the investor gains control. Consolidate time-apportioned operating result of the subsidiary with the parent from the date the parent gains control.

23.3.2 Step acquisition

Situation 2: In this case the parent had a previously held equity interest. This gave the parent no influence. Control was achieved by the second acquisition and consolidation commences from that point.

Illustrative Example 5: Step Acquisition

H has owned 10% of S for several years

H bought a further 60% of S on September 30, 2021.

Statements of profit or loss for the year ended 31 December 31, 2021:

	H	S
	₦	₦
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)
Gross Profit	**3,000**	**1,200**
Expenses	(1,000)	(300)
Profit before tax	**2,000**	**900**
Tax expense	(500)	(160)
Profit	**1,500**	**740**

A Consolidated Statement of Comprehensive Income can be prepared as follows:

	₦
Revenue (10,000 + (3/12 of 6,000)	11,500
Cost of sales (7,000 + (3/12 of 4,800)	(8,200)
Gross profit	**3,380**
Expenses (1,000 + (3/12 of 300)	1,075
Profit before tax	**2,225**
Income tax expense (500 + (3/12 of 160)	(540)
Profit	**1,685**

Total comprehensive Income attributable to:

Owners of the parent (balancing figure)	1,629
Non-controlling interest (3/12 x 30% x 740)	56
	1.685

23.3.3 Purchase of Additional Equity Interest After Control is Achieved

Situation 3: In this case the parent has a subsidiary for the whole year. Therefore, the results of that subsidiary must be consolidated for the whole year. However, the pattern of ownership changes during the year. The pattern of ownership is reflected in the statement of profit or loss by applying the appropriate NCI to the results for that part of the year in which that NCI was valid.

Ilustrative example 6:
H has owned 60% of S for several years
H bought a further 10% of S on 30th September 30, 20X1.

Statements of Profit or Loss for the year ended December 31, 2021:

	H	S
	₦	₦
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)

Gross Profit		**3,000**		**1,200**
Expenses	(1,000)		(300)	
Profit before tax		**2,000**		**900**
Income tax expense	(500)		(160)	
Profit for the year	**1,500**		**740**	

A consolidated statement of comprehensive income can be prepared as follows:

	₦	
Revenue (10,000 + 6,000)	16,000	
Cost of sales (7,000 + 4,800)	(11,800)	
Gross profit		**4,200**
Expenses (1,000 + 300)		1,300
Profit before tax	**2,900**	
Income tax expense (500 + 160)	(660)	
Profit		**2,240**

Total comprehensive Income attributable to:

Owners of the parent (balancing figure)		1,962
Non-controlling interest:		
(40% x 9/12 x 740) plus (30% x 3/12 x 740)	278	
		2,240

23.3.4 Purchase Turning Significant Influence into Control

Situation 4: In this case the parent had significant influence in the first part of the years and then made an acquisition which achieved control. The results for the year must be split into two parts. The results for the period in which the parent had significant influence must be equity accounted. The results for the period in which the parent had control must be consolidated.

Illustrative Example 7: Step Acquisition (Associate to Subsidiary)

H has owned 40% of S for several years. This holding gave H significant influence over S.
H bought a further 30% of S on September 30, 20X1.

Statements of Profit or Loss for the year ended December 31, 20X1:

	H		S	
	₦		**₦**	
Revenue	10,000		6,000	
Cost of sales		(7,000)		(4,800)
Gross Profit		**3,000**		**1,200**
Expenses		(1,000)		(300)
Profit before tax	**2,000**		**900**	
Income tax expense		(500)		(160)
Profit		**1,500**		**740**

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A Consolidated Statement of Comprehensive Income can be prepared as follows:

		₦
Revenue (10,000 + (3/12 of 6,000)	11,500	
Cost of sales (7,000 + (3/12 of 4,800)	(8,200)	
Gross profit		**3,380**
Expenses (1,000 + (3/12 of 300)		(1,075)
Share of profit of associate (40% x 9/12 x 740)	222	
Profit before tax	**2,447**	
Income tax expense (500 + (3/12 of 160)	(540)	
Profit		**1,907**
Total comprehensive Income attributable to:		
Owners of the parent (balancing figure)		1,861
Non-controlling interest (3/12 x 30% x 740)	56	
		1,907

23.4 Chapter review

Key points recap

Crossing the 50 percent threshold triggers acquisition accounting, re-measurement of the old holding, and recognition of goodwill.

Gain or loss on deemed disposal equals fair value of the old holding minus its carrying amount, and is reported in profit or loss.

Subsequent purchases that keep control are owner transactions, affect equity only, and do not change goodwill.

The **pattern of ownership** must be reflected in both profit allocation and NCI calculations for each part of the year.

When a financial-asset investment classified under IFRS 9 becomes a subsidiary, **previous OCI gains are transferred to retained earnings** and not recycled through profit or loss.

23.6.2 Self-test questions

No.	Scenario	Requirement
1	**Step acquisition to control:** Parent buys 25 percent of Delta for ₦150 million (fair value ₦150 million) on 1 Jan 20X8, then a further 55 percent for ₦500 million on 1 Oct 20X8 when Delta's net assets fair value is ₦620 million and the earlier holding is worth ₦170 million. NCI is measured at fair value ₦140 million.	(a) Gain or loss on deemed disposal, (b) goodwill at acquisition.
2	**Extra shares after control retained:** Parent already owns 65 percent of Echo. On 31 Dec 20X8 it buys another 15 percent for ₦90 million when Echo's net assets stand at ₦420 million.	Calculate the equity adjustment and updated NCI.
3	**Pattern of ownership impact:** Parent holds 45 percent of Foxtrot (associate) until 30 Sep 20X8, then buys a further 25 percent achieving control. Foxtrot's	Draft the consolidated statement of profit or loss extract, showing revenue to

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No.	Scenario	Requirement
	post-tax profit for the year is ₦120 million earned evenly.	profit after tax and profit attribution.

23.6.3 Outline Solutions

Gain on deemed disposal = ₦170 million − ₦150 million = ₦20 million;
Goodwill = ₦500 million + ₦170 million + ₦140 million − ₦620 million = ₦190 million.

Equity adjustment: cash ₦90 million vs reduction in NCI (15% × ₦420 million = ₦63 million) ⟶ debit NCI ₦63 million, debit group reserves ₦27 million, credit cash ₦90 million.

Consolidate Foxtrot's results from 1 Oct to 31 Dec: include 3/12 of revenue and expenses; recognise share of associate profit 45% × 9/12 × ₦120 million = ₦40.5 million; allocate NCI on 3 months' profit at 30 percent.

This review consolidates the core rules, provides practice scenarios, and helps you internalise the pragmatic steps for accounting and reporting business combinations achieved in stages.

23.5 End of chapter questions and suggested solutions

23.5.1 Questions

Question 1: Highland

On January 1, 2016 The Highland Company acquired 30% of the ordinary share capital of the Lowland Company by the issue of one million shares with a fair value of ₦4.00 each. From that date Highland did not exercise significant influence over Lowland, and accounted for the investment at fair value with changes in value included in profit or loss. At January 1, 2016 the net assets of Lowland had a carrying amount of ₦6.4 million and a fair value of ₦7.2 million.

On March 1, 2017, Highland bought a further 50% of the ordinary share capital of Lowland by issuing a further 2 million shares with a fair value of N5.00 each. At that date the net assets of Lowland had a carrying amount of ₦7.8 million and a fair value of ₦8.4 million. The noncontrolling interest had a fair value of ₦2 million, and the 30% interest already held by Highland had a fair value of ₦3 million.

Highland values the non-controlling interest using the full goodwill method.

Required:
Calculate the goodwill figure in the consolidated statement of financial position at 31 December 31, 2017, in accordance with IFRS 3, *Business Combinations*?

Question 2:

On January 1, Year 9, Somolu acquired 70% of the equity shares of Bariga for N450 million. The fair value of the identifiable net assets in Bariga at that date was N600 million. The fair value of the NCI at 1 January Year 9 was N264 million. Somolu subsequently acquired another 10% of the equity shares of Bariga on December 31, Year 9 for N102 million. The carrying value of the net assets of Bariga at December 31, Year 9 was N670 million. Somolu wishes to use the full goodwill method for consolidation.

Required:
Calculate the difference arising that will be taken to equity for each situation.

Question 3

Jackson, a public limited company, has acquired the following shareholdings in Gilbert a public limited company.

Data of Acquisition	**Holding Acquired**	**Fair Value of Net assets**	**Purchase Consideration**
Gilbert	**₦'m**	**₦'m**	
June 1, 2013	30%	40	15
June 1, 2014	50%	50	30

The following statements of financial position relate to Jackson and Gilbert at May 31, 2015:

	Jackson		**Gilbert**	
Assets		**₦' m**		**₦' m**
Property, plant and equipment	300		40	
Investment in Gilbert	45		–	
Current assets		122		20
Total Assets		**467**		**60**
Equity and Liabilities				
₦1 Equity share capital		100		10
Share premium account		50		20
Retained earnings	132		16	
Other components of equity	15		–	
Total Equity		**297**		**46**
Non-current liabilities		60		4
Current liabilities	110		10	
Total Equity and Liabilities	**467**		**60**	

The following information is relevant to the preparation of the group financial statements of the Jackson Group:

Gilbert has not issued any new share capital since the acquisition of the shareholdings by Jackson. The excess of the fair value of the net assets of Gilbert over their carrying amounts at the dates of acquisition is due to an increase in the value of Gilbert's non-depreciable land of ₦10 million at June 1, 2013 and a further increase of ₦4million at June 1, 2014. There has been no charge in the value of non-depreciable land since June 1, 2014.

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Before obtaining control of Gilbert, Jackson did not have significant influence over Gilbert. Jackson has accounted for the investment in Gilbert at market value with changes in value being recorded in profit or loss. The market price of the shares of Gilbert at June 1, 2014 had risen to ₦6 per share as there was speculation regarding a takeover bid. This impact has not yet been accounted for.

At June 1, 2014 the fair value of the non-controlling interest in Gilbert was ₦11 million.

Goodwill has been tested for impairment and is not impaired.

Required:
Prepare the consolidated statement of financial position of the Jackson Group as at May 31, 2015 in accordance with IFRS 3 Business Combinations.

23.5.2 Suggested solutions

Solution 1

	₦' 000
Consideration transferred	10,000
Non-controlling interest (fair value)	2,000
Fair value of retained interest	3,000
	15,000
Fair value of net assets of Lowland	(8,400)
Goodwill	**6,600**

Solution 2

At January 1, Year 9

Using the full goodwill method, the purchased goodwill at January 1, Year 9, when the original 70% of the shares in Bariga were acquired, is calculated as follows:

	₦'m	
Purchase consideration for shares at January 1, Year 9	450	
Fair value of NCI at January 1, Year 9	264	
	714	
Fair value of net assets acquired	600	
Purchased goodwill		**114**

When the additional 10% of shares are purchased from NCI on December 31, this is treated as an 'equity transaction' or 'treasury transaction' between equity interests in the group, and there is no alteration to the goodwill.

However, the NCI has been reduced from 30% to 20%, resulting in a reduction in NCI by 10%/30% = 1/3.

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	₦'m	
Fair value of NCI at 1 January Year 9	264	
NCI share of retained profits 1 January - 31 December		
= 30% × (670 – 600)		21
NCI net asset at 31 December		
(before share sale)	285	
Transfer to equity of Somolu equity shareholders (10/30)	(95)	
NCI: Balance at December 31 after share sale	**190**	

The consideration paid for the extra 10% of the shares was ₦102 million.

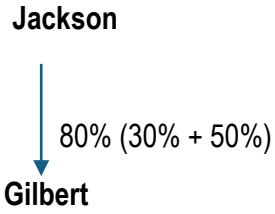
There is an adjustment to the equity attributable to Somolu shareholders, as follows:

	₦'m
Consideration paid	(102)
Equity transfer from NCI	95
Reduction in equity attributable to Somolu shareholders	**(7)**

Solution 3

ASSETS	**₦' million**
Non-current assets	
Property plant and equipment (300 + 40) + 14 (w2)	354
Goodwill (w3)	9
Current assets (122 + 20)	142
Total Assets	**505**
Equity and liabilities	
Equity share capital	100
Share Premium	50
Retained earnings (w5)	143
Other components of equity	15
Total equity	**308**
Non-controlling interest (w4)	13
Non-current liabilities (60 + 4)	64
Current liabilities (110 + 10)	120
Total equity and liabilities	**505**

Working 1 Group structure



Originally, Jackson paid ₦15 million for 3 million shares in Gilbert. This was 30% of 10 million shares owned by Gilbert.

To acquire those 3 million shares on June 1, 2023, (the date Jackson gained control), Jackson paid ₦18 million (3 million shares multiply by ₦6 market price per share on that date).

There is a need to calculate profit on deemed disposal and this is as follows:

	₦'m
Fair value of equity previously held	18
Less:	
Carrying value of equity previously held	15
Gain to be added to group retained earnings	**3**

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Working 2 **Net assets of subsidiary**

Gilbert	At Reporting date ₦' m	At Acquisition date ₦' m
N1 Equity share capital	10	10
Share premium	20	20
Retained earnings	16	6
	46	36
Fair value adjustments		
Land	14	14
Less depreciation on FV adjustments	-	-
	60	50

Working 3 **Computation of goodwill**

	₦'m
Cost of investment (45 + 3)	48
NCI at acquisition date	11
	59
Net asset of Subsidiary at acquisition date (W2)	(50)
Goodwill at acquisition and reporting date	**9**

Working 4 **Computation of non-controlling interest**

	₦'m
NCI at acquisition date (45 + 3)	11
NCI share of post-acquisition reserves (20% * (60 – 50)	2
	13

Working 5 Computation of group retained earnings

	N'm
Parent retained earnings	132
Parent's share of subsidiary's retained earnings (80% * 60 – 50)	8
Profit on deemed disposal of equity previously held on step acquisition	3
	143

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Professional Level

Strategic Business Reporting

CHAPTER 24

DISPOSAL OF SUBSIDIARIES

Contents

24.0	Learning objective
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24.3	Part disposals
24.4	Disposal of a subsidiary which does not contain a business
24.5	IFRS 5 and Disposals
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24 Disposal of Subsidiaries

24.0 Learning objective

This chapter discusses full and partial disposals of subsidiaries, whether or not the disposal meets the IFRS 5 discontinued-operation criteria, in both the parent's separate and the group financial statements.

24.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. **Calculate group-level profit or loss on disposal** of a subsidiary, including the impact of goodwill, non-controlling interest (NCI) and any residual investment.

b. **Prepare the consolidated statement of profit or loss** that reflects the correct pattern of ownership up to the date control is lost.

c. **Draft group financial statements when the disposal qualifies as a discontinued operation** under IFRS 5, showing separate disclosure of continuing and discontinued results.

d. **Distinguish accounting treatments for:**

   (i) a full disposal versus a part disposal that results in loss of control; and

   (ii) a part disposal after which control is retained (equity adjustment through OCI).

e. **Analyse strategic and reporting implications** of selling under-performing or non-aligned subsidiaries, including disclosure of gains, losses and reclassification adjustments.

f. **Apply IFRS 10 and IFRS 5 principles** to compute and present proceeds, carrying amounts, and recycling of OCI items (e.g. foreign-currency translation reserves) on disposal.

24.2 Full Disposal

24.2.1 Introduction

A parent company might dispose of all or some of its holding in a subsidiary. A parent may dispose of its holding in a subsidiary for the following reasons:

(a) The need to generate cash.

(b) underperformance of the subsidiary.

(c) the subsidiary may not fit in with the future strategic plans of the parent.

When such disposal – part or full – occurs, it needs to be accounted for in the parent's separate financial statements as well as in the group financial statements.

IFRS 10 Consolidated Financial Statements contains rules on accounting for disposals of a subsidiary.

Accounting for a disposal is an issue that impacts the statement of profit or loss.

There are two major tasks in constructing a statement of profit or loss for a period during which there has been a disposal of a subsidiary:

(a) The statement of profit or loss must reflect the pattern of ownership of subsidiaries in the period.

(b) When control is lost, the statement of profit or loss must show the profit or loss on disposal of the subsidiary.

The rules in IFRS 10 cover full disposals and part disposals. When a parent makes a part disposal of an interest in a subsidiary it will be left with a residual investment. The accounting treatment for a part disposal depends on the nature of the residual investment.

If a part disposal results in loss of control the parent must recognise a profit or loss on disposal in the consolidated statement of profit or loss.

A part disposal which does not result in loss of control is a transaction between the owners of the subsidiary. In this case the parent does not recognise a profit or loss on disposal in the consolidated statement of profit or loss. Instead, the parent recognises an equity adjustment.

Treatment of complete disposal in company's own financial statements

Profit or loss will be calculated by comparing the carrying amount of the investment with the proceed from the disposal of the investment

Recording the disposal

The disposal of the investment should be treated as a non-current asset disposal, which will result in profit or loss on disposal in the parent's separate financial statements. The accounting entry to record the disposal is:

	₦	₦
DR Cash/receivables (proceeds)	X	
CR Investment in S (carrying amount)		X
DR or CR Profit or loss (loss/profit on disposal)	X or	X

Illustrative Example 1:

Champion plc has held a 70% investment in Hercules Ltd for many years. On December 31, it disposed of all of this investment. Further details are as follows:

	₦
Consideration transferred on acquisition	2,000
Fair value of the identifiable assets acquired and liabilities assumed by Champion plc at the date of acquisition	1,900
Sale proceeds	2,100
Hercules Ltd.'s net assets at the date of disposal	2,400

Champion plc elected to measure non-controlling interests using the proportionate basis.

Required:

Calculate the profit/loss on disposal in Champion plc's individual accounts assuming that the investment is carried at cost.

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Suggested Solutions:

Champion Plc's Individual Accounts

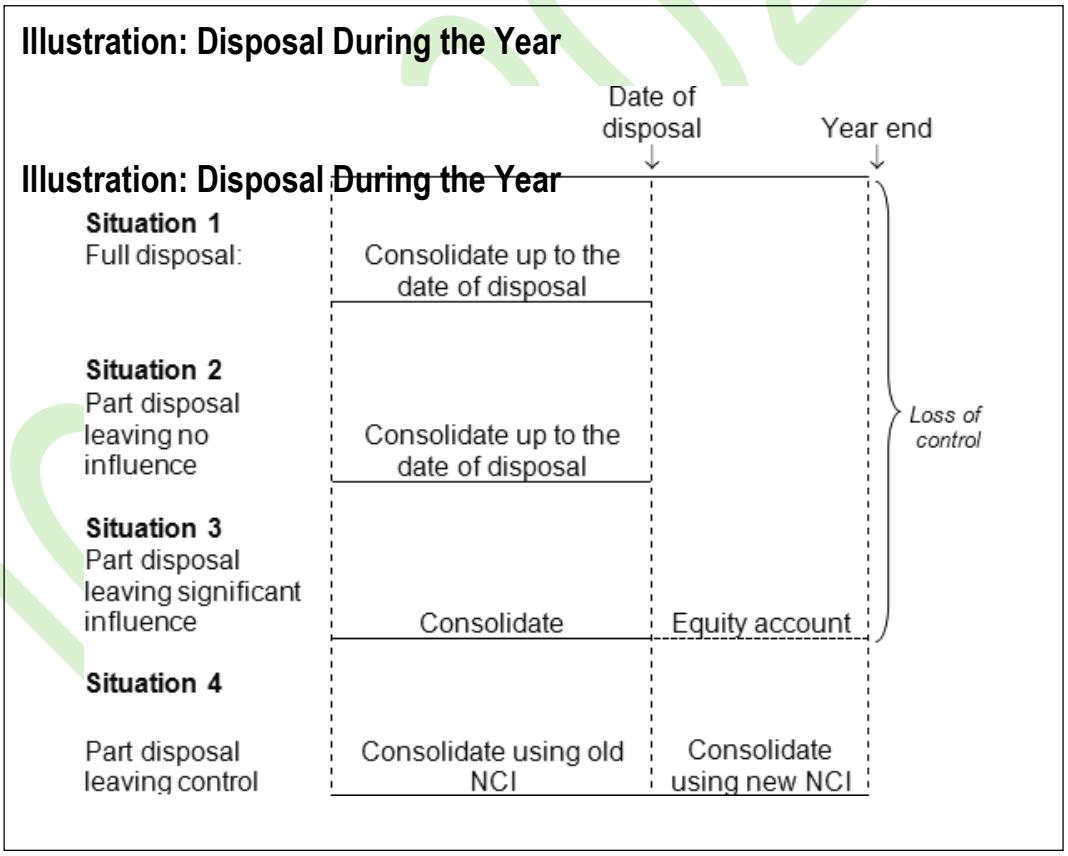
	₦
Proceeds	2,100
Cost	(2,000)
Profit on disposal	**100**

Pattern of ownership

The pattern of ownership in a period is always reflected in the consolidated statement of profit or loss.

IFRS 11 requires that an interest in a subsidiary is consolidated from the date of acquisition to the date of disposal.

Illustration: Disposal During the Year



An interest in an associate must also be equity accounted from the date that significant influence is achieved to the date that it is lost.

Thus, the figures from the statement of profit or loss and other comprehensive income that relate to the period up to the date of disposal must be identified. In practice, this would normally be achieved by constructing a set of accounts up to the date of disposal. In exam questions we tend

to use time apportionment.

There is another reason for consolidating up to the date of disposal. The calculation of the profit on disposal involves comparing the sale proceeds to what leaves the statement of financial position as at the date of disposal. Therefore, the results of the subsidiary must be consolidated up to the date of disposal in order to establish the correct net assets figure.

Treatment of Complete Disposal in Group Financial Statements

The parent's investment in the subsidiary is the sum of:
(a) The consolidated carrying amount of the subsidiary's net assets at the date of disposal; plus
(b) Goodwill at acquisition (less any impairments); less
(c) The non-controlling interest at the date of disposal

The profit or loss on disposal is calculated as follows:

	₦	₦
Proceeds		X
Less: amounts recognised before disposal:		
net assets of subsidiary	X	
goodwill	X	
non-controlling interest	(X)	
		(X)
Profit/loss		**X/(X)**

The calculation of profit or loss on disposal must be supported by several other calculations such as:
(a) the goodwill arising on acquisition, which in turn needs the net assets of the subsidiary at the date of acquisition; and
(b) the net assets of the subsidiary at the date of disposal, which in turn needs a calculation of the equity reserves at the date of disposal.

However, if the disposal was made during the year, working will be required to calculate both net assets and the non-controlling interest at the disposal date; and any dividends declared or

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paid in the year of disposal and before the disposal date must be deducted from the net assets of the subsidiary if they have not already been accounted for.

Illustrative example 2: Mid-year disposal

Kingdom acquired 80% of Westville on January 1, 2015 for ₦280,000 when Westville had share capital of ₦100,000 and retained earnings of ₦188,000. On this date the fair value of the non-controlling interest was ₦67,000. Kingdom's policy is to value the non-controlling interest using the fair value (i.e., full goodwill) method. Goodwill has suffered no impairment since acquisition.

On June 30, 2018, Kingdom disposed of its investment in Westville, raising proceeds of ₦350,000. The following are extracts from the accounts of Westville for the year ended December 31, 2018:

	₦'000
Retained earning b/f	215
Profit for the year	24

A final dividend for 2017 of ₦10,000 was paid on March 14, 2018. This has not yet been accounted for.

Required:

What profit or loss on disposal of Westville is reported in the Kingdom group accounts for the year ended December 31, 2018?

Suggested solutions:

Profit on disposal

	₦
Proceeds	**350,000**
***Less:* Amounts recognised before disposal**	
Net assets of Westville (₦100,000 + ₦215,000 + ½ × ₦24,000 – ₦10,000)	317,000
Goodwill (₦280,000 + ₦67,000) – (₦100,000 + ₦188,000)	59,000
NCI at disposal	
- Share of net assets (20% × ₦317,000)	(63,400)
- Goodwill on acquisition (₦67,000 – 20% × ₦288,000)	(9,400)
Total amounts recognised before disposal	**303,200**
Profit on disposal	**46,800**

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Illustrative example 3:

Champion plc has held a **70% investment in Hercules Ltd** for many years. On **December** 31 Champion plc disposed of **all** of this investment. The relevant figures are:

Description	₦'000
Consideration transferred on acquisition	2,000
Fair value of the identifiable assets acquired and liabilities assumed by Champion plc at the date of acquisition	1,900
Sale proceeds	2,100
Hercules Ltd's net assets at the date of disposal	2,400

Champion plc elected to measure **non-controlling interests (NCI) using the proportionate basis.**

Required

(a) **Calculate the profit or loss on disposal** in Champion plc's **individual** accounts, assuming the investment is carried at cost.

(b) **Calculate the profit or loss on disposal** in the **consolidated** accounts, assuming that in respect of goodwill:

(i) There has **been no impairment**.

(ii) There has **been an impairment loss of ₦470**.

Step-by-step approach — Extract

Step 1: Reflect the pattern of ownership

Construct a pro-forma answer with columns for the parent, the subsidiary and the consolidated figures. Enter the figures to be consolidated, remembering to pro-rate the subsidiary's figures up to the date of disposal, and add across to give the consolidated figures. The non-controlling interest can be calculated from the subsidiary's column.

Step 2: Construct the following workings:

(a) Net assets summary as at the date of disposal and the date of acquisition

(b) Retained earnings as at the date of disposal (for the above)

(c) Goodwill arising on acquisition (using the net assets at the date of acquisition from the net assets summary)

Step 3: Calculate the profit or loss on disposal

Step 4: Include the profit or loss on disposal in the consolidated statement of profit or loss and finish it off.

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CHAMPION PLC – Disposal of the Whole 70% Holding in Hercules Ltd
(All amounts in **₦'000** and rounded to the nearest whole thousand)

(a) Profit/(Loss) on Disposal in Champion Plc's *Individual* (Separate-Entity) Books

Carrying amount of the investment is its original cost; because the cost model is used there is no subsequent re-measurement.

	₦'000
Sale proceeds	**2,100**
Less: cost of the investment	(2,000)
Profit on disposal (separate financial statements)	**100**

(b) Profit/(loss) on Disposal in the *Consolidated* Financial Statements

Step 1 Goodwill at Acquisition

	₦'000
Consideration transferred (parent's cost)	2,000
Less: parent's share (70%) of identifiable net assets at acquisition (70% × 1,900)	(1,330)
Goodwill initially recognised	**670**

*Because the NCI was measured on the **proportionate share** basis, the NCI's share of goodwill is **nil**.*

Step 2 Net assets and NCI at the date of disposal

	₦'000
Hercules Ltd net assets at disposal	2,400
Parent's share (70%)	1,680
NCI (30%)	**720**

Step 3 Carrying amount of goodwill at disposal

a. Scenario (1) **no impairment** → carrying goodwill = 670

b. Scenario (2) **impairment loss of 470 already recognised** → carrying goodwill = 670 – 470 = **200**

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Step 4 Profit/(Loss) on Disposal

Formula (IFRS 10):
Proceeds + NCI derecognised + fair value of any retained interest – (carrying amount of subsidiary's net assets + carrying goodwill)

There is no retained interest (100% disposed).

	Scenario (1) no impairment	Scenario (2) impairment
Sale proceeds	2,100	2,100
+ NCI derecognised	**+ 720**	**+ 720**
Sub-total	**2,820**	**2,820**
– Net assets at disposal	(2,400)	(2,400)
– Goodwill carrying amount	**(670)**	**(200)**
Profit/(loss) on disposal (group)	**(250) Loss**	**220 Profit**

Summary of results

	Separateentity	Consolidated – scenario (1)	Consolidated – scenario (2)
Profit/(loss) on disposal	**₦ 100 profit**	**₦ 250 loss**	**₦ 220 profit**

These figures would be reported in the statement of profit or loss of the parent (individual accounts) and of the group, respectively, with the consolidated gain or loss presented within "profit on disposal of subsidiary" and classified as continuing operations because the subsidiary does not necessarily meet the IFRS 5 criteria for discontinued operations.

Illustrative example 4: Disposal of subsidiary (All figures in ₦'000)

Individual statements of profit or loss (Year-end December 31, 20X4)

	H (Plc)	S Ltd
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400)	(2,150)
Profit after tax	**7,550**	**1,650**

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Statement of changes in equity

	H (Plc)	S Ltd
Retained earnings b/f	3,760	1,850
Profit after tax (see above)	7,550	1,650
Retained earnings c/f	**11,310**	**3,500**

Additional information

i. H plc purchased **90%** of S Ltd four years ago for **₦ 3,750** when S Ltd's retained earnings were **₦ 500**; share capital of S Ltd is **₦ 3,000**.
ii. The entire holding was sold on **September 30, 2014** for **₦ 9,500**.
i. S Ltd does **not** meet IFRS 5's criteria for a discontinued operation.

Required:

Prepare the consolidated statement of profit or loss for the year ended December 31, 2014.

Suggested Solutions:

Reflect the Pattern of Ownership (9 Months of S Ltd)

	H (Plc)	S Ltd (9/12)	Group
Revenue	22,950	6,600	**29,550**
Expenses	(10,000)	(3,750)	**(13,750)**
Operating profit	12,950	2,850	**15,800**
Profit on disposal (W4)	–	–	***3,421**
Profit before tax	**12,950**	**2,850**	**19,221**
Tax	(5,400)	(1,612)	**(7,012)**
Profit after tax	**7,550**	**1,238**	**12,209**

*Non-controlling interest (NCI) on current-year profit: 10% × 1,238 = **₦ 124**.*

Supporting workings

W1 – Net-assets summary (S Ltd)

	At Disposal	At Acquisition
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net assets	**6,088**	**3,500**

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W2 – Retained earnings at date of disposal

	₦'000
Opening retained earnings	1,850
Profit to disposal date (9/12 × 1,650)	1,238
Retained Earnings at Disposal	**3,088**

W3 – Goodwill on acquisition

	₦'000
Cost of investment	3,750
NCI at acquisition (10% × 3,500)	350
Deemed consideration	**4,100**
Less: net assets at acquisition	(3,500)
Goodwill	**600**

W4 – Profit on disposal*

	₦'000
Sale proceeds (i)	**9,500**
Derecognised amounts:	
Net assets (W1)	(6,088)
Add back: NCI at disposal (10% × 6,088)	+ 609
Goodwill (W3)	(600)
Net assets & goodwill removed (ii)	**(6,079)**
Profit on disposal (I – ii)	**3,421**

Consolidated statement of profit or loss (H Plc Group)
for the year ended 31 December 20X4

	₦'000
Revenue	29,550
Expenses	(13,750)
Operating profit	**15,800**
Profit on disposal (W4)	3,421
Profit before tax	**19,221**
Tax	(7,012)
Profit after tax	**12,209**

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Profit attributable to:	
- Owners of the parent (balancing figure)	12,085
- Non-controlling interest (10% × 1,238)	124
Profit for the year	**12,209**

Note: These extracts present the key figures and workings exactly as they appear in the illustrative answer, laid out for easy reference when tackling similar disposal-of-subsidiary questions under IFRS 10 & IFRS 3.

24.3 Part disposals

Part disposal with Loss of Control (Subsidiary to Associate)

As stated previously there are two major tasks in constructing a statement of profit or loss for a period during which there has been a disposal of a subsidiary:

(a) The statement of profit or loss must reflect the pattern of ownership of subsidiaries in the period.
(b) When control is lost, the statement of profit or loss must show the profit or loss on disposal of the subsidiary.

When a parent makes a part disposal of an interest in a subsidiary it will be left with a residual investment. The accounting treatment for a part disposal depends on the nature of the residual investment.

Investment in a subsidiary may be disposed of such that an associate holding is retained e.g. a 90% holding in a subsidiary is reduced to a 35% holding. If a part disposal results in loss of control the parent must recognise a profit or loss on disposal in the consolidated statement of profit or loss.

Gain or Loss on Disposal

(loss of significant influence scenario)

	₦
Proceeds	X
Fair value of interest retained	X
Total consideration (i)	**X**
Net assets of subsidiary recognised before disposal:	
– Net assets	X
– Goodwill	X
– Non-controlling interest	(X)
Total net assets derecognised (ii)	**(X)**
Profit/(Loss) on Disposal	**X/(X)**

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Illustrative Example 5: Example: Profit on part disposal of a subsidiary

Allister Group acquired a 75% holding in Brown in 20X0, which it held until 31 December 20X8 when two-thirds of the investment were sold for N490,000. At this date the net assets of Brown were N800,000, goodwill arising on acquisition had been fully impaired and the fair value of a 25% interest in Brown was N220,000. The non-controlling interest is valued using the proportion of net assets method.

Required:
What gain or loss arises on the disposal in the Allister Group accounts in the year ended 31 December 20X8?

Allister Group – part-disposal of Brown Ltd (31 December 20X8)
(two–thirds of the 75% holding sold; 25% interest retained)

	₦'000
Proceeds from sale	490,000
Fair value of 25% interest retained	220,000
Total consideration (i)	**710,000**
Less : amounts derecognised	
– Net assets of Brown Ltd	(800,000)
– Goodwill (already fully impaired)	–
– NCI at disposal (25% × ₦800,000)	(200,000)
Total net assets & NCI removed (ii)	**(600,000)**
Gain on Part-Disposal (i - ii)	**110,000**

Decomposition of the Total Gain

	₦'000
Realised Gain	
Proceeds on disposal	490,000
- Carrying value of interest sold (50% × ₦800,000)	(400,000)
Realised Gain (i)	**90,000**
Holding (Remeasurement) Gain	
Fair value of 25% interest retained	220,000
- Carrying value of retained interest (25% × ₦800,000)	(200,000)
Holding Gain (ii)	**20,000**
Total Gain Recognised in Profit or Loss (i – ii)	**110,000**

*The residual 25% holding in Brown Ltd is accounted for at its fair value of **₦ 220,000** in the consolidated statement of financial position as at 31 December 20X8.*

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Illustrative Example 6: Part Disposal (Loss of Control, But Leaving Significant Influence)

The following financial statements are to the year-end December 31, 2014

	H	S
Statements of Profit or Loss	**₦ 000**	**₦ 000**
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	**12,950**	**3,800**
Tax	(5,400)	(2,150)
Profit after tax	**7,550**	**1,650**

	H	S
Statement of Changes in Equity	**₦ 000**	**₦ 000**
Retained Earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained Earnings c/f	**11,310**	**3,500**

Additional Information:

(a) H plc bought **90%** of S Ltd four years ago for **₦ 3,750,000** when the retained earnings of S Ltd were **₦ 500,000**. S Ltd has share capital of **₦ 3,000,000**.

(b) H plc sold **50%** of S Ltd on **September 30, 2014** for **₦ 5,000,000**.

(c) The remaining **40%** investment in S Ltd held by H plc resulted in H plc having **significant influence** over S Ltd. This residual investment was estimated to have a **fair value of ₦ 3,500,000**.

(d) S Ltd does **not** qualify to be treated as a **discontinued operation** under IFRS 5.

Required:

Prepare the consolidated statement of profit or loss for the year ended **December 31, 20X4**.

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Suggested Solutions:

H plc Group
Consolidated statement of profit or loss
for the year ended 31 December 20X4
(all amounts in ₦'000)

	H (Parent)	S Ltd (9 months)	Group
Revenue	22,950	6,600	**29,550**
Expenses	(10,000)	(3,750)	**(13,750)**
Operating profit	12,950	2,850	**15,800**
Share of profit of associate (40% × ₦ 412)	–	–	**165**
Gain on disposal of subsidiary (W4)	–	–	**2,421**
Profit before tax	**12,950**	**2,850**	**18,386**
Tax (H + 9 months of S)	(5,400)	(1,612)	**(7,012)**
Profit for the year	**7,550**	**1,238**	**11,374**

	₦'000
Profit attributable to:	
- Owners of the parent (balancing figure)	11,250
- Non-controlling interest (10% × ₦ 1,238)	**124**
Profit for the year	**11,374**

Key Workings

W1 Net-Asset Summary of S Ltd at 30 September 20x4 (Date of Disposal)

	₦'000
Share capital	3,000
Retained earnings:	
b/fwd	1,850
Profit Jan-Sep (9/12 × 1,650)	1,238
Net assets at disposal date	**6,088**

W2 Goodwill at acquisition (no impairment)

	₦'000
Consideration transferred (cost)	3,750
Parent's share of net assets at acquisition (90% × 3,500)	(3,150)
Goodwill	**600**

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W3 Non-controlling interest (NCI) at disposal

	₦'000
10% × net assets at disposal (10% × 6,088)	**609**

W4 Gain on loss of control

	₦'000
Proceeds on disposal (50% of shares)	5,000
Fair value of 40% interest retained	3,500
Carrying amount of NCI derecognised (W3)	+ 609
Subtotal	**9,109**
Less: net assets removed (W1)	(6,088)
Less: goodwill removed (W2)	(600)
Gain on disposal recognised in profit or loss	**2,421**

W5 Share of profit of associate (Oct–Dec 20X4)

	₦'000
S Ltd profit for last 3 months (1,650 – 1,238)	412
Parent's 40% share	**165**

Presentation notes:

(a) From 1 October 1, 2014 the 40% residual holding in S Ltd is accounted for under IAS 28 using the equity method.

(b) The gain on disposal is shown as a separate line within operating results because the transaction does **not** meet IFRS 5's definition of a discontinued operation.

(c) The share of profit of the associate is presented after operating profit but before tax, in line with IAS 1.

Subsidiary to investment

Shares may be disposed of such that an investment is still retained e.g., a 90% holding is reduced to a 10% holding.

Gain or loss on disposal

The gain or loss on disposal is calculated as described in section 2.1. Therefore, at the point of disposal, the retained interest is measured at fair value.

Statement of financial position

- The interest retained is initially recorded at fair value (as included within the gain calculation).

Statement of Profit or Loss and Other Comprehensive Income

- Consolidate results up to the date of disposal based on the pre-disposal holding
- Include dividend income after the date of disposal
- Include gain or loss on disposal as calculated above

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Reclassification of other comprehensive income
Upon loss of control, other comprehensive income recorded in relation to the subsidiary should again be accounted for in the same way as if the parent company had directly disposed of the assets that it relates to.

Associate to Investment
Shares may be disposed of such that an investment is still retained e.g., a 40% holding is reduced to a 10% holding.

Gain or loss on disposal
In this case there is a loss of significant influence, and a gain or loss on disposal is calculated as:

	₦	₦
Proceeds		X
Fair value of interest retained		X
Less: Cost of investment	X	
Share of post-acquisition profits retained by associate at disposal	X	
Impairment of investment to date	(X)	
		(X)
Profit/(Loss)		**X/(X)**

Part Disposal with No Loss of Control (subsidiary to subsidiary)
A part disposal does which does not result in loss of control is a transaction between the owners of the subsidiary. In this case the parent does not recognise a profit or loss on disposal in the consolidated statement of profit or loss. Instead, the parent recognises equity adjustment. In other words:
(a) no gain or loss on disposal is calculated
(b) no adjustment is made to the carrying amount of goodwill, and
(c) the difference between the proceeds received and the change in the non-controlling interest is accounted for in shareholders' equity

Illustrative example 7: Part disposal with *no* loss of control
(year-end 31 December 20X4 — all amounts in ₦'000)

H Plc and S Ltd – Published financial statements

	H	S
Statements of profit or loss		
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400)	(2,150)
Profit after tax	**7,550**	**1,650**

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	H H	S S
Statement of changes in equity		
Retained earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained earnings c/f	**11,310**	**3,500**

- **Additional information**
  H plc bought **90%** of S Ltd four years ago for **₦ 3,750,000** when S Ltd's retained earnings were **₦ 500,000**; S Ltd's share capital is **₦ 3,000,000**.
- On 30 September 20X4 H plc sold **10%** of S Ltd for **₦ 1,000,000** (control retained).

Required:

prepare the consolidated statement of profit or loss for the year ended December 31, 2014 and calculate the equity adjustment for the change in ownership.

Step 1 Reflect the pattern of ownership and complete the group profit or loss

	H	S	Group
Revenue	22,950	8,800	**31,750**
Expenses	(10,000)	(5,000)	**(15,000)**
Profit before tax	12,950	3,800	**16,750**
Tax	(5,400)	(2,150)	**(7,550)**
Profit after tax	**7,550**	**1,650**	**9,200**

Profit attributable to:

	₦'000
Owners of the parent (balancing figure)	8,993
Non-controlling interest (NCI)	
– 10% × 1,650 × 9/12	124
– 20% × 1,650 × 3/12	83
Total NCI share of profit	**207**

Step 2 Key workings

W1 Net-assets summary (S Ltd)

	At disposal	At acquisition
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net Assets	**6,088**	**3,500**

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W2 Retained earnings at date of disposal

	₦'000
Opening retained earnings	1,850
Profit to 30 Sept (9/12 × 1,650)	1,238
Retained Earnings at Disposal	**3,088**

W3 Goodwill (no impairment)

	₦'000
Cost of investment	3,750
NCI at acquisition (10% × 3,500)	350
Deemed Consideration	**4,100**
Less: net assets at acquisition	(3,500)
Goodwill	**600**

W4 'Profit on disposal' (Equity Transaction – *Not* Recognised in P/L)

	₦'000
Sale proceeds (10% interest)	1,000
Net assets sold to NCI (10% × 6,088)	(609)
Equity Adjustment (to Other Components of Equity)	**391**

24.4 Disposal of A Subsidiary Which Does Not Contain A Business

Background

This section concerns a situation where a parent loses control of a subsidiary that does not contain a business (as defined in IFRS 3) by selling an interest to an associate (or joint venture) accounted for using the equity method.

Such a transaction is the same as selling an asset to the associate (or joint venture).
Usually, if a parent loses control of a subsidiary, the parent must:

(a) derecognise the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
(b) recognise any investment retained in the former subsidiary at its fair value when control is lost; and
(c) recognise the gain or loss associated with the loss of control in the statement of profit or loss.

In the case of a part disposal, the parent must measure any residual investment at its fair value with any gain or loss being recognised in the statement of profit or loss.

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New Rules

If the subsidiary sold does not contain a business (as defined in IFRS 3) by selling an interest to an associate (or joint venture) accounted for using the equity method the gain or loss resulting from the transaction is recognised in the parent's profit or loss only to the extent of the unrelated investors' interests in that associate or joint venture.

The remaining part of the gain is eliminated against the carrying amount of the investment in that associate or joint venture. Also, any residual investment must be revalued to fair value and usually the gain or loss is recognised in profit or loss. The residual investment might be an associate (or joint venture) accounted for using the equity method. In that case the remeasurement gain or loss is recognised in profit or loss only to the extent of the unrelated investors' interests in the new associate or joint venture.

The remaining part of that gain is eliminated against the carrying amount of investment retained in the former subsidiary.

Journal entry to record the change in ownership

Accounting Entry:	Debit	Credit
Cash	1,000	
NCI		609
Other Components of Equity (OCE)		391

(No gain or loss passes through the consolidated statement of profit or loss because control is retained; the difference is taken directly to equity in accordance with IFRS 10.)

Illustrative Example 8: Loss of control of a subsidiary (that does not contain a business) by selling it to an associate

Fact Pattern	Detail
Parent	**H Plc**
Subsidiary before sale	**S Ltd** – H Plc owned **100%**
Associate	**A Ltd** – H Plc already owns **20%**
Disposal	On the date of sale H Plc **sold 70% of S Ltd to A Ltd** for **₦ 210 m**
Fair-value data at the sale date	• Identifiable net assets of S Ltd = **₦ 100 m** • Fair value of H Plc's **residual (30%) interest** in S Ltd = **₦ 90 m**
Key IFRS point	Because S Ltd is **not a "business"** (IFRS 10), the gain is recognised **only to the extent of the interests held by *unrelated* investors** in the transferee (A Ltd).

Overall gain on disposal

	₦ million
Consideration received (sale of 70%)	210.0
Fair value of residual 30% interest	90.0
Total "consideration"	**300.0**
Less: carrying amount of S Ltd's net assets derecognised	(100.0)
Total Gain	**200.0**

Split of the gain

	Total	Sale of 70%	Revaluation of 30%
Consideration/fair value	300.0	210.0	90.0
Net assets de-recognised	(100.0)	(70.0)	(30.0)
Gain	**200.0**	**140.0**	**60.0**

Ownership structure after the sale

Interest in A Ltd	
H Plc	20%
Unrelated investors	**80%**

Effective Interest in S Ltd	
Direct interest retained	30%
Indirect interest (20% of A Ltd's 70%)	14%
Total held by H Plc	**44%**
Held by unrelated investors	**56%**
Total Holdings	**100%**

Gain Recognised in profit or loss

Component	Basis	Recognised ₦ million
Sale gain (140 m)	140 m × unrelated investors in A Ltd (80%)	**112.0**
Revaluation gain (60 m)	60 m × unrelated investors in S Ltd (56%)	**33.6 ≈ 34.0**
Total gain reported		**146.0**

(The portion attributable to H Plc's continuing interests is eliminated.)

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24.5 IFRS 5 and Disposals

IFRS 5: Discontinued Operations

This was covered in an earlier chapter but is repeated here for your convenience.

IFRS 5 *non-current assets held for sale and discontinued operations* sets out requirements for disclosure of financial information relating to discontinued operations.

A discontinued operation is a disposal group that satisfies extra criteria. (IFRS 5 does not say as much but this is a helpful way to think of it).

Definition

Discontinued operation-A component of an entity that either has been disposed of or is classified as held for sale and:

(a) represents a separate major line of business or geographical area of operations,
(b) is part of a single coordinated 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.

A disposal group might be, for example, a major business division of a company.

Presentation of discontinued operations

Presentation in the statement of profit or loss

The following must be disclosed for discontinued operations:

1 a single amount on the face of the statement of profit or loss comprising the total of:
   a) the post-tax profit or loss of discontinued operations; and
   b) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

Discontinued operations and disposals

A disposal might satisfy the discontinued operations criteria. This will not affect measurement but will affect presentation.
The consolidation of the subsidiary up to the date of disposal is not carried out on a line-by-line basis. Instead, the profit after tax for this period combined with the profit (loss) on disposal and shown as a single figure.
The answer to the previous example is used below to show the difference.

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Illustrative Example 9: Disposal of Subsidiary Not Classified as a Discontinued Operation

H plc – Consolidated Statement of Profit or Loss for the Year Ended 31 December 20X4

Statements of Profit or Loss	H (₦'000)	S (9/12) (₦'000)	Group (₦'000)
Revenue	22,950	6,600	**29,550**
Expenses	(10,000)	(3,750)	**(13,750)**
Operating profit	**12,950**	**2,850**	**15,800**
Profit on disposal (W)	–	–	**3,421**
Profit before tax	**12,950**	**2,850**	**19,221**
Tax	(5,400)	(1,612)	**(7,012)**
Profit after tax	**7,550**	**1,238**	**12,209**

Profit Attributable To:	**₦'000**
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% × 1,238)	124
Profit for the year	**12,209**

Illustrative Example 10: Disposal of subsidiary classified as a discontinued Operation

H plc – Consolidated statement of profit or loss for the year ended December 31, 2014

Statements of profit or loss	Group (₦'000)
Revenue	22,950
Expenses	(10,000)
Profit before tax	**12,950**
Tax	(5,400)
Profit for the period from continuing operations	**7,550**
Profit for the year from discontinued operations (1,238 + 3,421)	4,659
Profit for the year	**12,209**

Profit Attributable To:	**₦'000**
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% × 1,238)	124
Profit for the year	**12,209**

24.6 Chapter review

Key points recap

a. Loss of control triggers **derecognition** of subsidiary assets and liabilities and recognition of any retained investment at fair value.
b. Disposal gain or loss = **fair value of consideration ± fair value of residual holding – carrying amounts of net assets – carrying amount of goodwill ± NCI**.
c. A **part disposal without loss of control** is treated as an owners' transaction: no P/L effect; adjust equity.
d. Where the subsidiary (or its major line of business) meets IFRS 5 criteria, present its post-tax results and disposal gain/loss **separately** from continuing operations.

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24.7 End of chapter questions and suggested solutions

24.7.1 Questions

Question 1:

On January 1, 2015 Foot Plc acquired 75% of the equity shares in Cone Ltd for ₦800,000. At that date the carrying amount of Cone Ltd.'s net assets was ₦640,000, which was equal to the fair value of the identifiable assets acquired and liabilities assumed by Foot plc. On the same date the fair value of the non-controlling interests in Cone Ltd was estimated at ₦180,000. At December 31, 20X7 the fair value and carrying amount of the net assets recognised by Cone Ltd was ₦900,000 and Cone Ltd.'s profit for the year ended December 31, 20X8 was ₦400,000. Foot plc disposed of its interest in Cone Ltd for ₦1.35 million on September 30, 20X8.

Required:

Calculate the profit or loss on disposal to be recognised in Foot plc's consolidated profit or loss for the year ended December 31, 2018 on the basis that at acquisition the non-controlling interests were measured at:

(a) Using the proportionate method.

(b) Using the fair value method

Question 2

Yogi plc has held an 80% investment in Bear Ltd for many years. On December 31, 2016 it fully disposed of its investment. Details for the acquisition and disposal are as follows.

	N	
Consideration transferred on acquisition	7,380,000	
Fair value of the identifiable assets acquired and liabilities assumed by Yogi plc at acquisition (equal to their carrying amounts)	9,000,000	
Sale proceeds on December 31, 2016		9,940,000

Goodwill acquired in the business combination has been fully written off after impairment reviews. The summarised statement of Bear Ltd.'s financial position on December 31, 2016 showed the below:

	N
Called up share capital	3,000,000
Retained earnings	7,350,000
Equity	**10,350,000**

Required:

What is the profit/(loss) on disposal of the shares in Bear Ltd that should be included as part of the profit for the period from discontinued operations figure in the consolidated statement of profit or loss of Yogi plc for the year ended December 31, 2016?

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Question 3:

Express acquired 90% of Billings in 2012 when Billings had retained earnings of ₦250,000. Goodwill was calculated as ₦45,000 using the proportion of net assets method to value the non-controlling interest. Goodwill has been impaired by ₦5,000 since acquisition.

At December 31, 2018 the abbreviated statements of financial position of the two entities were as follows:

Statement of Financial Position (Summarised)	Express (₦'000)	Billings (₦'000)
Non-current assets	2,300	430
Investments	360	–
Current assets	1,750	220
Total assets	**4,410**	**650**
Share capital	1,000	100
Retained earnings b/f	1,190	304
Profit for the year	120	36
Liabilities	2,100	210
Total Equity & Liabilities	**4,410**	**650**

Additional Information
Express disposed of a **10% holding in Billings on 31 August 31, 2018 for ₦70,000**; this transaction has **not yet been recorded** in Express's individual accounts.

Required:
Prepare the consolidated statement of financial position as at December 31, 2018.

Suggested Solutions:

Foot Plc – Disposal of 75% Holding in Cone Ltd on September 30, 20X8

*(all figures in **₦'000**, rounded to the nearest whole thousand; assume no goodwill impairment)*

	Proportionate-Share NCI	Fair-Value NCI
Step 1: Net Assets of Cone Ltd		
Net assets at acquisition (Jan 1, 2015)	640	640
Net assets at Dec 31, 2017	900	900
+ Profit Jan 1 – Sep 30, 2018 (9/12 × 400)	**+ 300**	**+ 300**
Net assets at disposal date	**1 200**	**1 200**

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	Proportionate-Share NCI	Fair-Value NCI
Step 2: Goodwill Recognised at Acquisition		
Consideration transferred (75%)	800	800
+ NCI at acquisition	**160** (25% × 640)	**180** (FV given)
− Net assets at acquisition	(640)	(640)
Goodwill at disposal	**320**	**340**
Step 3 Carrying Amount of NCI at Disposal		
Share of net assets (25% × 1 200)	300	300
+ Share of goodwill (FV method only)	–	+ 20 (340 – 320)
NCI De-recognised	**300**	**320**
Step 4 Profit on Disposal		
Proceeds received	1 350	1 350
+ NCI derecognised (Step 3)	+ 300	+ 320
− Net assets derecognised (Step 1)	(1 200)	(1 200)
− Goodwill derecognised (Step 2)	(320)	(340)
Profit/(loss) to group P/L	**₦ 130 Gain**	**₦ 130 Gain**

Observations

(a) Under both measurement bases the consolidated gain is the same (**₦ 130 000**).

(b) The different goodwill and NCI figures offset one another in the disposal calculation, so the net impact on the group profit or loss is neutral.

(c) After September 30, 2018 Foot plc holds **no interest** in Cone Ltd, so any post-disposal results of Cone Ltd are outside the group accounts.

These amounts would be presented as **"Profit on disposal of subsidiary"** within Foot plc's consolidated statement of profit or loss for the year ended December 31, 2018.

Solutions 2

Yogi Plc – Disposal of the whole 80% holding in Bear Ltd

*(all figures in **₦'000**; year-end December 31, 2016)*

	Note	Amount
Sale proceeds	per question	9,940
Add: Non-controlling interest (20% × ₦ 10,350,000)	A	2,070
Less: Carrying amount of Bear Ltd's net assets at disposal	B	(10,350)
Less: Carrying amount of goodwill	fully written off	–
Profit on disposal	to discontinued-operations line	**₦ 1,660**

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Notes

a. IFRS 10 requires the NCI's carrying amount to be de-recognised when control is lost.

b. Net assets at 31 Dec 20X6 equal share capital ₦3,000,000 + retained earnings ₦7,350,000 = ₦10,350,000 (per the summarised statement of financial position).

Result to Report

A gain of **₦1.66 million** should be included within **"profit for the period from discontinued operations"** in Yogi plc's consolidated statement of profit or loss for the year ended December 31, 2016.

Solution:

Express Group – Statement of Financial Position at December 31, 2018

(amounts in ₦'000)

	Calculations	**₦'000**
Non-current assets	₦2,300,000 + ₦430,000	2,730
Goodwill	₦45,000 – ₦5,000	40
Current assets	₦1,750,000 + ₦220,000 + proceeds ₦70,000	2,040
Total Assets		**4,810**
Share capital		1,000
Retained earnings	(W1)	1,412
Non-controlling interest	20% × (₦650,000 – ₦210,000)	88
Liabilities	₦2,100,000 + ₦210,000	2,310
Total Equity & Liabilities		**4,810**

Express Plc – Part-Disposal of 10% of its Subsidiary Billings Ltd on August 31, 2018

(control is retained: holding falls from 90% to 80%) All amounts are in **₦'000**.

Identify the Figures at the Disposal Date

	Billings' Equity Items	**Balance at Aug 31, 20X8**
Share capital	constant	100
Retained earnings b/f	constant	304
Current-year profit to Aug 31 (8/12 × 36)		24
Net Assets at Disposal Date		**428**

The 10% parcel sold therefore corresponds to **₦42,800** (10% × ₦428,000).

Calculate the Equity Adjustment (No Gain in Profit/Loss Under IFRS 10)

	₦'000
Cash proceeds received	70.0
Less: carrying amount of net assets transferred to the NCI (10% × 428)	(42.8)
Credit to Other Components of Equity (OCE)	**27.2**

Journal Entry at the Group Level:

Account	Debit	Credit
Cash	70.0	
Non-controlling interest *(increase from 10% to 20%)*		42.8
Other components of equity (OCE)		27.2

(No amount is taken to profit or loss because Express still controls Billings.)

Profit Attribution for the year ended Dec 31, 2018

Billings made **₦36,000** for the full year.

Period	Parent Share	NCI Share
Jan–Aug (8 months, 90%/10%)	90% × 24 = 21.6	2.4
Sep–Dec (4 months, 80%/20%)	80% × 12 = 9.6	2.4
Total Billings Profit Split	**31.2**	**4.8**

Add Express's Standalone Profit (**₦120,000**):

	Parent	NCI
Express profit	120.0	–
Billings split (see above)	31.2	4.8
Consolidated profit for the year	**151.2**	**4.8**

NCI Shown in the Consolidated Statement of Financial Position at Dec 31, 2018

	₦'000
NCI share of Billings' net assets (20% × 440)	**88.0**
Comprises:	
· Net assets transferred on 31 Aug (10% × 428)	42.8
· Existing NCI before disposal	42.8
· Share of post-disposal profit (20% × 12)	2.4
Closing NCI	**88.0**

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What to Present in the 2018 Consolidated Financial Statements

a. **Statement of Profit or Loss** – no disposal gain; only the normal group profits above.
b. **Statement of Changes in Equity** – show:
   - Debit Cash ₦70,000
   - Credit NCI ₦42,800
   - Credit OCE ₦27,200
c. **Statement of Financial Position** – NCI at year-end **₦88,000**.

These entries fully reflect a disposal that *does not* result in loss of control, in accordance with IFRS 10.

Consolidated Retained Earnings of Express Group
as at December 31, 2018 (all figures in **₦'000**)

	Explanation	Amount
Parent Company (Express Plc):		
Opening retained earnings (per trial balance)	*1,190*	
+ Profit for the year	*120*	
Subtotal – Parent (i)		**1,310**
Subsidiary (Billings Ltd) – Post-Acquisition Element Attributable to Express:		
(a) Retained earnings that are already post-acquisition at 1 Jan 20X8[1]	*90% × (304 – 212·5)*	83
(b) Share of profit 1 Jan – 31 Aug (pre-disposal)	*90% × 24*	22
(c) *Less:* portion transferred to NCI when 10% was sold on 31 Aug 20X8[2]	*10% × (328 – 212·5)*	(12)
(d) Share of profit 1 Sep – 31 Dec (post-disposal)	*80% × 12*	10
Subtotal – Subsidiary Contribution (ii)		103
Consolidated Retained Earnings at 31 Dec 20X8 (i + ii)	*1,310 + 103*	**1,412**

Notes

(a) *Retained Earnings at Acquisition*
   (i) Goodwill workings (not shown in full here) give net assets at acquisition of **₦350,000** (share capital ₦ 100 000 + retained earnings ₦212,500).
   (ii) Only the post-acquisition element of Billings' earnings (₦304,000 – ₦212,500) is consolidated; Express owned 90% up to the disposal date.

(b) *Adjustment on the 10% Sale (control retained)*
   (i) On 31 Aug 20X8 Express reduced its holding from 90% to 80%.
   (ii) IFRS 10 treats this as an **equity transaction**: 10% of the *post-acquisition* reserves that had previously been consolidated (i.e. ₦328,000 – ₦212,500) is re-allocated from the parent to NCI.
   (iii) The related cash/OCE entry (₦27,200) is shown in equity, not in retained earnings.

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(c) *Goodwill Impairment*

(i) The goodwill figure in the statement of financial position (₦45,000 – ₦5,000 = ₦40,000) indicates the impairment was recognised in **a prior period**, so no further charge affects 20X8 retained earnings.

The above reconciliation explains the **₦1,412,000** consolidated retained-earnings figure shown in the draft group statement of financial position.

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Professional Level

Strategic Business Reporting

CHAPTER 25

OTHER GROUP STANDARDS

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25.0 Learning objective

This chapter discusses **IAS 27** ***Separate Financial Statements*** and **IFRS 12** ***Disclosure of Interests in Other Entities***.

25.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. **Explain the concept and purpose of separate financial statements**, identifying circumstances in which an entity may, or must, present them under IAS 27.
b. **Select and apply an appropriate measurement basis**, cost, equity method or IFRS 9, for investments in subsidiaries, associates and joint ventures when preparing separate financial statements, and account for any subsequent disposal or classification as held for sale.
c. **Analyse and draft the full set of IFRS 12 disclosures** for interests in subsidiaries, joint ventures, associates and unconsolidated structured entities, including significant judgements in determining control or significant influence, and summarised financial information.
d. **Discuss and comply with additional IAS 27 disclosure requirements**, such as the list of significant investees, when a parent elects, or is exempted, from preparing consolidated financial statements.
e. **Evaluate exam scenarios** to determine, present and disclose the correct amounts in group or separate financial statements, justifying each treatment with clear reference to the relevant standard.

25.2 IAS 27 Separate Financial Statements

Introduction to IAS 27

IAS 27 contains accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements.

IAS 27 requires an entity preparing separate financial statements to account for those investments at cost or in accordance with *IFRS 9: Financial Instruments*.

IAS 27 does say which entities must produce separate financial statements.

Definition

Separate financial statements: Those presented by a parent or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 Financial Instruments

Separate financial statements are those presented in addition to consolidated financial statements or in addition to financial statements in which investments in associates or joint ventures are accounted for using the equity method.

However, if a company is exempt from the need to consolidate or account for an investment using the equity method the separate financial statements are its only financial statements.

Preparation of separate financial statements

Separate financial statements must be prepared in accordance with all applicable IFRSs.

Investments in subsidiaries, joint ventures and associates must be accounted for in separate financial statements, either:

a. at cost; or
b. in accordance with IFRS 9; or
c. using the equity method.

A company must apply the same accounting for each category of investments. Investments accounted for at cost are subject to the rules in IFRS 5 when they are classified as held for sale.

Disclosure

All applicable IFRSs apply when providing disclosures in separate financial statements as well as the following requirements.

When a parent prepares separate financial statements, it must disclose:

a. the fact that the 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; and
    iii. its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.
    iv. a description of the method used to account for the investments listed.

In addition, if a parent is exempt from preparing consolidated financial statements and elects not to do so, and instead prepares separate financial statements, it must disclose:

- the fact that the financial statements are separate financial statements;
- that the exemption from consolidation has been used;
- the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with IFRS have been produced for public use; and
- the address where those consolidated financial statements are obtainable.

IAS 28: Investments in Associates and Joint Ventures allows a company to measure its investments in associates or joint ventures at fair value through profit or loss. Such investments must be accounted for in the same way in its separate financial statements.

Dividends are recognised in profit or loss in separate financial statements when the right to receive the dividend is established.

IAS 28 does not apply to investments in associates or joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities that are measured at fair value in accordance with IFRS 9.

The standard requires investments in associates to be accounted for using the equity method, unless the investment is classified as 'held for sale' in accordance with IFRS 5, in which case it should be accounted for under IFRS 5.

An investor is exempt from applying the equity method if (IAS 28.17):

a. it is a parent exempt from preparing consolidated financial statements under IAS 27 (Revised); or

b. all of the following apply:
   i. The investor is a wholly owned subsidiary or it is a partially owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method.
   ii. Its securities are not publicly traded.
   iii. It is not in the process of issuing securities in public securities markets.
   iv. The ultimate or intermediate parent publishes consolidated financial statements that comply with International Financial Reporting Standards.

Furthermore, the standard does not allow an investment in an associate to be excluded from equity accounting when an investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. Significant influence must be lost before the equity method ceases to be applicable.

The use of the equity method should be discontinued from the date that the investor ceases to have significant influence.

From that date, the investor shall account for the investment in accordance with IFRS 9. The fair value of the retained interest must be regarded as its fair value on initial recognition as a financial asset under IFRS 9.

25.3 IFRS 12: Disclosure of Interests in Other Entities

25.3.1 Introduction to IFRS12

The objective of IFRS 12 is to require companies to disclose information that enables users of their financial statements to evaluate:

a. the nature of, and risks associated with, its interests in other entities; and
b. the effects of those interests on its financial position, financial performance and cashflows.

This requires disclosure of:

(i) the significant judgements and assumptions it has made in determining the nature of its interest in another entity or arrangement, and in determining the type of joint arrangement in which it has an interest; and

(ii) information about its interests in:
- subsidiaries;
- joint arrangements and associate); and
- structured entities that are not controlled by the entity (unconsolidated structured entities).

IFRS 12 sets out required disclosures but disclosure, of additional information might be necessary to meet IFRS 12's objective.

IFRS 12 must be applied by a company that has an interest in any of the following:

a. subsidiaries;
b. joint arrangements (i.e. joint operations or joint ventures);
c. associates;
d. unconsolidated structured entities.

The disclosure required by IFRS 12 is as follows:

25.3.2 Significant judgements and assumptions

A company must disclose information about significant judgements and assumptions it has made (and changes to those judgements and assumptions) in determining:

(a) that it has control of another entity;
(b) that it has joint control of an arrangement or significant influence over another entity; and
(c) the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle.

To comply with the above a company must disclose, for example, significant judgements and assumptions made in determining that:

(i) it does not control another entity even though it holds more than half of the voting rights of the other entity;
(ii) it controls another entity even though it holds less than half of the voting rights of the other entity;
(iii) it does not have significant influence even though it holds 20% or more of the voting rights of another entity; and
(iv) it has significant influence even though it holds less than 20% of the voting rights of another entity.

25.3.3 Interests in subsidiaries

A company must disclose information that enables users of its consolidated financial statements to understand:

a. the composition of the group; and
b. the interest that non-controlling interests have in the group's activities and cash flows; and
c. to evaluate:
    i. the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
    ii. the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
    iii. the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and
    iv. the consequences of losing control of a subsidiary during the reporting period.

When the financial statements of a subsidiary used in the preparation of consolidated financial statements are as of a date or for a period that is different from that of the consolidated financial statements, a company must disclose:

a. the date of the end of the reporting period of the financial statements of that subsidiary; and
b. the reason for using a different date or period.

Non-controlling interests

A company must disclose for each of its subsidiaries that have non-controlling interests that are material to the reporting entity:

a. the name of the subsidiary;
b. the principal place of business (and country of incorporation if different) of the subsidiary;
c. the proportion of ownership interests held by non-controlling interests;
d. the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interest shield

e. the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period;
f. accumulated non-controlling interests of the subsidiary at the end of the reporting period; and
g. summarised financial information about the subsidiary.

The nature and extent of significant restrictions

A company must disclose:

a. any significant restrictions on its ability to access or use the assets and settle the liabilities of the group, such as:
b. those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group;
c. guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group; and
d. the carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

Consequences of losing control of a subsidiary during the reporting period

A company must disclose the gain or loss arising on the loss of control of a subsidiary during the period together with the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).

Interests in joint arrangements and associates

A company must disclose information that enables users of its financial statements to evaluate:

a. the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and
b. the nature of, and changes in, the risks associated with its interests in joint ventures and associates.

Nature, Extent and Financial Effects of Interests in Joint Arrangements and Associates

A company must disclose:

a. for each material joint arrangement and associate:
b. the name of the joint arrangement or associate;
c. the nature of the entity's relationship with the joint arrangement or associate;
d. the principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement or associate; and
e. the proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).
    i. for each material joint venture and associate that is material to the reporting entity:
    ii. whether the investment in the joint venture or associate is measured using the equity method or at fair value.
    iii. summarised financial information about the joint venture or associate.

iv. if the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, if there is a quoted market price for the investment.
v. financial information about the entity's investments in joint ventures and associates that are not individually material:
    - in aggregate for all individually immaterial joint ventures and, separately,
    - in aggregate for all individually immaterial associates.

A company must also disclose:

a. the nature and extent of any significant restrictions on the ability of joint ventures or associates to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity.
b. when the financial statements used in applying the equity method are as of a date or for a period that is different from that of the entity:
    i. the date of the end of the reporting period of the financial statements of that joint venture or associate; and
    ii. the reason for using a different date or period.
    iii. the unrecognised share of losses of a joint venture or associate, both for the reporting period and cumulatively, if the entity has stopped recognizing its share of losses of the joint venture or associate when applying the equity method.

Risks Associated with an Entity's Interests in Joint Ventures and Associates

A company must disclose:

a. commitments that it has relating to its joint ventures separately from the amount of other commitments, and
b. contingent liabilities incurred relating to its interests in joint ventures or associates (unless the probability of loss is remote).

Structured entities

Definition

Structured entity: An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

Consolidated structured entities

A company must disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity. A company must also disclose any support given where there is no contractual obligation and any intention to provide financial or other support to a consolidated structured entity.

Unconsolidated structured entities

A company must disclose information that enables users of its financial statements:

a. to understand the nature and extent of its interests in unconsolidated structured entities; and
b. to evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

25.4 Chapter review

Key principles to remember

AREA	Crucial takeaway
Definition of separate FS	Separate FS show a parent's investments *at cost, equity method or IFRS 9*; they coexist with, but never replace, consolidated FS unless an exemption in IFRS 10 applies.
Consistency of measurement	An entity must apply the *same* measurement model to *each* category of investee: e.g., all subsidiaries at cost, all associates using IFRS 9, and disclose the policy chosen.
Dividends in separate FS	Recognise dividend income **when the right to receive is established**, regardless of the measurement model adopted.
IFRS 5 interaction	Investments measured at cost that become *held for sale* are re-measured under IFRS 5; those measured under IFRS 9 continue under IFRS 9.
IFRS 12 disclosure pillars	1 significance of interests, 2 risk exposure, 3 effects on financial position & performance. Additional granular disclosures apply to unconsolidated structured entities.
Judgement disclosures	Disclose *key judgements and assumptions* made in assessing control, joint control or significant influence.
Summarised financial data	Provide *condensed* statements of financial position & performance for each material subsidiary, joint venture or associate.
Changes in ownership	Explain the financial effect of gaining or losing control, joint control or significant influence, including consideration transferred and gain or loss recognised.

Self-check questions

a. *Measurement choice*: A parent owns 40% of Alpha Ltd and measures it at cost in separate FS. Alpha is now classified as held for sale. Outline the accounting entries required.
b. *Disclosure drill-down*: Beta Plc holds 30% of Delta JV and 55% of an unconsolidated structured entity. List the minimum IFRS 12 disclosures for each.
c. *Judgement test*: Gamma Ltd holds preference shares carrying 60% of voting rights in Sigma Co but cannot appoint directors. Discuss, with reasons, whether Gamma controls Sigma for IFRS 12 purposes.

Use these questions to test your grasp of recognition, measurement and disclosure requirements. Answers follow the principles summarised above, check that your response cites the relevant standard paragraph and gives a clear numerical or narrative justification.

25.5 End of chapter questions and suggested solutions

25.5.1 Questions

Question 1: Separate financial statements measurement choice

Bridge Plc holds the following interests, all of which are *material*:

Investee	Interest	Carrying amount on January 1, 2015	Measurement basis elected in separate financial statements
Alpha Ltd (subsidiary)	80%	₦ 480,000,000	Cost
Beta Ltd (associate)	30%	₦ 120,000,000	Equity method
Gamma Ltd (joint venture)	50%	₦ 160,000,000	IFRS 9 (FVOCI)

On June 30, 20X5 Bridge Plc decides to sell its entire holding in Alpha Ltd. The sale is highly probable and expected to complete within six months for ₦ 550,000,000 (fair value on that date ₦ 540,000,000).

Required

a. Explain, with supporting calculations, how Bridge Plc should account for Alpha Ltd in its *separate* financial statements for the year ended 31 December 20X5, referring to IAS 27 and IFRS 5.
b. State the effect, if any, on the measurement of Beta Ltd and Gamma Ltd at December 31, 2015.

Question 2: IFRS 12 Disclosure Package

Delta Group prepares consolidated financial statements for the year ended December 31, 2016. The group structure is summarised below:

Subsidiaries: 100% of Sigma Ltd and 60% of Theta Ltd (Theta is individually material).

Associate: 25% of Omega Ltd (acquired during the year).

Unconsolidated structured entity: 15% interest in Phoenix SPV, set up to securitise trade receivables of Delta Group. Delta provides a credit enhancement guarantee limited to ₦ 40,000,000.

Required

Prepare a list of the minimum IFRS 12 disclosures Delta Group must provide for:

a. Theta Ltd,
b. Omega Ltd, and
c. Phoenix SPV.

Your answer should group the disclosures under clear sub-headings and identify any quantitative information that must be presented.

Question 3: Judgement in assessing control

Epsilon Plc owns 48% of the ordinary shares of Zeta Ltd, all of which carry voting rights. The remaining shares are widely dispersed. Epsilon also holds convertible preference shares issued by Zeta that, if converted, would raise Epsilon's holding to 55%. Conversion is economically favourable but requires the approval of Zeta's board. The board comprises five directors: three appointed by Epsilon, one by another shareholder, and one independent. Board decisions require a simple majority.

Recent board minutes show Epsilon's directors usually support strategies proposed by Zeta's chief executive, who is not linked to any shareholder. Epsilon supplies critical components to Zeta under normal trading terms and has no other contractual rights.

Required

(a) a. Analyse whether Epsilon controls, jointly controls, or merely has significant influence over Zeta Ltd, applying the IFRS 10 control model and IFRS 12 disclosure principles.

(b) Identify the key *judgements and assumptions* that must be disclosed in Epsilon's financial statements under IFRS 12.

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25.5.2 Suggested Solutions:

Solution 1

Relevant Guidance

IAS 27 allows investments in subsidiaries, associates and joint ventures to be measured **at cost, under IFRS 9 or using the equity method**; the same basis must be applied consistently within each category. Where a cost-measured investment becomes *held for sale*, IAS 27 sends the entity to IFRS 5; the asset is re-measured at *the lower of carrying amount and fair value less costs to sell* and presented separately as a current asset.

(a) Alpha Ltd: Subsidiary Measured at Cost

Step	Journal Entry	Explanation
30 June 20X5 – classification as held for sale	*Debit:* Asset held for sale ₦480,000,000 *Credit:* Investment in Alpha ₦480,000,000	Reclassify at the *lower* of carrying amount ₦480,000,000 and fair value less costs to sell ₦540,000,000, so no impairment arises. The asset is shown as "non-current asset held for sale".
31 Dec 20X5 – completion of sale	*Debit:* Bank ₦550,000,000 *Credit:* Asset held for sale ₦480,000,000 *Credit:* Gain on disposal ₦70,000,000	Record cash proceeds and recognise the gain in profit or loss.

Tax and selling costs have been assumed immaterial; adjust if exam data provide different figures.

(b) Effect on Beta Ltd (Associate) and Gamma Ltd (Joint Venture)

Beta Ltd continues to be carried using the equity method as elected for associates. Alpha's sale does not trigger a re-measurement or change of policy.
Gamma Ltd remains measured at fair value through OCI under IFRS 9. IFRS 5 is *not* applied because Gamma is already in the IFRS 9 category, and IAS 27 requires that model to be retained.

Consistency of measurement across each class of investee is therefore preserved

Solutions 2

Required Area	Minimum Disclosures	Key References
(i) Theta Ltd – individually material subsidiary	*Composition and NCI information:* name, principal place of business, % ownership and% voting rights held by NCI, profit or loss and accumulated NCI, summarised financial information for Theta. *Restrictions:* significant restrictions on asset transfers and dividend payments. *Changes in ownership/loss of control:* effects, if any, during the year.	IFRS 12 paras on interests in subsidiaries - disclosures of composition, NCI data and significant restrictions
(ii) Omega Ltd – newly acquired associate	*Relationship details:* name, nature of relationship, principal place of business,% ownership and% voting rights. *Measurement basis:* equity method, or fair value if elected. *Summarised financial information:* statement of financial position and performance for Omega. *Quoted price:* fair value of the investment if Omega has a quoted market price. *Aggregated information:* for individually immaterial associates if relevant. *Significant restrictions:* on transfers of funds to the investor.	IFRS 12 paras on interests in joint arrangements and associates - nature, extent, financial effects and restrictions
(iii) Phoenix SPV – unconsolidated structured entity	*Nature and purpose:* why the SPV was established and how it is financed. *Interest held:* type (e.g. residual tranche), carrying amount at reporting date and maximum loss exposure, including the ₦40,000,000 credit-enhancement guarantee. *Liquidity support provided:* any	IFRS 12 objectives and structured-entity requirements to explain nature, risk and financial impact of the interest

Required Area	Minimum Disclosures	Key References
	contractual facilities, funding commitments or derivatives. *Income recognised:* from the SPV and any changes in the carrying amount of the interest. *Risk exposures:* maturity analysis of funding commitments and a description of triggers that could require additional support.	

Present the disclosures in clearly labelled notes with cross-references to related line items in the primary statements.

Solutions 3

(a) Assessment of Epsilon's Relationship with Zeta Ltd

Control Element	Evidence in Scenario	Conclusion
Power over relevant activities	Epsilon appoints **three of the five directors**. Board decisions pass by simple majority, so Epsilon can direct policy.	Power exists despite holding < 50% of shares.
Exposure to variable returns	48% ordinary shareholding and supply contract profits give Epsilon significant upside and downside linked to Zeta's performance.	Exposure confirmed.
Link between power and returns	The board majority enables Epsilon to influence returns from its shareholding and trading relationship.	Link established.

Potential voting rights (convertible preference shares) strengthen, but are *not necessary* for, the control conclusion. The widely dispersed remainder of the share capital limits the practical ability of other shareholders to out-vote Epsilon. On balance, **Epsilon controls Zeta** and must consolidate Zeta under IFRS 10. If the board composition changed or a shareholder bloc emerged, control would need to be reassessed.

Where judgement is finely balanced the entity must disclose the factors considered.

(b) Judgements and assumptions to disclose under IFRS 12

that Epsilon controls Zeta even though it owns **less than half** of the voting shares;
reliance on **board representation** as the primary source of power;
assessment that **potential voting rights** (the convertible preference shares) are substantive;
conclusion that other shareholders are **widely dispersed** and do not act together;
absence of additional contractual rights beyond normal trading terms; and
statement that management will **monitor future changes** in share ownership, board structure and contractual arrangements.

These disclosures satisfy IFRS 12's requirement to explain the significant judgements made in determining control, joint control or significant influence.

Examiner's Note

In practice, mark schemes reward clear linkage of calculations and disclosures to the relevant standard paragraphs, logical structure, and concise explanations. Candidates should quote paragraph numbers where time permits, but clarity of reasoning carries the highest marks.

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Professional Level

Strategic Business Reporting

CHAPTER 26

FOREIGN CURRENCY TRANSACTIONS

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26 Foreign Currency Transactions

26.0 Learning objective

This chapter discusses treatment of foreign -currency transactions in the financial statements in accordance with IAS 21.

26.1 Learning outcomes

On the successful completion of this chapter, readers should be able to:

a. Define *functional currency*, *presentation currency* and *foreign currency*, and determine an entity's functional currency in straightforward scenarios.
b. Translate foreign-currency transactions at initial recognition and measure the resulting monetary and non-monetary items at subsequent reporting dates.
c. Distinguish between monetary and non-monetary assets and liabilities, explaining how exchange gains or losses are recognised for each class.
d. Account for settlement of foreign-currency receivables and payables, including recognition of exchange differences in profit or loss.
e. Translate the financial statements of foreign operations for consolidation, applying closing-rate, spot-rate and average-rate techniques as required.
f. Present resulting exchange differences in other comprehensive income and maintain a separate exchange-reserve column within equity.
g. Explain the treatment of goodwill and fair-value adjustments on acquisition of a foreign subsidiary, including annual retranslation.
h. Reclassify the cumulative exchange reserve on disposal or partial disposal of a foreign operation, preparing the related profit-or-loss entries.
i. Exercise judgement in areas such as functional-currency changes, hyperinflation indicators and choice of practical average rates.

26.2 IAS 21: The Effects of Changes in Foreign Exchange Rates

26.2.1 The Scope of IAS 21

Many businesses have transactions and investments that are denominated in a foreign currency. Individual companies often enter into transactions in a foreign currency. These transactions need to be translated into the company's own currency in order to record them in its ledger accounts. For example:

a. a US company may take out a loan from a French bank in euros and will record the loan in its ledger accounts in US dollars; or
b. a German company may sell goods to a Japanese company invoiced in yen and will record the sale and the trade receivable in euros in its ledger accounts.

Groups often contain overseas entities. A parent company might own a foreign subsidiary or associate. This foreign entity will normally maintain its accounting records and prepare its financial statements in a currency that is different from the currency of the parent company and the group's consolidated accounts.

For example, if a Japanese company has a US subsidiary, the financial statements of the US subsidiary will be prepared in US dollars, but will need to be translated into yen for the purpose of preparing the group's consolidated financial statements.

The rules on accounting for foreign currency items are concerned with translating or converting items from one currency into another currency, at an appropriate rate of exchange between the currencies. The rules are mostly contained in IAS 21 *The effects of changes in foreign exchange rates*. The rules in IAS 21 can be divided into two areas:

a. Transactions affecting individual entities. IAS 21 deals with the translation of these transactions when they occur and at subsequent reporting dates when re-translation at a different exchange rate may be necessary.
b. Foreign operations (subsidiaries, associates etc.) which affect the consolidated financial statements. The rules in IAS 21 explain how to translate the financial statements of the foreign subsidiaries, associates or joint ventures. Once translated, the normal consolidation rules or equity accounting rules will apply.

IAS 21 defines foreign transaction as a transaction that is denominated in or requires settlement in a foreign currency, including transactions arising when an entity:

(i) buys or sells goods or services whose price is denominated in a foreign currency;
(ii) borrows or lends funds when the amounts payable or receivable is denominated in a foreign currency;
(iii) otherwise acquires or disposes of assets, or incurs or settles liabilities, nominated in a foreign currency

One area that IAS 21 does not deal with is the translation of any transactions and balances that fall within the scope of IFRS 9 on financial instruments. For example, if a company takes out a forward foreign exchange contract to hedge against foreign currency exposure, the accounting treatment is covered by the rules in IFRS 9, because a forward contract is a financial instrument.

The Two Main Accounting Issues

Transactions and assets and liabilities in foreign currencies are translated or converted from the foreign currency into the currency of the reporting entity. The process of translation would be quite simple if exchange rates between currencies remained fixed. However, exchange rates are continually changing. The translated valuation of foreign currency assets or liabilities in the statement of financial position might therefore change if they are translated at different times.

The two main accounting issues when accounting for foreign currency items is:

a. What exchange rate(s) should be used for translation?
b. How to account for the gains or losses that arise when exchange rates change?

Before looking at these accounting rules in detail, it is important to understand the precise meaning of some key terms used in IAS 21.

Terms and Definitions Used in IAS 21: Currency Definitions

Definitions

Presentation Currency – the currency used to present an entity's financial statements.

Functional Currency – the currency of the primary economic environment in which the entity operates.

Foreign Currency – any currency other than the entity's functional currency.

IAS 21 identifies three types of currency: the presentation currency, the functional currency and foreign currency.

Presentation currency

An entity is permitted to present its financial statements in any currency. This reporting currency is often the same as the functional currency, but does not have to be.

Functional currency

When a reporting entity records transactions in its financial records, it must identify its functional currency and make entries in that currency. It will also, typically, prepare its financial statements in its functional currency. This rule applies to stand-alone entities, parent companies and foreign operations

(such as a foreign subsidiary or a branch). When financial statements prepared in a functional currency are translated into a different presentation currency, the translation of assets and liabilities must comply with the rules in IAS 21.

Functional currency is the currency of the primary economic environment in which the entity operates, which is the currency in which the reporting entity measures the items in its financial statements, and may differ from the presentation currency in some instances (Alibhai, et al., 2023).

IAS 21 describes the functional currency as:

a. The currency that mainly influences:
    - sales prices for goods and services; and
    - labour, material and other costs of providing goods or services.
b. The currency in which funds are generated by issuing debt and equity.
c. The currency in which receipts from operating activities are usually retained.
d. The functional currency is not necessarily the currency of the country in which the entity operates or is based, as the next example shows.

Illustrative Example 1: Presentation and functional currencies

Scenario:

Entity A operates an oil refinery in Nigeria. All sales are denominated in US dollars because refined-oil products are priced in that currency on global markets. Operating expenses are split as follows:

a. 20 per cent – salaries contractually payable in US dollars
b. 25 per cent – imports of plant and spare parts, invoiced in US dollars
c. 55 per cent – local costs incurred and settled in Naira

Depreciation is calculated in US dollars because the assets were funded in that currency, although it is a non-cash expense.

Required:

Identify the functional currency in line with IAS 21.

Suggested Solutions:

IAS 21 directs management to consider the currency that most significantly influences:

a. **Sales prices and revenue generation** – here, pricing and receipts are wholly in US dollars.
b. **Costs of labour, materials and other inputs** – although more than half of the day-to-day expenses are in Naira, a substantial 45 per cent (salaries and imported materials) is dollar-denominated. Depreciation is ignored for this assessment because it does not involve current cash flows.

Secondary indicators such as the currency of financing and the currency in which cash from operations is retained are also likely to point to the US dollar, given the nature of the industry.

Conclusion

Because revenue is driven almost entirely by US dollar pricing and a significant portion of costs is likewise dollar-based, the US dollar provides the most faithful representation of the economic environment in which Entity A generates and expends cash. Management is therefore justified, under IAS 21, in selecting the US dollar as the functional currency. If the financial statements are presented in Naira, they must be translated from this US-dollar functional currency.

Change of functional currency

An entity's functional currency may change when its business operations change, leading to a different primary economic environment being identified. This is not a change in accounting policy, but instead

results from a change in circumstances, and therefore the new functional currency should be adopted prospectively from the date of that change. The new functional currency is applied by retranslating all items and comparative amounts into the new currency at the date of the change in circumstances. The carrying amounts of non-monetary items translated into the new currency at the date of change should be deemed to be their historical translated amounts.

Illustrative Example 2: Change of functional currency
Scenario
An entity founded in Belgium originally used the euro (€) as its functional currency. Over time, it:

Exported goods to the United Kingdom, invoicing sales in pounds sterling (£).
Established a small manufacturing branch in the United Kingdom, where both costs and revenues were in pounds.

By the end of 2016, United Kingdom activity represented roughly 75 percent of total operations. Management therefore judged, early in 2017, that the United Kingdom had become the primary economic environment. They decided that the functional currency would switch from the euro to the pound with effect from 1 January 2018.
At December 31, 2017, the entity's equity and net assets totalled €80,000,000. The closing exchange rate was £1: €1.59.

Required:

How might the change be reflected in the financial statements?

Suggested Solutions: Impact on the financial statements
IAS 21 requires a functional-currency change to be accounted for prospectively, using the exchange rate on the date of change. All assets, liabilities and equity balances are translated once and become the opening carrying amounts in the new functional currency.

Equity and net assets in pounds = €80,000,000/1.59 ≈ **£50,314,465**
Thus, from January 1, 2018 the opening equity and net-asset figure recorded in the books is £50,314,465.

Disclosure requirement
IAS 21 also mandates a clear note explaining:

a. That the functional currency has changed during the period.
b. The date of the change.
c. The principal reason, namely that most revenues and cash flows are now generated in the United Kingdom.

Providing this information helps users understand why the pounds sterling better reflects the entity's economic environment.

Terms and definitions used in IAS 21:other definitions
Exchange Rate Definitions

Definitions

Exchange rate – the price at which one currency can be exchanged for another, for example £1 = $1.25.

Spot rate – the exchange rate in force on the date a transaction takes place.

IAS 21 uses the following terms to describe which exchange rate should be used in the translation. For example, suppose that on November 16, a German company buys goods from a US supplier, and the goods are priced in US dollars. The financial year of the company ends on December 31, and at this date the goods have not yet been paid for.

The spot rate is the euro/dollar exchange rate on November 16, when the transaction occurred. The closing rate is the exchange rate at December 31.

Other definitions

Definitions

Foreign operation – A subsidiary, associate, joint venture or branch that conducts its activities in a currency or country different from the reporting entity's functional currency.

Net investment in a foreign operation – The reporting entity's interest in the net assets of that foreign operation.

Exchange difference – The gain or loss that arises when the same assets, liabilities, income or expenses are translated between currencies using different exchange rates.

Monetary items – Cash, and assets or liabilities that will be received or settled in a fixed or determinable amount of money; for example, cash balances, loans, trade receivables, trade payables and interest payable.

Non-monetary items – Assets and liabilities that do not qualify as monetary items, such as property, plant and equipment, investments in other companies, investment property and deferred tax balances.

26.3 The Individual Entity: Accounting rules

Introduction

An individual company may have transactions that are denominated in a foreign currency. These must be translated into the company's functional currency for the purpose of recording the transactions in its ledger accounts and preparing its financial statements.

These transactions may have to be translated on several occasions. When a transaction or asset or liability is translated on more than one occasion, it is:

translated at the time that it is originally recognised; and

re-translated at each subsequent occasion.

Re-translation may be required, after the transaction has been recognised initially:

(a) at the end of a financial year (end of a reporting period);

(b) when the transaction is settled (which may be either before, or after the end of the financial year)?

(c) On each subsequent re-translation, an exchange difference will occur. This gives rise to a gain or loss on translation from the exchange difference.

Initial recognition translation of transactions

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On initial recognition, a transaction in a foreign currency must be translated at the **spot rate** on the date of the transaction.

If the company purchases goods on most days in the foreign currency, it might be administratively difficult to record every transaction at the actual spot rate. For practical reasons, IAS 21 therefore allows entities to use an **average rate** for a time period, provided that the exchange rate does not fluctuate significantly over the period. For example, an entity might use an average exchange rate for a week or a month for translating all the foreign currency-denominated transactions in that time period.

These rules apply when an entity:

a. buys goods or services that will be paid for in another currency;
b. sells goods or services invoiced in another currency;
c. borrows or lends when the interest payments and repayments of principal are in another currency;
d. purchases or disposes of non-current assets in another currency; or
e. receives dividends and other payments in another currency.

Illustrative example 3: Initial recognition

Brianco Ltd.'s functional currency is the CU. Brianco Ltd buys a large consignment of goods from a supplier in Germany. The order is placed and the goods are delivered on 1 May. The agreed price is €127,875. At the time of delivery, the exchange rate was €1.50 to CU1.

Required:
Prepare the journal entry to record the initial transaction in the accounting records.

Suggested solution:
Brianco Ltd would record the purchase at the spot rate at the date of the transaction in its accounts as follows:

		CU	CU
Debit: Purchases	(€127,875 ÷ 1.50)	85,250	
Credit: Trade payables			85,250

Multiple exchange rates

It may be the case that a country operates a two (or more) rate system, such as one for capital transactions and another for revenue items. Where more than one exchange rate exists, the rate to be applied is the one at which the transaction or balance would have been settled if settlement had taken place at the measurement date. If there is a temporary lack of published exchange rates between two currencies, the entity should apply the next available exchange rate published.

Suspension of Rates

On certain occasions, developing countries experience economic problems that affect the convertibility of their currency. There is no exchange rate to be used in this case to translate foreign currency transactions. The standard requires companies to use the rate on the first subsequent date at which exchanges could be made.

Reporting at the End of Each Reporting Period

Transactions in a foreign currency

Transactions in a foreign currency may still 'exist' in the statement of financial position at the end of the financial period. They were recognised initially in the accounts at the spot rate on the date of the transaction. However, exchange rates change over time and the exchange rate at the end of the reporting period will not be the same as the spot rate on the date of the transaction.

For example, there may be a trade receivable in the statement of financial position relating to a sale denominated in a foreign currency. The trade receivable would have been translated at the spot exchange rate on the transaction date. It is still a receivable in a foreign currency at the end of the reporting period.

Illustrative Example 4: Initial Recognition and Choice of Exchange Rate for Interest Income

Scenario

An entity with sterling (£) as its functional currency purchased a Ruritanian-denominated bond on 1 January 1, 2021 for RU 1,000. Key facts are:

Detail	Information
Coupon	Variable, currently 6%
Term	Five years to maturity
Interest accrual	Daily, for a calendar year
First cash coupon	31 January 20X2 (covers interest earned in 20X1)
Classification	Measured at amortised cost
Accounting	Interest income and exchange differences recognised in profit or loss

Exchange rates:
Acquisition date, January 1, 2021 RU 1 = £1.50
Period-end, December 31, 2021 RU 1 = £2.00
Daily weighted-average for 2021 RU 1 = £1.75 (as published by the Central Bank of Ruritania)

Required:

Which exchange rate should management apply when translating the daily-accrued interest income, given the significant fluctuations during the period?

Suggested solution:

IAS 21 permits the use of an average rate when it approximates the result of using spot rates on each transaction date. Because interest accrues evenly throughout the year, a **daily weighted-average rate** best reflects the pattern of cash generation and captures the volatility in the exchange markets. Using a simple (unweighted) average would misstate income where rates move sharply, so it is not appropriate in this context.

Journal entry to record interest receivable at year-end

Account	Debit (£)	Credit (£)
Investment in debt instrument	105	
Interest income		105

Computation: RU 60 interest (6% × 1,000) × £1.75 weighted-average rate = £105.

Conclusion

Management should translate the accrued interest using the officially published daily weighted-average exchange rate, ensuring that the recognised sterling amount mirrors the economic substance of daily accruals amid significant rate movements.

An important accounting question is therefore: Should a different exchange rate now be used now to translate the asset into the functional currency of the entity, for the purpose of preparing the financial statements for the year?

Revaluations of non-current assets

A non-current asset in a foreign currency might be re-valued during a financial period. For example, a UK company might own an office property in the US. The cost of the office would have been translated at the spot rate when the property was originally purchased. However, it might subsequently be re-valued. The revaluation will almost certainly be in US dollars, and this re-valued amount will have to be translated into the functional currency of the entity (in this example, sterling).

What exchange rate should be used to record the revaluation?

What exchange rate should be used at the end of the reporting period, and at the end of any subsequent reporting period?

The rules

The rules in IAS 21 for reporting assets and liabilities at the end of a subsequent reporting period make a distinction between:

monetary items, such as trade payables and trade receivables; and

non-monetary items, such as non-current assets and inventory.

Year-end translation rules for a single-entity financial statements

Item Type	Statement of Financial Position Treatment
Monetary assets and liabilities	Re-translate using the closing rate at the reporting date.
Non-monetary assets and liabilities measured at historical cost	Do not re-translate; keep the original spot rate applied on the transaction date.

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Non-monetary assets and liabilities measured at fair value	Re-translate using the exchange rate in force on the date the fair value was determined.

Gain or loss arising on translation

Any subsequent re-translation after the initial recognition of a transaction will give rise to an exchange gain or loss if the exchange rate has changed since the initial transaction date.

The gain or loss is the difference between the original and re-translated value of the item.

There is an exchange **gain** when an asset increases in value on re- translation, or when a liability falls in value.

There is an exchange **loss** when an asset falls in value on re-translation, or when a liability increases in value.

Again or loss arising on there- translation of a monetary item should be recognised in profit or loss in the period that it arises.

When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange rate gain or loss relating to it should also be included in other comprehensive income. For example, when a gain or loss on revaluation of a non-current asset is reported in other comprehensive income, the related exchange difference is also recognised in other comprehensive income rather than in profit or loss for the period.

Illustrative example 5: Year-end retranslation of a foreign-currency loan

Facts

Functional currency of borrower is £ sterling
Borrowing US $900,000 taken on 3 June
Spot rate on June 3, is US $1.80 = £1
Spot rate on December 3. (interest paid) is US $1.85 = £1
Spot rate on December 31, (reporting date) is US $1.90 = £1
Interest cash payment is US $18,500 on December 3

Step 1 – Initial recognition

Loan principal in sterling = $900,000/1.80 = £500,000

Step 2 – Recognition of the interest payment

The payment is translated at the spot rate on 3 December:
$18,500/1.85 = £10,000

Step 3 – Year-end retranslation of the loan

Closing carrying amount = $900,000/1.90 = £473,684

Step 4 – Exchange difference

Exchange gain = £500,000 − £473,684 = £26,316

Because the loan is a monetary liability, the exchange gain is recognised immediately in profit or loss for the year.

Summary journal entries

Date	Account	Debit (£)	Credit (£)
3 June 3	Cash	500,000	
	Loan payable (US $900,000)		500,000
3 December 3	Loan payable – interest	10,000	
	Cash		10,000
31 December 31	Loan payable – retranslation		26,316
	Exchange gain (Profit/Loss)	26,316	

The carrying amount of the loan at the reporting date is £473,684, and the £26,316 gain improves current-year profit.

Illustrative example 5:

A UK company bought a machine from a German supplier for €260,000 on March 1, when the exchange rate was €1.30 = £1. By December 31, the end of the company's accounting year, the exchange rate was €1.20 = £1.

At December 31, the UK company had not yet paid the German supplier any of the money that it owed for the machine.

At the year-end

The machine is recognised initially at £200,000 (€260,000 / 1.30). As it is a non-monetary item, it will not be re-translated and there is no gain or loss.

However, the company purchased the machine on credit and had not settled the account payable by the year-end. The amount payable should be re-translated at the closing rate, because this is a monetary item. The payable would therefore be re-translated to £216,667 (= €260,000/1.20).

The re-translation will give rise to an exchange difference. In this example the re-translated amount of the liability is higher, and a loss of £16,667 should be reported in profit or loss for the year.

Year-end translation: non-monetary asset versus monetary liability

Transaction

March 1: machine purchased from a German supplier for €260,000, spot rate €1.30 = £1, settlement deferred.

December 31: reporting date, spot rate €1.20 = £1, liability still unpaid.

Initial Recognition (March 1)

Item	Amount in Euros	Spot Rate	Amount in Sterling	Comment
Machine (PPE)	€260,000	1.30	£200,000	Non-monetary asset recorded at historical cost

Trade payable	€260,000	1.30	£200,000	Monetary liability measured at the same spot rate

Year-end treatment (December 31)

Item	Measurement Rule	Calculation	Carrying Amount	Effect on Profit or Loss
Machine	No retranslation because it is a non-monetary item carried at cost	—	£200,000	Nil
Trade payable	Retranslate at the closing rate because it is a monetary item	€260,000 ÷ 1.20	£216,667	Exchange loss £16,667

Result

Liability increases from £200,000 to £216,667, creating an exchange loss of **£16,667** that must be recognised in profit or loss for the year.

Carrying amount of the machine remains **£200,000**; no gain or loss arises on the asset.

This example illustrates the IAS 21 rule that only monetary items are retranslated at the closing rate, while non-monetary items held at historical cost remain at the original spot rate.

Reporting at the settlement of a transaction

The settlement of a foreign currency transaction involves a receipt or payment in foreign currency. Settlement in the foreign currency is made at the spot exchange rate that applies on that date. (Note: This chapter ignores the possibility of using a forward exchange contract to fix the exchange rate in advance: the accounting effects of forward contracts are explained in another chapter.)

The exchange rate at the settlement date may be:

a. different from the spot rate on the date of the original transaction, and
b. different from the closing exchange rate at the end of the previous reporting period (if there is a year-end between the original transaction and settlement).

A gain or loss on translation may therefore occur:

a. at the end of a reporting period; and in addition
b. at settlement of the transaction.

For example, suppose that a UK company buys goods, payable in US dollars, from a US supplier on December 10 Year 1. Its year end is December 31, and the company pays the supplier on February 9, Year 2.

In this situation:

a. The purchase transaction will be recorded in sterling at the spot rate on December 10, Year 1.
b. The trade payable will also be recorded in sterling at the spot rate on December 10, Year 1.
c. The trade payable will be re-translated on December 31, at the year-end, because it is a monetary item. A gain or loss will arise on the re-translation, and this will be recognised in profit or loss for the year ending December 31, Year 1.

The US supplier is paid on February 9, and the cost of obtaining the dollars to make the payment will be the exchange rate available on 9 February, the settlement date.

If the cost of the settlement is different from the amount at which the transaction is recorded in the ledger accounts (the amount at which the payable was re- translated on December 31, Year 1), a further gain or loss will arise. This is the difference between the translated value of the liability in the ledger accounts and the actual cost of making the settlement. This settlement gain or loss should be included in profit or loss for the year ended December 31, Year 2.

Illustrative example 6: Settlement of a transaction

A UK company sells goods to a customer in Saudi Arabia for $72,000 on September 12, when the exchange rate was $1.80 = £1. It received payment on November 19, when the exchange rate was $2 = £1. The financial year-end is December 31.

The sale will be initially translated at the spot rate. This will give rise to revenue and receivables of £40,000 ($72,000/1.80).

The receipt of the payment is recorded at £36,000 ($72,000/2.00). The receivable has fallen in value over the two months: it was initially recorded at £40,000 but at settlement it is only worth £36,000. The company has an exchange loss on settlement of £4,000. This is recognised in profit or loss for the year.

Illustrative Example 7: Settlement of a transaction

A UK company buys goods from a US supplier for $30,000 on 30 November Year 1 when the spot exchange rate was $1.50 = £1. The company has a financial year that ends on December 31. At December 31, Year 1, the exchange rate is $1.80 = £1. The payment for the goods is made on March 16, Year 2, when the exchange rate was $1.60 = £1.

The transaction is recorded initially at £20,000 ($30,000 ÷ 1.50):

Debit:	Purchases	£20,000
Credit:	Trade payables	£20,000

If the purchased inventory is still held at the end of the reporting period on December 31 Year 1, it is not re-translated because inventory is a non-monetary item.

However, the amount payable at December 31, Year 1 is re-translated to the closing rate, giving a revised balance of £16,667 ($30,000 ÷ 1.80).

The re-translated amount of the liability is lower, so there is a gain on the re-translation of £3,333.

This gain is included in profit or loss for Year 1:

Debit:	Trade payables	£3,333
Credit:	Profit or loss	£3,333

The payment on March 19, Year 2 is recorded at the exchange rate on the settlement date. The payment is therefore £18,750 ($30,000 ÷ 1.60).

Debit:	Trade payables	£16,667
Credit:	Cash	£18,750

There is a loss on settlement of £2,083 (£18,750 – £16,667), arising from the exchange difference between translating the foreign-currency amount at the end of the previous reporting period and at the settlement date. This gain or loss from the exchange difference is included in profit or loss for Year 2.

26.4 The foreign operation: Accounting rules

Three stages in the consolidation process

If a company has a foreign operation (such as a foreign subsidiary) that prepares its accounts in a functional currency that is different from the group's presentation currency, there are three stages in the accounting process, for the purpose of preparing consolidated financial statements (or including the foreign associate or joint venture in the financial statements of the reporting entity).

Stage	Key Actions
1. Adjust and update	Confirm that the foreign entity's own financial statements are complete and accurate. Post any correcting entries in the foreign entity's books, using its functional currency.
2. Translate	Translate the foreign entity's assets, liabilities, equity, income and expenses into the parent's presentation currency. Apply IAS 21 translation rules (for example, closing rate for assets and liabilities, average rate for income and expenses).
3. Consolidate	With all statements now in a single currency, apply standard group-accounting procedures to produce the consolidated financial statements.

The translation stage

The rules set out below apply where the functional currency of the foreign entity is not a currency suffering from hyperinflation. (Hyperinflation is where the country's rate of inflation is very high. When there is hyperinflation, IAS 29 provides special accounting rules, which are described later.)

The normal rules for translation, contained in IAS 21, are as follows:

The statement of financial position

The assets and liabilities of the foreign operation, for inclusion in the consolidated statement of financial position, are translated at the **closing rate**. (Comparative figures for the previous year are translated at the same rate.)

For foreign subsidiaries, this rule also applies to **purchased goodwill** arising on the acquisition of the subsidiary.

The statement of profit or loss

Income and expenses for inclusion in the consolidated statement of profit or loss are translated at the **spot rates** at the dates of each of the transactions.

For practical reasons, **average rates** for a period may be used, if they provide a reasonable approximation of the spot rates when the transactions took place.

Exchange differences

All resulting exchange differences are recognised in other comprehensive income for the period and are credited (gain) or debited (loss) to a **separate reserve** within the equity section of the consolidated statement of financial position, and this reserve is maintained within equity until the foreign operation is eventually disposed of.

Gains or losses are therefore reported as gains or losses in other comprehensive income and movements in the separate reserve, and not as a gain or loss in profit or loss and an increase or reduction in retained earnings.

The Gain or Loss on Translation

The exchange differences on translation (see (3) above) result in a gain or loss. These gains or losses arise from a combination of two factors:

Income and expense items are translated at the exchange rates ruling during the period (or an average rate as an approximation) but assets and liabilities are translated at closing rates. The profit is therefore calculated at the actual (average) exchange rates, but the accumulated profit in the consolidated statement of financial position is re-translated at the closing rate.

The net assets of the subsidiary were translated at last year's closing rate at the end of the previous financial year. These net assets have now been retranslated and included in this year's statement of financial position at this year's closing rate.

IAS 21 states that these differences on translation are not recognised in profit or loss because changes in the exchange rates for these items have little or no effect on cash flows from operations. It would therefore be misleading to include them in profit or loss.

Illustrative example 8:

A UK parent company has a US subsidiary, which is 100% owned. The following information is available about the subsidiary for the year to December 31, Year 5:

Opening net assets, January 1,	$20,000
Profit for the year	$10,000
Closing net assets, December 31	$30,000
Dividends paid	$0
Relevant $/£ exchange rates are as follows:	
January 1, Year 5	$1.70 = £1
Average for the year	$1.80 = £1
December 31 Year 5	$1.90 = £1

Required

Calculate the total gain or loss on translation for the year, analyzing it between:

a. The gain or loss on re-translating income and expenses.
b. The gain or loss on re-translating the opening net assets.

Exchange-difference calculation and presentation

Step	USD Amount	Rate Used	Sterling Equivalent	Exchange Effect
a) Opening net assets	20,000	Opening 1.70	£11,765	
	20,000	Closing 1.90	£10,526	**Loss £1,239**
b) Current-year profit	10,000	Average 1.80	£5,556	
	10,000	Closing 1.90	£5,263	**Loss £293**

Total exchange loss recognised in other comprehensive income

£1,239 + £293 = **£1,532**

Notes

Because no dividend was paid, the full profit for the period remains in accumulated profits.

Under IAS 21, the £1,532 exchange loss is reported in other comprehensive income and accumulated in a separate translation-reserve column within equity in the consolidated statement of financial position.

The consolidation stage

After the translation stage, the financial statements of the overseas entity are in the presentation currency of the parent company.

The basic rule is that normal consolidation techniques can now be used. However, a foreign exchange reserve must be included in the consolidated statement of financial position for the cumulative exchange differences.

It is also necessary to comply with the requirements of IAS 21 for purchased goodwill and foreign subsidiaries.

Purchased goodwill and foreign subsidiaries

IAS 21 requires that goodwill and any fair value adjustments arising on the acquisition of a foreign subsidiary are to be treated as part of the assets and liabilities of the foreign subsidiary. The rules already described apply to these items.

This means that:

Goodwill arising on the purchase of the foreign subsidiary (and also any fair value adjustments to the value of assets of the subsidiary) should be stated in the functional currency of the foreign subsidiary.

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The goodwill and fair value adjustments will therefore be translated each year at the **closing exchange rate**.

A gain or loss on translation will therefore arise (as described above for other assets and liabilities).

The effect of this rule is that goodwill and the acquisition of a foreign operation is re-stated over time because it is re-translated every year at the new closing exchange rate.

The rationale behind this accounting rule is that the amount paid for the investment in the subsidiary has been based on the expected future earnings stream. The goodwill relates to a business which operates in the economic environment of another country and should therefore be expressed in the functional currency of the foreign subsidiary.

Illustrative Example 9: Retranslation of Goodwill

Scenario

A UK holding company acquired 100% of the share capital of a US subsidiary on **30 September Year 6** for **$ 8 million**. The fair value of the subsidiary's net assets on that date was **$ 3 million**.

The holding company prepares financial statements to **31 December** each year and applies the **Partial-Goodwill Method** (no goodwill is attributed to the non-controlling interests).

Date	Spot Exchange Rate
30 September Year 6	$ 2.00 = £ 1
31 December Year 6	$ 1.90 = £ 1

Required

Calculate the goodwill arising on the acquisition date, in pounds sterling (£).

Calculate the amount of goodwill (in £) that will appear in the consolidated statement of financial position as at **31 December Year 6**.

Suggested Solutions:

	$ million	Rate $: £	£ million
(a) Goodwill at acquisition (30 Sep Y6)		2.00	
- Cost of investment	8	2.00	4.0
- Net assets acquired	3	2.00	1.5
Goodwill	5	2.00	**2.5**

(b) Goodwill in the consolidated statement of financial position – 31 Dec Y6

Retranslate the $ 5 million goodwill at the closing rate of **$ 1.90 = £ 1**

£ carrying amount = $5 million/1.90 = £2.632 million

Exchange gain on retranslation

£2.632 million − £2.5 million = £0.132 million

The £0.132 million exchange gain is recognised in **other comprehensive income** and credited to the foreign-exchange reserve within equity in the consolidated statement of financial position.

Illustrative examples 10: Consolidation

The following example looks at the whole process of foreign currency consolidation, beginning with the translation of the foreign subsidiary's accounts and finishing with their consolidation into the parent group accounts.

Scenario:

AB owns 75% of JK which is located in a different country. The currency of this country is the Florin (Fl). AB acquired its shares in JK on 1 May Year 6 for 240 million Florins when the retained earnings of JK were 160 million Florins. Their statements of financial position are shown below:

Statements of financial position –April 30, Year 7

	AB ($ million)	**JK (Fl million)**
Tangible non-current assets	594	292
Investment in JK	48	–
Current assets	768	204
Total Assets	**1,410**	**496**
Share capital	120	64
Share premium	100	40
Retained earnings	720	190
Total Equity	**940**	**294**
Non-current liabilities	60	82
Current liabilities	410	120
Total Equity & Liabilities	**1,410**	**496**

Notes:

The fair value of JK's net assets at acquisition is the same as their carrying value.

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JK operates with autonomy in its business operations.

AB uses the **partial goodwill method** to account for non-controlling interests, and NCI does not include an amount for goodwill.

The following exchange rates are relevant:

May1,Year6 Fl 5.0 =$1

Average for the year Fl 4.0 =$1

April 30, Year7 Fl 4.2 =$1

Required:

Prepare a consolidated statement of financial position at April 30, Year 7.

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Suggested Solution:

Stage	Action	Outcome
Step 1 Adjust and update	Eliminate inter-company items if required.	None required in this example.
Step 2 Translate subsidiary	Convert JK's statement of financial position into US dollars at the closing rate, Fl 4.2 = $1.	See translation table below.
Step 3 Compute consolidation figures	• Goodwill at closing rate • Exchange gain on cost of investment • Non-controlling interest (NCI) • Group reserves	Detailed workings shown below.
Step 4 Consolidate	Combine AB figures with the translated JK figures.	Consolidated statement of financial position prepared at April 30, Year 7.

Step 2 – Translation of JK Balances at Fl 4.2 = $1

JK Item	Florin Amount (m)	Exchange Rate (Fl ÷ $)	$ million
Tangible assets	292	4.2	69.5
Current assets	204	4.2	48.5
Total Assets	**496**		**118.0**
Share capital	64	4.2	15.2
Share premium	40	4.2	9.5
Retained earnings at acquisition	160	4.2	38.1
Post-acquisition profits	30	4.2	7.1
Non-current liabilities	82	4.2	19.5
Current liabilities	120	4.2	28.6
Total Equity and Liabilities	**496**		**118.0**

Step 3 – workings

Item	Computation	$ million
Goodwill at closing rate	Cost of investment: Fl 240 million ÷ 4.2	57.1
	Parent share of net assets acquired: 75% × Fl 264 million ÷ 4.2	(47.1)
	Goodwill	**10.0**
Exchange gain on cost	Cost at acquisition: 240 ÷ 5.0 = 48.0 Cost at closing: 240 ÷ 4.2 = 57.1	**9.1**
NCI (25%)	25% × JK closing net assets $69.9 million	**17.5**
Group reserves	Parent retained earnings $720.0 million + 75% × post-acquired profit $7.1 million = 5.3 + exchange gain $9.1 million	**734.4**

Consolidated Statement of Financial Position

AB Group – Consolidated Statement of Financial Position

As at May 31, Year 7 (figures in $ million)

	$ million
Non-Current Assets	
Tangible assets (594 + 69.5)	663.5
Goodwill	10.0
Current Assets (768 + 48.5)	816.5
Total Assets	**1,490.0**
Equity attributable to owners of AB	
Share capital	120.0
Share premium	100.0
Retained earnings	734.4
Equity - to the Parent	**954.4**
Non-controlling interests (25% of subsidiary)	17.5
Total Equity	**971.9**
Non-Current Liabilities (60 + 19.5)	79.5
Current Liabilities (410 + 28.6)	438.6
Total Liabilities	**518.1**
Total Equity and Liabilities	**1,490.0**

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The $9.1 million exchange gain on the investment cost is taken to the foreign currency translation reserve within equity.

Exchange Differences in Other Comprehensive Income

Using the method of creating the consolidated statement of financial position shown in the previous example, you do not need to worry about exchange differences. By translating every balance in the subsidiary's statement of financial position at the closing rate, the exchange differences are automatically included in reserves.

However, you may be asked to calculate exchange differences arising for reporting in other comprehensive income and a separate equity reserve.

The easiest way to work out the exchange differences (excluding the gain or loss on re-translation of goodwill) is to create the accounting equation for the foreign subsidiary in its own currency. Once this is translated into the parent's currency it will not balance, and the exchange differences are the balancing figure. These are the exchange differences arising from:

re-translating the opening net assets of the subsidiary at the closing rate, and

re-translating the subsidiary's post-acquisition profit at the closing rate. An example will be used to demonstrate the calculation.

Illustrative Example 11:

The same example that was used above will be used here, with the exception that the acquisition occurred one day earlier, at the end of the previous financial year.

AB owns 75% of JK which is located in a different country. The currency of this country is the Florin (Fl). AB acquired its shares in JK on 30 April Year 6 for 240 million Florins when the retained earnings of JK were 160 million Florins. The statement of financial position of JK as at 30 April Year 7 is shown below:

JK: Statement of Financial Position at 30 April Year 7

	Fl million
Tangible Non-Current Assets	292
Current Assets	204
Total Assets	**496**
Share Capital	64
Share Premium	40
Retained Earnings	190
Total Equity	**294**
Non-Current Liabilities	82
Current Liabilities	120
Total Equity & Liabilities	**496**

Notes:

AB measures non-controlling interest on acquisition as a proportionate share of net assets.

JK did not pay any dividends during the year.

Relevant exchange rates:

April 30, Year 6 Fl 5.0 = $1

Average for the year Fl 4.0 = $1

April 30, Year 7 Fl 4.2 = $1

Suggested solution:

Consolidated impact of subsidiary JK – summary for AB Group

Step 1. Position at 30 April Year 6

Component	Florins (m)	Rate Fl / $	US $ (m)
Cost of investment	240	n/a	—
Parent's share of JK net assets (75% × (64 + 40 + 160))	198	5.0	39.6
Goodwill	42	5.0	**8.4**
Full net assets of JK (64 + 40 + 160)	264	5.0	52.8
Non-controlling interest (NCI) 25%	66	5.0	13.2

Step 2. Year to April 30, Year 7

Movement	Florins (m)	Rate used	US $ (m)
JK post-acquisition profit	30	average 4.0	7.5
– attributable to AB (75%)	22.5	4.0	5.6
– attributable to NCI (25%)	7.5	4.0	1.9

Step 3. Closing net assets and exchange gains (30 April Year 7)

Item	Florins (m)	Rate 4.2	US $ (m)
Closing net assets (264 + 30)	294	4.2	**70.0**
Opening net assets + current-year profit	—	—	60.3
Exchange gain on net assets	—	—	**9.7**

Allocation of the exchange gain:

Parent (75%): $7.3 million

NCI (25%): $2.4 million

Step 4. Exchange gain on goodwill

Item	Florins (m)	Rate	US $ (m)
Opening goodwill	42	5.0	8.4
Closing goodwill	42	4.2	10.0
Exchange gain	—	—	**1.6**

Entirely attributable to the parent.

Step 5. Movement in Equity (Parent and NCI)

Consolidation Bridge – Movement from April 30, Year 6 to April 30, Year 7

Component	Florins (m)	Rate Fl/ $	US $ (m)	Comments
Assets recognised				
• Goodwill (constant Fl 42 m)	42.0	4.2	10.0	Retranslated at closing rate
• Closing net assets of JK	294.0	4.2	70.0	Includes post-acquisition profit
Total carrying amount of JK			**80.0**	Matches asset side in group SOFP
Equity recognised				
Parent's share of JK profit (75% × Fl 22.5 m)	22.5	4.0	5.6	Profit translated at average rate
Exchange gain – goodwill	—	—	1.6	Entirely to parent OCI
Exchange gain – net assets (75% × $9.7 m)	—	—	7.3	Parent share of translation gain
Increase in parent reserves			**14.5**	5.6 + 1.6 + 7.3
Non-controlling interest (25% × $70 m)	—	—	17.5	Closing NCI equity
Total equity entries			**32.0**	14.5 + 17.5
Balancing figure			**48.0**	Equals historical cost of investment

Exchange gains recognised in OCI

Gain on goodwill translation **$1.6 million**

Parent share of net-asset gain **$7.3 million**

Total to parent reserves $8.9 million
(credited to the foreign-currency translation reserve).

Non-controlling interest reconciliation (US $ m)

	Amount
Opening NCI (30 Apr Y6)	13.2
+ Share of JK profit (25% × $7.5 m)	1.9
+ Share of net-asset exchange gain (25% × $9.7 m)	2.4
Closing NCI (30 Apr Y7)	**17.5**

All figures comply with IFRS 3 (partial-goodwill method) and IAS 21 translation rules, providing a clear audit trail from opening balances to the consolidated position at 30 April Year 7.

Disposal of a Foreign Subsidiary

Most of the accounting rules for the disposal of a foreign subsidiary, or for the partial disposal of a foreign subsidiary, are set out in IFRS 10. Disposals are explained in another chapter.

However, IFRS 10 does not deal with the accounting treatment of the balance on the separate equity reserve account when a foreign subsidiary is disposed of.

This matter is dealt with by IAS 21.

When the entire investment in a foreign subsidiary is disposed of, the cumulative balance in the separate equity reserve (which represents amounts previously recognised in other comprehensive income) should now be reclassified from equity to profit and loss.

If there was a non-controlling interest in the subsidiary, the NCI is derecognised in the consolidated statement of financial position. Amounts previously recognised in other comprehensive income and attributed to NCI must not be reclassified and recognised in profit or loss of the reporting entity.

When a proportion of an investment in a foreign subsidiary is disposed of, a proportionate share of the amounts previously recognised in other comprehensive income (the cumulative balance in the separate equity reserve) should now be reclassified from equity to profit or loss.

When income previously recognised as other comprehensive income is reclassified as a gain or loss to profit or loss as a re-classification adjustment, there must be an offsetting loss or gain in other comprehensive income, to avoid double-counting of the gain (or loss).

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Illustrative Example 12: Disposal

A company held 100% of the equity of a subsidiary S but sold the entire investment on June 1, when the carrying value of the net assets S and the purchased goodwill were ₦30 million. The consideration received from selling the shares was ₦37 million.

The company had previously recognised exchange gains of ₦2 million in other comprehensive income on its investment in S.

Required

Show the amount to be recognised in the statement of profit or loss in respect of this disposal.

Disposal of Subsidiary – Profit or Loss Impact

Calculation	**₦ million**
Proceeds from sale of shares	37.0
Carrying amount of subsidiary's net assets	(30.0)
Gain on disposal	**7.0**
Add: exchange gain previously recorded in OCI (reclassification)	2.0
Total gain recognised in profit or loss	**9.0**

Note: A debit of ₦2 million is posted to other comprehensive income to remove the exchange gain that has now been recycled to profit or loss, thereby preventing double counting.

AB Group – Consolidated statement of financial position

As at May 31, Year 7 (US $ million)

Non-Current Assets	
Tangible assets	663.5
Goodwill	10.0
Current Assets	816.5
Total Assets	**1,490.0**
Equity attributable to owners of AB	
Share capital	120.0
Share premium	100.0
Retained earnings	734.4
Equity to AB Shareholders	**954.4**
Non-controlling interests	17.5
Total Equity	**971.9**
Non-Current Liabilities	79.5
Current Liabilities	438.6
Total Equity and Liabilities	**1,490.0**

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26.5 Chapter review

Key concepts you should now command

a. Scope and objectives of IAS 21.
b. Identification of functional versus presentation currency.
c. Initial recognition and subsequent measurement of foreign-currency transactions.
d. Treatment of monetary and non-monetary items at year-end.
e. Consolidation procedures for foreign operations, including exchange-reserve accounting.
f. Disposal rules for foreign subsidiaries and the recycling of cumulative exchange gains or losses.

Self-assessment checklist

Tick each box only when you can perform the task confidently, using concise professional language suitable for ICAN examinations.

Competence statement
• **Identify the functional currency of an entity that earns revenue and incurs costs in more than one jurisdiction.**
• **Record a sale, year-end retranslation and final settlement of a foreign-currency receivable, showing all exchange differences.**
• **Decide whether a foreign-currency loan is a monetary item and demonstrate the correct year-end treatment.**
• **Translate a subsidiary's statement of profit or loss using spot or average rates and its statement of financial position at the closing rate.**
• **Prepare the exchange-reserve movement arising from retranslation of opening net assets and current-year profits.**
• **Calculate and present the gain or loss on disposal of a foreign subsidiary, including recycling of the exchange reserve.**
• **Draft disclosure notes that satisfy IAS 21 requirements for functional-currency change and exchange-difference presentation.**

Moving From Knowledge to Application

Apply the rules. Select a recent Nigerian listed company with foreign operations and map its IAS 21 disclosures against the checklist above.

Integrate thinking. Prepare a one-page working paper that reconciles the exchange-reserve movement between opening and closing equity.

Reflect and refine. Identify one area where the company could enhance clarity or compliance and propose a practical improvement.

Completing these steps will consolidate your ability to analyse, account for and communicate the effects of foreign exchange movements at the standard expected of a professional accountant.

26.6 End of chapter questions and suggested solutions

26.6.1 Questions

QUESTION 1:

On January 1, 2015 an entity whose functional currency is the pound sterling purchased a US dollar denominated equity instrument at its fair value of $500,000. (The entity has made an irrevocable election under IFRS 9 to record changes in the value of investments in equity instruments in other comprehensive income.) The exchange rate at acquisition date was $1.90/£. The exchange rates and the fair value of the instrument denominated in US dollars at different reporting dates are given below.

Equity instrument value

	$/£1	$
December 31, 2015	1.80	480,000
December 31, 2016	1.60	450,000

Required:

What is the fair value of the asset at 1 January 20X5, 31 December 20X5 and 31 December 20X6 in pounds sterling, and how will the changes in fair value be accounted for?

QUESTION 2:

The abridged statements of financial position and profit or loss of Darius Co and its foreign subsidiary, Xerxes Inc, appear below.

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Draft statement of financial position as at December 31, 2019

	Darius Co		Xerxes Inc	
	£	£	€	€
Non-current assets				
Plant at cost	600		500	
Depreciation	(250)	350	(200)	300
Investment in Xerxes				
100 shares @ £0.25 per share		25		375
			300	
Current assets				
Inventories		225		200
Receivables		150		100
		375		300

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	750	600
Equity and liabilities		
Equity		
Ordinary £1/€1 shares	300	100
Retained earnings	300	280
	600	380
Long-term loans	50	110
Current liabilities	100	110
	750	600

Statements of profit or loss for the year ended December 31, 2019

	Darius Co	Xerxes Inc
	£	€
Profit before tax	200	160
Income tax	(100)	(80)
Profit after tax, retained	100	80

The following further information is given:

a. Darius Co has had its interest in Xerxes Inc since the incorporation of the company.
b. Depreciation is 8% per annum on cost.
c. The carrying amount of equity of Xerxes at December 31,2018 was €300.
d. There have been no loan repayments or movements in non-current assets during the year. The opening inventory of Xerxes Inc was €120. Assume that inventory turnover times are very short.
e. Exchange rates:
   €4 to £1 when Xerxes Inc was incorporated
   €2.50 to £1 when Xerxes Inc acquired its long-term assets
   €2 to £1 on December 31, 2018
   €1.60 to £1 average rate of exchange year ending December 31, 2019
   €1 to £1 on December 31, 2019

Required:

a. Prepare the summarised consolidated statement of profit or loss and statement of financial position of Darius Co using the £ as the presentation currency.
b. Calculate the exchange difference and prepare a separate consolidated statement of profit or loss and other comprehensive income for the year.

Question 3:

White Cliffs Co, whose year-end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40,000 and is due for settlement on 30 November. The exchange rate moved as follows.

€/£1	
30 September	1.60
30 November	1.80

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Required:
State the accounting entries in the books of White Cliffs Co.

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Question 4

White Cliffs Co, whose year-end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40,000 and is due for settlement in equal instalments on 30 November and 31 January. The exchange rate moved as follows.

	€/£1
30 September	1.60
30 November	1.80
31 December	1.90
31 January	1.85

Required:

State the accounting entries in the books of White Cliffs Co.

26.6.2 Suggested solutions

Solutions 1

Equity investment carried at fair value – exchange-difference illustration

Under IFRS 9 an equity instrument that is designated at FVOCI is a **non-monetary financial asset**. IAS 21 therefore requires the fair value to be translated at the **spot rate on each re-measurement date**, with both the fair-value movement and any exchange difference taken to other comprehensive income (OCI).

Date	Spot Rate (US $: £1)	Fair Value (US $)	Translated Fair Value (£)	OCI Recognised in Period (£)	Cumulative OCI (£)
Jan 1, 2015 (initial recognition)	**1.90**	500,000	263,158	–	–
Dec 31, 2015	**1.80**	480,000	266,667	**+ 3,509**	3,509
Dec 31, 2016	**1.60**	450,000	281,250	**+ 14,583**	18,092

Analysis

2015: although the dollar fair value fell by $20,000, the weaker dollar (1.90 → 1.80) meant the sterling value **increased** by £3,509. This net uplift is recognised in OCI.

2016: the dollar fair value dropped by another $30,000, but the dollar weakened further to $1.60 = £1, so the sterling carrying amount rose by a further £14,583. Cumulative OCI now totals £18,092.

All movements, both price changes and currency effects, remain in OCI; they are **never recycled to profit or loss** on disposal because the FVOCI election for equity instruments is irrevocable.

Solution 2

Step 1. Translation of Xerxes Inc – Year Ended December 31, 2019

€ figures (not shown) translated at the average rate € 1.60 = £ 1	£ 000
Profit before tax	100
Income tax	(50)
Profit after tax (retained)	**50**

Step 2. Consolidated Profit or Loss – Darius Co Group

	£ 000
Profit before tax (Darius £200 + Xerxes £100)	300
Income tax (Darius £100 + Xerxes £50)	(150)
Profit after tax – attributable to owners	**150**

Step 3. Xerxes Inc – Statement of financial position translated at the closing rate € 1 = £ 1

	£ 000
Non-Current Assets (carrying amount)	300
Current Assets	
Inventories	200
Receivables	100
Total Assets	**600**
Non-Current Liabilities	(110)
Current Liabilities	(110)
Net Assets/Equity	**380**

Original cost of the investment to Darius was £25 000 (€100 000 at historical rate €4 = £1). The post-acquisition movement in Xerxes' equity is therefore £380 – £25 = £355 000.

Step 4. Consolidated statement of financial position –December 31, 2019

Assets	£ 000
Non-current assets (NBV) £350 + £300	**650**
Current Assets	
Inventories £225 + £200	425
Receivables £150 + £100	250
Total Assets	**1,325**
Equity and Liabilities	**£ 000**
Ordinary £1 shares (Darius only)	300
Retained earnings (opening £300 + post-acquisition £355)	655
Equity attributable to Darius Shareholders	**955**
Non-current liabilities: loans £50 + £110	160
Current liabilities £100 + £110	210
Total Equity and Liabilities	**1,325**

Step 5. Exchange-Difference reconciliation

	£ 000
Xerxes' equity interest at 31 Dec 31, 20X9	380
Less **equity interest at 1 Jan 20X9 (€300/2)**	(150)
Exchange gain	**230**
Less retained profit (above)	(50)
Exchange gain recognised in OCI	**180**

Step 6. Consolidated statement of profit or loss and other comprehensive income

	£ 000
Profit after tax (section 2)	150
Exchange difference on translation of foreign operation	180
Total comprehensive income	**330**

The exchange gain of £180 000 is taken to a separate foreign-currency translation reserve; the cumulative post-acquisition reserves at the reporting date are £325 000 (Xerxes £125 000 + Darius £200 000).

Solution 3

Foreign-currency purchase and settlement – journal overview (White Cliffs Co)

Date	Event	FX Rate (€/£)	Ledger Entry	£ Amount	Comment
Sep 30	Record purchase of goods (€40,000)	1.60	Dr: Purchases	25,000	Initial recognition at spot rate (€40,000 ÷ 1.60).
			Cr: Trade payables	25,000	Liability measured at the same rate.
30 Nov	Settle liability (€40,000)	1.80	Dr: Trade payables	25,000	Remove original sterling liability.
			Cr: Cash	22,222	Cash paid at settlement spot (€40,000 ÷ 1.80).
			Cr: Exchange gain (P/L)	2,778	Gain arises because £ cost falls from £25,000 to £22,222.

Outcome

Exchange gain recognised in profit or loss: £2,778

Accounting rationale: The purchase is a monetary liability, so it is initially recorded at the transaction-date rate and re-measured on settlement. The difference goes straight to profit or loss under IAS 21.

Solution 4

Date	Event	€ Amount	Spot Rate (€/£)	Cash £	Liability £ After Re-Measure	Exchange Gain/(Loss) £	Key Journal (Simplified)
30 Sep	Purchase inventory on credit	40,000	1.60	—	25,000	—	Dr: Purchases 25,000 Cr: Trade payables 25,000
30 Nov	Pay first instalment (50 %)	20,000	1.80	11,111	12,500*	**+1,389**	Dr: Trade payables 12,500 Cr: FX gain 1,389 Cr: Cash 11,111
31 Dec	Year-end retranslation of balance	20,000	1.90	—	10,526	**+1,974**	Dr: Trade payables 1,974 Cr: FX gain 1,974
31 Jan	Pay second instalment	20,000	1.85	10,811	—	**(285)**	Dr: Trade payables 10,526 Dr: FX loss 285 Cr: Cash 10,811

White Cliffs Co – Foreign-currency payable: timeline, FX impact and journals

** Liability after part-payment equals the remaining €20,000 translated at the original rate of 1.60 (= £12,500).*

Profit-or-loss impact

Total exchange **gain for Year to 31 Dec**: £1,389 + £1,974 = **£3,363** (reported in operating profit).

Exchange **loss in January of next year**: £285 (recognised in that period).

The entries follow IAS 21: monetary liabilities are initially recorded at the transaction-date rate, re-translated at each reporting date, and on settlement; resulting differences go straight to profit or loss.

Professional Level

Strategic Business Reporting

CHAPTER 27

IAS7: STATEMENT OF CASHFLOWS

Contents

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27 IAS7: Statement of Cash Flows

27.0 Learning objective

This chapter discusses IAS 7 – Statement of Cash Flows

27.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. Prepare extracts from a statement of cash flow;
b. Prepare a statement of cashflow.
c. Prepare extracts from a consolidated statement of cash flow; and
d. Prepare a consolidated statement of cash flow.

27.2 Statement of cash flows: introduction

27.2.1 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. The purpose of the statement of cash flows is to provide information on how the entity generates and spends cash. It also 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.

The cashflow statement provides a useful basis for users of financial statements to assess the ability of the entity to generate cash (and cash equivalents) and to obtain a clearer view on how the entity uses and expends its cash balances including its ability to distribute cash to investors.

A statement of cash flows groups inflows and outflows of cash under three broad headings:

a. cash from operating activities: these are primarily derived from the principal revenue-producing activities of the entity
b. cash used in (or obtained from) investing activities: these are cash flows derived from acquisition and disposal of non-current assets and other investments not included in cash equivalents
c. cash paid or received in financing activities: these are cash flows generated from activities that result in changes in the size and composition of the equity capital and borrowings of the entity

It also shows whether there was an increase or a decrease in the amount of cash held by the entity between the beginning and the end of the period.

Illustration: Statement of cash flows

Cash from operating activities	X/(X)
Cash used in (or obtained from) investing activities	X/(X)
Cash paid or received in financing activities.	X/(X)
Net cash inflow (or outflow) during the period	X/(X)
Cash and cash equivalents at the beginning of the period	X/(X)
Cash and cash equivalents at the end of the period	X/(X)

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A statement of cash flows reports the change in the amount of cash and cash equivalents held by the entity during the financial period.

Cash and cash equivalents

> ***Definition: Cash, cash equivalents and cash flows***
>
> Cash comprises cash on hand and demand deposits.
>
> Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value. They are not held for investment or other long-term purposes but rather to meet short-term cash commitments, and their maturity date should be within three months from their acquisition date.
>
> Cash flows are inflows and outflows of cash and cash equivalents.

27.2.2 Format

IAS 7 does not include a format that must be followed. However, it gives illustrative examples of formats that meet the requirements in the standard.

This section provides examples of these.

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.

IAS 7 allows entities to use either method of presentation. It encourages entities to use the direct method. However, the indirect method is used more in practice.

The two methods differ only in the way that they present the cash flows for cash generated from operations. In all other respects, the figures in the statement of cash flows using the direct method are identical to the figures in a statement using the indirect method – cash flows from investing activities and financing activities are presented in exactly the same way.

The indirect method

The indirect method identifies the cash flows from operating activities by adjusting the profit before tax figure. It arrives at the cash from operating activities figure indirectly by reconciling a profit figure to a cash figure.

The starting point for the statement of cash flows for a company is the operating profit after deducting interest but before taxation.

This profit figure is adjusted to calculate the amount of cash received by the business or the amount of cash paid out as a consequence of its trading operations.

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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).

Basic example of a classified statement of cash flows using the indirect method

Exemplum Reporting PLC

Statement of Cash Flows

For the Year Ended December 31, 202X

	N		**N**
Cash flows from operating activities:			
Cash receipts from customers	X		
Cash paid to suppliers and employees	(X)		
Cash generated from operations		X	
Interest paid		(X)	
Income taxes paid	(X)		
Net cash from/ (used in) operating activities			X
Cash flows from investing activities:			
Acquisition of subsidiaries, net of cash acquired	X		
Purchase of property, plant and equipment	(X)		
Proceeds from the sale of equipment	X		
Interest received	X		
Dividends received	X		
Net cash from/ (used in) investing activities			X
Cash flows from financing activities:			
Proceeds from the issue of share capital		X	
Proceeds from long-term borrowings	X		
Dividends paid		(X)	
Net cash from/ (used in) financing activities			X
Net increase/decrease in cash and cash equivalents			X/(X)
Cash and cash equivalents at beginning of period			X
Effects of foreign exchange rate changes on the balance of cash held in foreign currencies			X
Cash and cash equivalents at the end of period			X

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The major disadvantage of the indirect method is the users' difficulty in comprehending the information presented. The method does not show where cash was received from or to where cash was paid. The IASB encourages entities to use the direct method even though the indirect method is used in practice.

Direct method: Accruals-based figures

The figures in the two statements are identical from 'Cash generated from operations' down to the end. The only differences are in the presentation of the cash flows that produced the 'Cash generated from operations'.

IAS 7 allows some variations in the way that cash flows for interest and dividends are presented in a statement of cash flows, although the following should be shown separately:

i. interest received;
ii. dividends received;
iii. interest paid; and
iv. dividends paid.

IAS 7 permits interest paid, interest received and dividends received to be classified as operating because they enter into the determination of profit or loss. Alternatively, they may be classified as investing and financing cash flows because they are costs of obtaining financial resources or returns on investments. However, dividends paid may be classified as either financing cash flow because they are a cost of obtaining financial resources, or as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.

The direct method calculates the cash flow from operating activities by calculating cash received from customers, cash paid to suppliers and so on.

Direct method

	N
Cash flows from operating activities:	
Cash received from sale of goods	X
Cash dividends received	X
Cash provided by operating activities	X
Cash paid to suppliers	(X)
Cash paid for operating expenses	(X)
Cash paid for income taxes*	(X)
Cash disbursed for operating activities	(X)
Net cash flows from operating activities	X

Interest

The interest liability at the start of the year and the interest charge during the year is the most the business would pay. If the business had paid nothing it would owe this figure. The difference between this amount and the liability at the end of the year must be the amount that the business has paid.

Example: Interest paid

A company had liabilities in its statement of financial position at the beginning and at the end of 2019, as follows:

	Interest (₦)
Beginning of 2019	4,000
End of 2019	22,000

During the year, interest charges in the income statement were ₦22,000.

The interest payment for inclusion in the statement of cash flows can be calculated as follows:

		₦
Liability at the start of the year	4,000	
Charge for the year		22,000
Total amount payable in the year	26,000	
Liability at the end of the year	(3,000)	
Cash paid		23,000

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Taxation

The tax paid is the last figure in the operating cash flow calculation.

Example: Taxation paid

A company had liabilities in its statement of financial position at the beginning and at the end of 2019, as follows:

During the year, taxation on profits was ₦77,000.
The tax payment (cashflows)for inclusion in the statement of cash flows can be calculated as follows:

	₦
Taxation liability at the start of the year	53,000
Charge for the year	77,000
Total amount payable	130,000
Taxation liability at the end of the year	(61,000)
Cash paid	69,000

Deferred taxation

A question might include deferred taxation.

A deferred tax balance might be an asset or a liability. Deferred tax liability is more common (in practice and in questions) so this discussion will be about liabilities.

A deferred tax liability is an amount that a company expects to pay in the future. Therefore, it has had no cash effect to date.

Any movement on the deferred tax liability will be due to a double entry to tax expense in the profit or loss section of the statement of comprehensive income. (There are double entries to other comprehensive income and directly to equity but these are outside the scope of your syllabus).

There are two possible courses of action in dealing with deferred tax. Either:

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.

Example: Deferred tax

A company had liabilities in its statement of financial position at the beginning and at the end of 2019, as follows:

	Taxation (₦)	Deferred taxation(₦)
Beginning of 2019	53,000	20,000
End of 2019	61,000	30,000

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The tax expense for the year in the statement of profit or loss was ₦87,000.

This was made up of the current tax expense of ₦77,000 and the deferred tax of ₦10,000.

The tax payment(cashflows) 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

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:

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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27.3 Cash flows from investing activities

27.3.1 Cash paid for the purchase of property, plant and equipment

This is the second part of a statement of cash flows, after cash flows from operating activities.

The most important items in this part of the statement are cash paid to purchase non-current assets and cash received from the sale or disposal of non-current assets but it also includes interest received and dividends received on investments.

movement on non-current assets might be summarised as follows:

Illustration: Movement on non-current assets

	₦
At cost or valuation,a the beginning of theyear	X
Disposals during the year (cost)	(X)
Upward/(downward) revaluation during the year	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 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)

Example: Cash paid for property, plant and equipment

The statements of financial position of Grand Company at the beginning and end of 2019 include the following information:

Property, plant and equipment	2018	2019
	₦	₦
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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During the year,some property was revalued upwards by ₦200,000. Anitem of equipment was disposed of during the year at a profitof₦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.

	Cost	NBV
Balance at the start of the year	1,400,000	1,050,000
Disposals during the year:		
At cost	(260,000)	
At carrying amount: (260,000 – 240,000)		(20,000)
Depreciation		(265,000)
Revaluation	200,000	200,000
	1,340,000	965,000
Additions (balancing figure)	560,000	560,000
Balance at the end of the year	1,900,000	1,525,000

	Cost	NBV
Balance at the start of the year	1,400,000	1,050,000
Disposals during the year:		
At cost	(260,000)	
At carrying amount: (260,000 – 240,000)		(20,000)
Depreciation		(265,000)
Revaluation	200,000	200,000
	1,340,000	965,000
Additions (balancing figure)	560,000	560,000
Balance at the end of the year	1,900,000	1,525,000

The revaluation recognised in the year can be found by comparing the opening and closing balances on the revaluation surplus account. There might also be revaluation double entry recognised as a gain or loss in other comprehensive income. You need to total revaluation recognised in the year so you may have to add or net both amounts.

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Cash from disposals of property, plant and equipment

A statement of cash flows should include the net cash received from any disposals of non-current assets during the period.

This might have to be calculated from the gain or loss on disposal and the carrying amount of the asset at the time of its disposal.

Illustration: Disposal of property, plant and equipment

At cost (or re-valued amount at the time of disposal)	X
Accumulated depreciation, at the time of disposal	(X)
Net book value/carrying amount at the time of disposal	X
Gain or (loss) on disposal	X
Net disposal value (= **assumed cash flow**)	X

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
Revaluatio	X/(X)

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27.4 Cash flows from financing activities

Examples of cash flows from financing activities

Examples of cash flows from financing activities are listed below:

Cash payments	Cash receipts
Cash payments to redeem/buy back shares	Cash proceeds from issuing shares
Cash payments to repay a loan or redeem bonds	Cash proceeds from a loan or issue of bonds
Cash payments to a lessor under a lease agreement that represent a reduction in the remaining lease obligation (= a reduction in the leases creditor)	

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Dividends are also usually included within cash flows from financing activities, in this part of the statement of cash flows. (Some entities may also include interest payments in this section, instead of including them in the section for cash flows from operating activities.)

Cash from new share issues

The cash raised from new share issues can be established by comparing the equity share capital and the share premium in the statements of financial position at the beginning and the end of the year.

Illustration: Cash from new share issues

	₦
Share capital + Share premium at the end of the year	X
Share capital + Share premium at the beginning of theyear	X

Example: Cash from new share issues

The statements of financial position of Company Pat 1January and 31December included the following items:

The cash obtained from issuing shares during the year is calculated as follows.

	1 January 2019	31 December 2019
	₦	₦
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 tor raise cash for the purchase of new plant.

(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).

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 X7/6)	(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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Cash from new loans or cash paid to redeem loans in the year can be calculated simply by looking at the difference between the liabilities for loans and bonds at the beginning and the end of the year.

An increase in loans or bonds means there has been an inflow ofcash.

A reduction in loans or bonds means there has been a payment (outflow) of cash.

Remember to add any loans, loan notes or bonds repayable within one year (current liability) to the loans, loan notes or bonds repayable after more than one year (non-current liability) to get the total figure for loans, loan notes or bonds.

.

Illustration: Cash from loans

	₦
Loans at end of year (current and non-current liabilities) Loans	X
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.

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

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Illustration:

Illustration:

	₦
Retained earnings reserve at the beginning of the year	X
Profit for the year after tax	X
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

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:

Practice questions

From the following information, calculate the cash flows from investing activities for Company X in 2019. **2**

	Beginning of 2019	End of 2019
	₦	₦
Share capital (ordinaryshares)	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 12months	600,000	520,000
Loans repayable within12 months or less	80,000	55,000

The company made a profit of ₦420,000for the year after taxation.

Required

Calculate for 2019, for inclusion in the statement of cash flows:

the cash from issuing new shares
the cash flows received or paid for loans
the payment of dividend to ordinary shareholders.

Repayments on leases

When non-current assets are acquired under a lease, the lessee makes payments under the lease agreement which are treated:

partly as interest payments; and

partly as repayment of the lease finance.

For the purposes of the statement of cashflows:

The interest element in the lease payments is treated as an interest payment. It is included either as a cash flow from operating activities or a cash flow from financing activities

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The repayment of the lease liability is treated as a repayment of a debt and is included as a cash flow from financing activities.

Changes in liabilities arising from financing activities

An entity must provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.

One way of doing this would be to provide a reconciliation showing:

(a) opening balances of liabilities arising from financing activities;

(b) movements in the period, including:

  (i) changes from financing cashflows;

  (ii) changes arising from obtaining or losing control of subsidiaries or other businesses;and

  (iii) other non-cash changes (for example, the effect of changes in foreign exchange rates).

(c) closing balances of liabilities arising from financing activities.

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Practice Question

Elida is a publicly listed company. The following financial statements of Elida are available:

Statement of profit or loss and other comprehensive income for year ended March 31, 2018

	N'000	
Revenue		5,740
Cost of sales	(4,840)	
Gross profit		900
Income from and gains on investment property	60	
Distribution costs	(120)	
Administrative expenses (Note (ii))	(350)	
Finance costs	(50)	
Profit before tax	440	
Income tax expense		(160)
Profit for the year		280
Other comprehensive income		
Gains on property revaluation	100	
Total comprehensive income		380

Statement of financial position as at:

	31 March 2018		31 March 2017	
	N'000	N'000	N'000	N'000
ASSETS				
Non-current assets (Note (1))				
Property, plant and equipment		2,880		1,860
Investment property		420		400
		3,300		2,260
Current assets				
Inventory		1,210		810
Trade receivables	480		540	
Income tax asset	-		50	
Bank	10	1,700	-	1,400
Total asset		5,000		3,660
Equity and liabilities				
Equity				
Equity shares of 20p each (Note (3))		1,000		600
Share premium	600		-	
Revaluation reserve	150		50	

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Retained earnings	1,440		2,190		1,310
1,360					
			3,190		
		1,960			
Non-current liabilities					
6% loan notes (Note (2))	-				400
Deferred tax		50		50	30
430					
Current liabilities					
Trade payables		1,410			1,050
Bank overdraft		-			120
Warranty provision (Note (4))		200			100
Current tax payable		150		1,760	-
1,270					
Total equity and liabilities			5,000		
3,660					

The following supporting information is available:

(1) An item of plant with a carrying amount of N240,000 was sold at a loss of N90,000 during the year. Depreciation of N280,000 was charged (to cost of sales) for property, plant and equipment in the year ended March 31, 2018.

Elida uses the fair value model in IAS 40, *Investment Property*. There were no purchases or sales of investment property during the year.

(2) The 6% loan notes were redeemed early incurring a penalty payment of N20,000 which has been charged as an administrative expense in the statement of profit or loss.

(3) There was an issue of shares for cash on October 1, 20X7. There were no bonus issues of shares during the year.

(4) Elida gives a 12-month warranty on some of the products it sells. The amounts shown incurrent liabilities as warranty provision are an accurate assessment, based on past experience, of the amount of claims likely to be made in respect of warranties outstanding at each year end. Warranty costs are included in cost of sales.

(5) A dividend of 3kobo per share was paid on 1 January 20X8.

Required

Prepare a statement of cash flows for Elida for the year to 31 March 20X8 in accordance with IAS 7, *Statement of Cash Flows*.

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Solution to practice question

N

Elida – statement of cash flows for the year to March 31, 2018

	N'000	N'000
Cash flows from operating activities		
Profit before tax		440
Loss on sale of plant	90	
Depreciation	280	
Early redemption penalty		20
Finance costs	50	
Investment income		(60)
Increase in warranty provision (200 – 100)		100
		920
Increase in inventory (1,210 – 810)	(400)	
Decrease in receivables (480 – 540)		60
Increase in trade payables (1,410 – 1,050)		360
Cash generated from operations	940	
Interest paid	(50)	
Tax refund received (W1)		60
Net cash from operating activities		950
Cash flows from investing activities		
Proceeds of sale of plant (240 – 90)	150	
Purchase of plant (W2)	(1,440)	
Income from investment property (60 – 20)	40	
Net cash used in investing activities	(1,250)	
Cash flows from financing activities		
Share issue ((1,000 – 600) + 600)	1,000	
Loan notes repaid	(400)	
Early redemption penalty	(20)	
Dividend paid (1,000 × 5 × 0.03)	(150)	
Net cash from financing activities		430
Net increase in cash and cash equivalents		130

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Cash and cash equivalents at beginning of period	(120)
Cash and cash equivalents at end of period	10

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Workings

Income tax payable

N'000		*N'000*	
Bal b/d (current tax)	*50*	*Bal b/d (deferred tax)*	*30*
Bal c/d (current tax)	*150*	*Profit or loss charge*	*160*
Bal c/d (current tax)	*50*	*received (bal figure)*	*60*
	250		*250*

(2) Property, plant and equipment

N'000		*N'000*	
Bal b/d	*1,860*	*Disposal*	*240*
Revaluation (150 – 50)	*100*	*Depreciation*	
280			
Additions (balancing figure)	*1,440*	*Bal c/d*	
2,880			
	3,400		
	3,400		

27.5 Consolidated statement of cash flows

The special features of a consolidated statement of cash flows

A consolidated statement of cash flows is prepared largely from the consolidated statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. The rules for preparing a group statement of cash flows are similar to the rules for a statement of cash flows for an individual entity.

However, there are additional items in a consolidated statement of cash flows that are not found in the statement of cash flows of an individual company. The most significant of these are cash flows (or adjustments to profit before tax) relating to:

a. Dividends paid to the non-controlling interest
b. Dividend received from associates and joint ventures
c. Acquisitions/disposals of subsidiaries
d. Acquisitions/disposals of associates and joint ventures

The aim of the consolidated statement of cash flows is to show the cashflows between the group and third parties

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Cash flows to the non-controlling interest

The non-controlling interest represents a third party, so dividends paid to the non-controlling interest are reflected as a cash outflow. This payment should be presented separately and classified as 'Cash flows from financing activities. Dividends paid to the non-controlling interest may be calculated using a T-account as follows:

NON-CONTROLLING INTEREST

NCI dividend paid (balancing figure)	**X**	NCI (CSFP)$^{b}/_{f}$	
X			
NCI$^{c}/_{f}$ (CSFP)	X	NCI (CIS)	
X			

Associates and joint ventures

There are two issues to consider with regard to the associate/joint venture. (Note that joint ventures are treated like associates in that they are equity accounted, so the points below apply to both.)

(a) The aim of the statement of cash flows is to show the cash flows of the parent and any subsidiaries with third parties, therefore any cash flows between the associate and third parties are irrelevant. As a result, the group share of profit of the associate must be deducted as an adjustment in the reconciliation of profit before tax to cash generated from operations. This is because group profit before tax includes the results of the associate.

(b) Dividends received from the associate must be disclosed as a separate cash flow classified as 'Cash flows from investing activities. the cash receipt is calculated as follows:

INVESTMENTS IN ASSOCIATES

Balance $^{b}/_{f}$ Investment in Associate(CSFP)	**X**	**Dividend received (Bal. figure)**	**X**
Share of profit in Associate (CSPL)	X	Bal $^{c}/_{d}$Inv in Associate(CSFP)	X

Acquisitions and disposals of subsidiaries

If a subsidiary is acquired or disposed of during the accounting period, the net cash effect of the purchase or sale transaction should be shown separately under 'Cash flows from investing activities'.

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The net cash effect will be the cash purchase price/cash disposal proceeds net of any cash or cash equivalents acquired or disposed of.

As the cash effect of the acquisition/disposal of the subsidiary is dealt with in a single line item as we saw above, care must be taken not to double count the effects of the acquisition/disposal when looking at the movements in individual asset balances.

Each of the individual assets and liabilities of a subsidiary acquired/disposed of during the period must be excluded when comparing group statements of financial position for cash flow calculations as follows:

Subsidiary acquired in the period	Subtract PPE, inventories, payables, receivables etc, at the date of acquisition from the movement on these items.
Subsidiary disposed of in the period	Add PPE, inventories, payables, receivables etc, at the date of disposal to the movements on these items

This would also affect the calculation of the dividend paid to the non-controlling interest. The T-account working is modified as follows:

NON-CONTROLLING INTEREST

NCI in Subsidiary at disposal X		**X**	NCI (CSFP) $^{b}/_{f}$
NCI dividend paid (balancing figure)	**X**	**NCI in subsidiary at acquisition**	**X**
NCI $^{c}/_{f}$ (CSFP) X		X	NCI (CIS)

Acquisitions and disposals of associates

If an associate is acquired or disposed of during the accounting period the payment or receiptof cash is classified as investing activities.

Exchange rate differences

A gain or loss arising from exchange rate differences is not a cash flow item. When the indirect method is used to present cash flows from operating activities, it is therefore necessary to make an adjustment to get from 'profit' to 'cash flow'.

A loss arising from exchange rate differences (shown in the example above as a 'foreign exchange loss') must be added back.

A gain arising from exchange rate differences must be subtracted.

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Illustrative format

It might be useful to look at the format of a consolidated statement of cash flows, to see where these items appear. The indirect method is used here to present the cash flows from operating activities.

Illustration: X Plc: Consolidated statement of cash flows for the year ended December 31, 2017

	₦000	₦000
Cash flows from operating activities		
Profit before tax	X	
Adjustments for:		
Depreciation and amortization charges	X	
Loss on disposal of plant and machinery	X	
Share of profit of associates and joint ventures	(X)	
Foreign exchange loss	X	
Investment income	(X)	
Interest expense	X	
	XX	
Increase in trade and other receivables	(X)	
Increase in inventories	(X)	
Increase in trade payables	X	
Cash generated from operations	XX	
Interest paid	(X)	
Income taxes paid	(X)	
Net cash from operating activities		XX
Cash flows from investing activities		
Acquisition of subsidiary, net of cash acquired (note1)	(X)	
Purchase of property, plant and equipment (note 2)	(X)	
Proceeds from the sale of equipment	X	
Interest received	X	
Dividends received from associates	X	
Net cash used in investing activities		(XX)
Cash flows from financing activities Proceeds from the issue of share capital	X	
Proceeds from long-term loan	X	
Redemption of debt securities	(X)	
Payment of lease liabilities	(X)	
Dividends paid to non-controlling interests	(X)	
Dividends paid to parent company shareholders	(X)	
Net cash inflow from financing activities		XX
Net increase in cash and cash equivalents		XX
Cash and cash equivalents at the start of the year(note3)		XX
Cash and cash equivalents at the end of the year(note3)		X
		X

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Illustration: Notes to the statement of cash

flows Note1: Acquisition of subsidiary

During the year, the group acquired a subsidiary A Limited. The fair value of assets acquired and liabilities assumed were as follows:

	₦000
Cash	X
Inventories	X
Trade receivables	X
Property, plant and equipment	X
Trade payables	(X)
Long-term loan	(X)
Total purchase price	XX
Minus cash of A Limited	(X)
	XX
Shares issued as part of the purchase price	XX

Note 2: Property, plant and equipment

During the year, the group acquired property, plant and equipment with a total cost of ₦400,000, of which ₦180,000 was acquired by means of leases. Cash payments of ₦220,000 were made to acquire property, plant and equipment.

Note 3: Cash and cash equivalents

Cash and cash equivalents consist of cash in hand, bank balances, and money market investments. Cash and cash equivalents in the statement of cash flows comprise the following amounts in the statement of financial position:

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	20X7	20X6
	₦000	₦000
Cash in hand and balances with banks	X	
		X
Short-term investments		X
	X	
Cash and cash equivalents as previously reported	XX	XX
Effect of exchange rate changes	-	(X)
Cash and cash equivalents as re-stated	XX	XX

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27.6 NON-controlling interests and associates (or JVS) in the statement of cash flows

27.6.1 Obtaining the required figures for cash flows

The cash flows and adjustments in a group statement of cash flows are obtained from the other group financial statements. You should expect an examination question to provide you with an opening and closing consolidated statement of financial position, together with the related consolidated statement of profit or loss and other comprehensive income, and possibly a statement of changes in equity. Other relevant information may also be provided.

A group statement of cash flows reports the cash flows that affect the group's consolidated cash (and cash equivalents). Any transactions not affecting the group cash position should not be shown in the statement of cash flows, except (with the indirect method) where a non-cash item is presented as an adjustment to the profit before tax to calculate the 'Cash generated from operations.

Non-controlling interests and the group statement of cash flows

Unless there is an acquisition or a disposal of a subsidiary during the year, the only cash flow relating to non-controlling interests is the amount of dividends paid to the non-controlling interests by subsidiaries.

This might have to be calculated as a balancing figure, using the following calculation:

Illustration:Dividends paid to NCI

	₦
Non-controlling interest in group net assets at the beginning of the year	X
Non-controlling interest in profits after tax for the year	(X)
	X
Dividends paid to non-controlling interests (balancing figure) non-controlling interest in group net assets at the end of the year	(X)
	X

The dividends paid to non-controlling interests by subsidiaries are usually included in the 'Cash flows from **financing activities**' part of the statement of cash flows. (This is the same part of the statement of cash flows where dividends paid to the parent company shareholders are usually shown.)

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Example: Dividends paid to NCI

The following information has been extracted from consolidated financial statements of P, a holding company which prepares accounts to 31 December. P has a subsidiary Q, for which a final dividend is declared before the end of the financial year.

	2017	2016
	₦000	₦000
Non-controlling interest in group net assets	1,510	1,380
Non-controlling interest in consolidated profit after taxation	250	470

What figure should appear in the consolidated statement of cash flows for the year to December 31, 2017 for the dividends paid to non-controlling interests?

Under what heading will this figure appear in the group statement of cash flows?

Answer

	₦000
Non-controlling interest in group net assets at the beginning of the year	**1,380**
Non-controlling interest in profits after tax for the year	**250**
	1,630
Dividends paid to non-controllinginterests (balancing figure)	**(120)**
Non-controlling interest in group net assets at the end of the year	**1,510**

The dividend paid of ₦120,000 will be disclosed as cash flow from financing activities.

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	Year 4	Year 3
	₦000	₦000
Dividends payable to non-controlling interests	200	320
Non-controlling interests in group equity	1,560	1,380
Non-controlling interest in profit for the year	240	220

What figure will appear in the consolidated statement of cash flows for the year to 31 December year 4 in respect of non-controlling interest

Practice question

The following information has been extracted from the consolidated financial statements of X Plc:

	Year 4	year 5
	₦000	₦000
NCI dividends payable at 31 December	20	25
NCI share of group profits after tax for the year	270	300
NCI share in group net assets as at 31 December	600	630

What figure will appear in the consolidated statement of cash flows for the year to 31 December year 5 in respect of non-controlling interest

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Practice question 2

The consolidated financial statements of Entity P for the year ended March 31, Year 6 showed the following balances:

Non-controlling interests in the consolidated profit for the year ended March 31, Year 6 are ₦ 6million (₦3.6 million at March 31, Year 5)

Non-controlling interests in the consolidated profit for the year ended March 31, Year 6 is ₦ 2 million

During the year ended March 31, Year 6, the group acquired a new 75% subsidiary whose net assets at the date of acquisition were ₦ 6.4 million.

On March 31, Year 6, the group revalued all its properties and the non-controlling interest in the revaluation surplus was ₦1.5million.

There were no dividends payable to non-controlling interests at the beginning or end of the year.

What is the dividend paid to non-controlling interests that will be shown in the consolidated statement of cash flows of Entity P for the year ended March Year 31, 6?

27.6.2 Dividends paid to non-controlling interests and foreign exchange adjustments

If there is a gain or loss on translation for a foreign subsidiary, the non-controlling interests has a share of this exchange gain or loss. This means that the amount shown as the non-controlling interest in the consolidated statement of financial position includes the non-controlling interest share of any foreign exchange gains or is after deducting any foreign exchange losses.

A gain or loss arising from exchange rate differences is not a cashflow, but it changes the amount for non-controlling interest in the consolidated statement of financial position. When the figures for non-controlling interest in the opening and closing statements of financial position are used to calculate dividend payments to non-controlling interests, we must therefore remove the effect of exchange rate differences during the year.

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Illustration: Dividends paid to NCI

	₦
Non-controlling interest in group net assets at the beginning of the year	X
Non-controlling interest in profits after tax for the year	(X)
	X
Dividends paid to non-controlling interests (balancing figure) Non-controlling interest in group net assets at the end of the year	(X)
	X

27.6.3 Associates (or JVs) and the group statement of cash flows

When a group has an interest in an associate entity, the consolidated statement of cash flows must show the cash flows that occur between the associate (or JV) and the group. The consolidated statement of cash flows shows the effect on the groups cash position of transactions between the group and its associate (or JV).

The cash held by an associate (or JV) is not included in the group's cash figure in the consolidated statement of financial position. This is because the equity method of accounting does not add the associate's (or JV) cash to the cash of the holding company and subsidiaries. As far as cash flows are concerned, the associate (or JV) is outside the group. (The same principles apply to other investments accounted for under the equity method, such as joint ventures accounted for by the equity method).

Share of profit (or loss) of an associate (or JV)

In the consolidated statement of profit or loss, the group profit includes the group's share of the profits of associates (or JV's). these profits are not a cash flow item. When the indirect method is used to present the cash flows from operating activities, an adjustment is therefore needed to get from profit to cash flow.

The group's share of the profit of an associate (or JV) must be deducted from profit.

The group's share of the loss of an associate (or JV) must be added to profit.

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Cash flows involving associates (or JVs)

The cash flows that might occur between a group and an associate (or JV), for inclusion in the consolidated statement of cash flows are as follows:

Investing activities

cash paid to acquire shares in an associate (or JV) during the year

cash received from the disposal of shares in an associate (or JV) during the year

dividends received from an associate during the year.

Financing activities

cash paid as a new loan to or from an associate (or JV) during the year

cash received as a repayment of a loan to or from an associate (or JV) during theyear.

Note that dividends received from an associate (or JV) are shown as cash flows from investing activities; whereas dividends paid to non-controlling interests in subsidiaries are (usually) shown as cash flows from financing activities.

Calculating dividends received from an associate (orJV)

In an examination, you may be required to calculate the dividends received from an associate (or JV), using information in the opening and closing consolidated statements of financial position and the consolidated statement of profit or loss. The technique is similar to the calculation of dividends paid to non-controlling interests.

Illustration: Dividends received from an associate(orJV)

	₦
Group investment in net assets of associate (orJV)at the beginning of the year	X
Group share of associate's (or JV's) profits before tax	(X)
	X
	(X)
Dividends received from associate (or JV) in the year	X

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Example: Dividends received from an associate (or JV)

The following information has been extracted from the consolidated financial statements of P for the year ended 31 December 20X7. The group has neither purchased nor disposed of any investment during this period.

Group statement of profit or loss

	₦000
Group operating profit	1,468
Share of associate's profit after tax	136
	1,604
Tax on profit on ordinary activities:	
Income taxes: group	(648)
Profit on ordinary activities after tax	956

Groupstatementoffinancialpositionat31December

	20X7	**20X6**
	₦000	₦000
Investments in associates		
Share of net assets	932	912

Required

What figure should appear in the group statement of cash flows f to31December20X7fortheassociate?

Under which heading would you expect this figure to appear in the group statement of cashflows?

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Answer

(a)

	₦000
Group investment in net assets of associate at the beginning of the year	912
Group share of associate's profits after tax	136
	1,048
Dividends received from associate in the year (as a balancing figure)	(116)
Group investment in net assets of associate at the end of the year	932

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Practice question **6**

The following information has been extracted from the consolidated financial statements of P, a holding company which prepares accounts to 31 December each year:

Consolidated statement of financial position (extract):

	Year 4	Year 3
	₦000	₦000
Investments in associated undertakings	932	912
Current assets		
Dividend receivable from associate	96	58

Consolidated statement of profit or loss (extract):

Investments in associated undertakings	Year 4
	₦000
Group operating profit	1,468
Share of operating profit of associate	136
	1,604
Income taxes:	(648)
Profit after tax	956

What figure will appear in the consolidated statement of cash flows for the year to 31 December Year 4 in respect of dividend received from associates?

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27.7 Acquisitions and disposals of subsidiaries in the statement of cashflows

Acquisition of a subsidiary in the statement of cash flows

When a subsidiary is acquired:

the group gains control of the assets and liabilities of the subsidiary, which might include some cash and cash equivalents, and

the group pays for its share of the subsidiary, and the purchase consideration might consist partly or entirely of cash.

In the group statement of cash flows, a single figure is shown (under the heading 'Cash flows from investing activities') for the net effect of the cash flows from acquiring the subsidiary. This net effect is:

Illustration: Cash paid for a subsidiary

	₦
Cash element in the purchase consideration	X
Minus: Cash assets of the subsidiary at the acquisition date	(X)
Cash payment on acquisition of subsidiary,net of cash received	X

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This net cash payment is the amount shown in the group statement of cash flows.

Example: Cash paid for a subsidiary

Blue Group acquired 80% of the shares in Green Entity on September 5, 2016, when the net assets of Green Entity were ₦800,000, including ₦25,000 in cash and cash equivalents. The purchase consideration was ₦700,000, consisting of

₦500,000 in new shares of Blue (the holding company) and ₦200,000 in cash.

The cash flow shown in the group statement of cash flows for the year to 31 December 31, 2016 is:

	₦
Cash element in the purchase consideration	200,000
Minus: Cash assets of the subsidiary at the acquisition date	(25,000)
Cash payment on acquisition of subsidiary, net of cash received	175,000

Note that in the above example, even though only 80% of the shares in Green Entity have been acquired, the full ₦25,000 of cash held by the subsidiary is brought into the group statement of financial position at the acquisition date. The figure deducted from the cash in the purchase consideration is therefore 100% of the subsidiary's cash and cash equivalents acquired.

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Note to the statement of cash flows on acquisitions

In an examination, it is useful to prepare a statement summarizing the cash flow effects of an acquisition. This statement is actually required by IAS 7, and should be presented as a note to the statement of cash flows.

The statement should be presented as follows:

Illustration:Note to the cash flow statements reacquisition

	₦
Assets of the subsidiary at the acquisition date, at fair value	X
Liabilities of the subsidiary at the acquisition	(X)
date Net assets of the subsidiary at the	X
acquisition date	
Minus non-controlling interest in the subsidiary at this date (%non-controlling interest × Net assets)	(X)
	X
Purchased goodwill	
Fair value of net assets acquired Satisfied by:	X
	X
New shares in holding	
company Cash	
Purchase consideration	

The total purchase consideration equals the fair value of the net assets acquired.

The cash of the subsidiary at the acquisition date (C_2) is then deducted from the cash paid (C_1) to arrive at the figure that appears in the statement of cash flows for the 'Acquisition net of cash received'.

Avoiding double counting when a subsidiary has been acquired

Cash flow information is often calculated from information in the opening and closing statements of financial position.

If there is an acquisition during the year, it is important to make an adjustment to the calculation for the assets or liabilities in the subsidiary that were acquired.

Unless this adjustment is made, the assets and liabilities in the subsidiary at the acquisition date will be counted twice and the calculations will be incorrect.

An adjustment will be needed for every item of asset or liability acquired, **except for** cash and cash equivalents.

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Inventory, trade receivables, trade payables

When the indirect method is used to present cash flows from operating activities, the changes in receivables, inventory and trade payables are shown as adjustments to the profit figure, to get to a figure for cash flow.

When preparing a statement of cash flows for an individual company, the changes in these items are calculated by calculating the difference in the figure in the closing statement of financial position and the corresponding value in the opening statement of financial position.

However, when a subsidiary has been acquired, the working capital brought into the group (receivables plus inventory minus trade payables of the acquired subsidiary) is paid for in the purchase price to acquire the subsidiary. As we have seen, this is treated as a separate item in the investing activities section of the statement of cash flows.

To avoid double counting of the effects of the working capital in the subsidiary at the acquisition date, we need to deduct from the value in the closing statement of financial position, **or** add to the value in the opening statement of financial position:

the receivables in the net assets of the subsidiary acquired, as at the acquisition date;

the inventory in the net assets of the subsidiary acquired, as at the acquisition date; and

the trade payables in the net assets of the subsidiary acquired, as at the acquisition date.

Example: Adjustment to calculation

D Group is preparing a group statement of cash flows for the year using the indirect method. In the group opening and closing statements of financial position, inventories were:

Atthebeginningoftheyear	₦120,000
At the end of the year	₦190.000

During the year, the group acquired a 75% interest in a new subsidiary, Entity S, which had inventories of ₦40,000 at the acquisition date.

Required

What figure should be shown in the group statement of cash flows as the adjustment for the increase or decrease in inventories?

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Answer	₦
Group inventories at the beginning of the year	120,000
Add: Inventories acquired in the subsidiary	40,000
	160,000
Adjustmentforincreaseininventoriesonacquisitionofnew subsidiary	30,000
Group inventories at the end of the year	190,000

Inventories have increased by ₦30,000 after allowingfor the ₦40,000 of inventories brought into the group when the subsidiary was purchased.

This would usually be shown as a working on the face of the answer as (₦190,000 –(120,000 + 40,000)).

Purchases of non-current assets

When non-current assets are shown at their carrying amount (net book value) and a subsidiary has been acquired during the year, purchases of non-current assets (assumed to be cash payments) are calculated as follows.

Example: Cash paid to buy non-current assets

	₦
Non-current assets at carrying amount, at the beginning of they ear	240,000
Net book value of disposals of non-current assets during the year	(30,000)
Depreciation charge for the year	(40,000)
Cash paid to acquire non-current assets during the year (second balancing figure)	55,000
Non-current assets acquired on acquisition of the subsidiary	65,000
Total additions (first balancing figure)	120,000
Non-current assets at carrying amount, at the end of the year	290,000

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Other items

Similar principles can be applied to all other assets and liabilities to find the cash effect, for example to calculate loan repayments and repayments of leasing obligations.

Example: Tax paid

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 2016:

	At January1, 2016	At December 31, 2016
	₦000	₦000
Current tax payable	250	325
Deferred tax (liability)	136	165

TheSpotGroupacquireda60%holding in a subsidiary, EntityB,on7May20X6. The total tax liability of Entity B at this date was ₦120,000. The total charge for taxation in the consolidated statement of profit or loss of the Spot Group for the year to 31 December 20X6 was ₦950,000.

Required

What was the cash payment for taxation during the year, for inclusion on the group statement of cash flows?

Answer

The tax liability in the subsidiary when it was acquired should be deducted from the closing tax liability for the group (or added to the opening tax liability for the group) to avoid double counting.

	₦000
Group tax liability at the beginning of the year	386
Tax liability acquired in the subsidiary	120
Group tax charge in the year	950
	1,456
Tax paid in the year	(966)
Group tax at the end of the year (325 + 165)	490

Note

To calculate the tax payment for the year, you should take the entire tax charge at the beginning and at the end of the year–both current tax and deferred tax.

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Example: dividends paid to non-controlling interest when a subsidiary has been acquired

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1January 20X6	At 31December 20X6
	₦000	₦000
Non-controlling interest	350	

The Spot Group acquired a 60% holding in a subsidiary, Entity B, on 7 May 20X6. The net assets of Entity B at this date were ₦800,000 at fair value. The profit attributable to non-controlling interests in the group's statement of profit or loss for the year to 31December 20X6 was ₦270,000.

Required

What dividends were paid to the non-controlling interests during the year to December 31, 20X6?

	₦000
Non-controlling interest at the beginning of the year	350
Non-controlling interest acquired in the subsidiary (40% ×800)	320
Non-controlling interest share of profits for the year	270
	940
Dividends paid to non-controlling interest during the year	(525)
Non-controlling interest at the end of the year	415

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Answer

Again, to avoid double counting we need to:

deduct the non-controlling interest acquired from the value for non-controlling interest in the closing consolidated statement of financial position; or

(as shown below) add the non-controlling interest acquired to the non-controlling interest in the opening consolidated statement of financial position.

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Example: adjustment for the impairment of goodwill

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1 January 20X6	At31December20 X6
	₦000	₦000
Goodwill	600	540

TheSpotGroupacquireda60%holding in a subsidiary, Entity B, on 7 May 20X6. Purchased good will arising on the acquisition of Entity B was ₦110,000. The Spot Group uses the indirect method to present its group statement of cashflows.

Required

What is the impairment to goodwill for the year, and where would it appear in the group statement of cashflows?

Answer

The impairment of goodwill is a non-cash item that reduces profit. When the indirect method is used to present cash flows from operating activities, any impairment of assets during the year and charged against profit must be added back to the profit figure (in the same way that depreciation and amortization charges are added back).

When a subsidiary is acquired during the year, the calculation of the impairment must allow for the purchased goodwill in the newly-acquired subsidiary. An adjustment is needed to avoid double-counting.

	₦000
Goodwill at the beginning of the year	600
Goodwill acquired in the subsidiary	110
	710
Impairment	(170)
Goodwill at the end of the year	540

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Disposal of a subsidiary in the statement of cash flows

The procedures for reporting the cash effect of disposals of subsidiaries in a group statement of cash flows are similar to those used for acquisitions, except that the process applies in reverse.

In the group statement of cash flows, the cash received from the disposal is the cash actually received from the disposal, minus any cash in the subsidiary at the disposaldate.

A note to the statement of cash flows should show the details of the disposal, including the cash received from the sale minus the cash in the subsidiary at the disposaldate.

The assets and liabilities disposed of, and the non-controlling interest leaves the group on the disposal. To avoid double counting the other cash flow items in the statement of cash flows.

Example: Disposal

Entity D disposed of its 80% interest in the equity capital of Entity S for a cash sumof₦550million.ThestatementoffinancialpositionofEntitySatthedateof disposal showed the following balances:

	₦000
Tangible non-current assets	500
Inventories	200
Trade receivables	300
Trade payables	(200)
Taxation (including deferred taxation)	(80)
Bank overdraft	(320)
	400

D acquired its interest in S at the date of incorporation of that company, so no goodwill arose.

Required

Prepare a statement summarising the effect of the disposal as a note to the consolidated statement of cash flows.

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Answer

Cash received from the sale of the shares in the subsidiary is ₦550,000. However, a note to the statement of cash flows should present the detail net assets disposed of, the proceeds from the sale, and the profit or loss on disposal.

The profit or loss is the difference between the value of the net assets disposed of and the proceeds from the sale. It is a balancing figure, in the same way that the purchased goodwill is the balancing figure in a similar note to the statement of cash flows when a subsidiary has been acquired.

In this example, the subsidiary had a bank overdraft when it was disposed of. The cash in the subsidiary at the date of disposal was therefore a negative amount. The group no longer has the bank overdraft, which means that its cash flow position improved by selling off the subsidiary.

In the statement of cash flows itself, the cash proceeds from the disposal of the subsidiary (net of cash'lost') is the cash from the disposal proceeds plus the bank overdraft that is no longer in the group (₦550,000+₦320,000=₦870,000).

₦000

Net assets disposed of:

Tangible non-current assets	500
Inventories	200
Trade receivables	300
Trade payables	(200)
Taxation	(80)
Bank overdraft	(320)
	400
Non-controlling interest (20% × 400)	(80)
	320
Profit on disposal	230
Proceeds	550
Satisfied by:	
Cash	550

Extract from the statement of cash flows

Investing activities

Sale of subsidiary (550 + 320)	870

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Example: Disposal

Suppose that the group in the previous example uses the indirect method of computing the cash flow from operating activities. Inventories were ₦1,600,000 in the opening group statement of financial position at the beginning of the year and ₦1,500,000 in the closing group statement of financial position.

Required

What figure in respect of inventories would be used as an adjustment in calculatingthecashflowsfromoperatingactivities?

Answer

	₦000
Group inventories at the beginning of the year	1,600
Inventories disposed of in the subsidiary	(200)
	1,400
Adjustment for increase in inventories	100
Group inventories at the end of the year	1,500

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27.8 Chapter review

Chapter review

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

a. Prepare extracts from a statement of cashflow;
b. Prepare a statement of cashflow;
c. Prepare extracts from a consolidated statement of cashflow; and
d. Prepare a consolidated statement of cashflow.

27.9 End of chapter questions and suggested solutions

27.9.1 Questions

Question 1

Below is the consolidated statement of financial position of the Caitlin Group as at June 30, 2018 and the consolidated statement of profit or loss for the year ended on that date:

Consolidated statement of financial position as at June 30

	2018 N'000		2017 N'000	
Non-current assets				
Property, plant and equipment		4,067		3,950
Current assets				
Inventories		736		535
Receivables		605		417
Cash and cash equivalents	294		238	
	1,635		1,190	
	5,702		5,140	
Equity attributable to owners of the parent				
Share capital		1,000		1,000
Retained earnings	3,637		3,118	
	4,637		4,118	
Non-controlling interest	482		512	
Total equity		5,119		4,630
Current liabilities				
Trade payables	380		408	
Income tax payable		203		102
	583		510	

5,702	5,140

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Consolidated statement of profit or loss for the year ended June 30, 2018 (summarised)

Continuing operations	
N'000	
Profit before tax	862
Income tax expense	(290)
Profit for the year from continuing operations	572
Discontinued operations	
Profit for the year from discontinued operations	50
Profit for the year	622
Profit attributable to:	
Owners of Caitlin plc	519
Non-controlling interest	103
	622

You are given the following information:

Caitlin plc sold its entire interest in Desdemona Ltd on March 31, 2018 for cash ofN400,000. Caitlin plc had acquired an 80% interest in Desdemona Ltd on incorporation several years ago.

The net assets at the date of disposal were:

	N'000
Property, plant and equipment	390
Inventories	50
Receivables	39
Cash and cash equivalents	20
Trade payables	(42)
	457

(2) The profit for the period from discontinued operations figure is made up as follows:

N'000	
Profit before tax	20
Income tax expense	(4)
Profit on disposal	34
	50

(3) The depreciation charge for the year was N800,000.There were no disposals of non-current assets other than on the disposal of the subsidiary.

Required:

With regard to the consolidated statement of cash flows for the year ended 30 June 30, 2018:

(a) Show how the disposal will be reflected in the statement of cash flows.

(b) Calculate additions to property, plant and equipment as they will be reflected in the statement of cash flows.

(c) Calculate dividends paid to the non-controlling interest.

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(d) Prepare the note to the statement of cash flows required for the disposal of the subsidiary.
(e) Prepare the reconciliation of profit before tax to cash generated from operations.

Note: Work to the nearest N'000.

Question 2

Able Ltd's statement of profit or loss and statement of changes in equity for the year ended December 31, 2017 and statements of financial position at December 31, 2016 and December 31, 2017 were as follows.

ABLE LTD

Statement of profit or loss for the year ended December 31, 2017

	N'000	N'000	
Revenue		720	
Raw materials consumed	70		
Staff cost	94		
Depreciation	118		
Loss on disposal of non-current asset	18		
		(300)	
Profit from operations			420
Finance cost			(28)
Profit before tax		392	
Income tax expense			(124)
Profit for the year		268	
		91	

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ABLE LTD

Statements of financial position as at 31 December

	20X7		20X6	
	N'000	N'000	N'000	N'000
ASSETS				
Non-current assets				
Cost	1,596		1,560	
Depreciation	318		224	
		1,278		1,336
Current assets				
Inventory	24		20	
Trade receivables	76		58	
Bank	48		56	
		148		134
Total assets		1,426		1,470
EQUITY AND LIABILITIES				
Equity				
Share capital (N1 ordinary shares)	360		340	
Share premium	36		24	
Retained earnings	686		490	
		1,082		854
Non-current liabilities				
Long-term loans	200		500	
Current liabilities				
Trade payables	42		30	
Taxation	102		86	
		144		116
Total equity and liabilities		1,426		1,470

ABLE LTD

Statement of changes in equity (extract) for the year ended December 31, 2017

	Retained earnings N'000
At January 1, 2017	490
Dividend paid on ordinary shares	(72)
Total comprehensive income for the year	268
At December 31, 2017	686

During the year, the company paid N90,000 for a new piece of machinery.

Required: Prepare a statement of cash flows for Able Ltd for the year ended December 31, 2017 in accordance with the requirements of IAS 7, using the indirect method. The reconciliation of profit before tax to cash generated from operations should be shown as a note.

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Question 3

Middlesex Ltd

The statement of financial position of Middlesex Ltd as at June 30, 2018, including comparative figures, is given below.

ASSETS

Non-current assets

	2018 N		2017 N	
Property, plant and equipment	333,000		311,000	
Less depreciation		(70,000)		(69,000)
	263,000		242,000	
estment		50,000		-
Current assets	313,000		242,000	
Inventories		12,000		11,000
Trade and other receivables	29,000		27,000	
	2018 N		2017 N	
Cash and cash equivalents		20,000		10,000
	61,000		48,000	
Total assets	374,000		290,000	
Equity and liabilities				
Equity				
Ordinary share capital (N1 shares)	95,000	50,000		
Share premium	5,000	10,000		
Revaluation surplus	12,000	12,000		
Retained earnings		149,000		115,000
		271,000	187,000	
Non-current liabilities				
Interest-bearing borrowings				
(12% debentures 20Z1)	50,000	60,000		
Current liabilities				
Provisions		-		2,000
Trade and other payables		27,000		19,000
Tax liabilities	7,000	3,000		
Accruals		19,000		19 ,000
	53,000	43,000		
Total equity and liabilities	374,000	290,000		

You are also given the following information which is already reflected correctly in the accounts.

a. During the year a bonus issue of 1 for 10 was made on the ordinary shares in issue at June 30, 2017, utilising available profits.
b. New shares were issued on July 1, 2017. Part of the proceeds was used to redeemCU10,000 12% debentures 20Z1 at par.

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c. During the year certain tangible non-current assets were disposed of for CU20,000. The assets had originally cost CU40,000 and had a carrying amount at the disposal date ofN18,000.
d. Trade and other payables include N5,000 for 2018 relating to the non-current asset purchases.
e. The income tax charge for the year is N7,000.

Required:

Prepare a statement of cash flows for the year ended June 30, 2018 and the note reconciling profit before tax with cash generated from operations

27.9.2 Suggested solution

Solution 1

(a) Cash flows from investing activities

	N'000	
Disposal o f subsidiaryDesdemonaLtd, net of cash disposed of (400 – 20)		380

(b) Cash flows from investing activities

	N'000
Purchase of property, plant and equipment (W1)	(1,307)

(c) Cash flows from financing activities

	N'000
Dividends paid to non-controlling interest (W2)	(42)

(d) Note to the statement of cash flows

During the period the group disposed of subsidiary Desdemona Ltd. The book values of assets and liabilities disposed of were as follows:

	N'000	
Cash and cash equivalents	20	
Inventories		50
Receivables		39
Property, plant and equipment	390	
Payables		(42)
Non-controlling interest (W2)	(91)	
	366	
Profit on disposal	34	
Total sale proceeds		400
Less cash of Desdemona Ltd disposed of	20	
Cash flow on disposal net of cash disposed of	380	

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(e) Reconciliation of profit before tax to cash generated from operations

	N'000	
Profit before tax (862+20)	882	
Adjustments for:		
Depreciation		800
	1682	
Increase in receivables (605 – 417+ 39)	(227)	
Increase in inventories (736 – 535+ 50)	251)	
Increase in payables (380 – 408+42)	14	
Cash generated from operations	1218	

Workings

PROPERTY, PLANT AND EQUIPMENT – CARRYING AMOUNT

Balance b/f	3,950	Disposal of subsidiary	390
Additions (balancing figure)	1,307	Depreciation charge	800
NCI$^{c}/_{f}$ (CSFP)	4,067	Balance c/d	
	5,257		5,257

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NON-CONTROLLING INTEREST

NCI in Subsidiary at disposal (20% x 457)	91	NCI (CSFP)$^{b}/_{f}$	512
NCI dividend paid (balancing figure)	42	NCI in subsidiary at acquisition	103
NCI$^{c}/_{f}$ (CSFP)	482		

Solution 2

Cash flows from operating activities		
Cash generated from operations (see note)	546	
Interest paid		(28)
Tax paid (86 + 124 – 102)	(108)	
Net cash from operating activities	410	
Cash flows from investing activities		
Purchase of property, plant and equipment	(90)	
Proceeds from sale of property, plant and equipment (W)	12	
Net cash used in investing activities	(78)	
Cash flows from financing activities		
Proceeds from issue of share capital (360 + 36 − 340 − 24)	32	
Long-term loans repaid (500 − 200)	(300)	
Dividends paid	(72)	
Net cash used in financing activities	(340)	
Decrease in cash and cash equivalents	(8)	
Cash and cash equivalents at 1.1.17	56	
Cash and cash equivalents at 31.12.17		48

Note to the statement of cash flows

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Reconciliation of profit before tax to cash generated from operations for the year ended December 31, 20X7

	N'000	
Profit before tax	392	
Depreciation charges		118
Loss on sale of tangible non-current assets	18	
Interest expense	28	
Increase in inventories		(4)
Increase in receivables	(18)	
Increase in payables		12
Cash generated from operations	546	

WORKING

Non-current asset disposals

COST

	N'000		N'000
Balance b/d	1,596	Balance c/d	1,560
Purchases	90	Disposals (balancing figure)	54
	1,650		1,650

ACCUMULATED DEPRECIATION

	N'000		N'000
Balance c/d	224	Balance b/d	318
Depreciation on disposals (balancing figure)	24	Charge for year	118
	342		342

Carrying amount of disposals (54 – 24)	30
Net loss reported	(18)

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Proceeds of disposals	12

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Solution 3

Middlesex Ltd

Statement of cash flows for the year ended 30 June 30, 20Y8

	N	N
Cash flows from operating activities		
Cash generated from operations (Note)		71,000
Interest paid (W6)		(6,000)
Tax paid (W2)	(3,000)	
Net cash from operating activities		62,000
Cash flows from investing activities		
Purchase of property, plant and equipment (W3)	(57,000)	
Proceeds from sale of property, plant and equipment	20,000	
Purchase of investments	(50,000)	
Net cash used in investing activities		(87,000)
Cash flows from financing activities		
Issues of ordinary shares (W4)	45,000	
Redemption of non-current interest-bearing borrowings	(10,000)	
Net cash from financing activities		35,000
Net change in cash and cash equivalents		10,000
Cash and cash equivalents brought forward		10,000
Cash and cash equivalents carried forward		20,000

Reconciliation of profit before tax to net cash generated from operations for the year ended June 30, 2018

	N
Profit before tax (W7)	46,000
Finance cost (W6)	6,000
Property, plant and equipment – depreciation charge (W1)	23,000
Profit on disposal of property, plant and equipment	(2,000)
Change in inventories (W5)	(1,000)
Change in trade and other receivables (W5)	(2,000)
Change in trade and other payables (W5)	3,000

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Change in provision
(2,000)

Cash generated from operations 71,000

WORKINGS (1)

PROPERTY, PLANT AND EQUIPMENT – ACCUMULATED DEPRECIATION

	N		N
Disposal (40,000 – 18,000) 69,000	22,000	B/f	
C/f 23,000	70,000	Charge for year (β)	
	92,000		
	92,000		

TAX PAID

	N		N
Cash (β) 3,000	3,000	B/f	
C/f 7,000	7,000	Charge for year	
	10,000		
	10,000		

PROPERTY, PLANT AND EQUIPMENT – COST OR VALUATION

B/f	311,000	Disposal	40,000
Additions (β) 333,000	57,000	C/f	
C/f	5,000		
	373,000		
	373,000		

SHARE CAPITAL AND PREMIUM

		B/f (50,000 + 10,000)	60,000

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		Accumulated profit/losses	
		(bonus issue) (50,000 ÷ 10)	5,000
C/f (95,000 + 15,000)	110,000	Cash (β)	45,000
	110,000		
	110,000		

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Changes in current items

	N	
Inventories (12,000 – 11,000)		(1,000)
Receivables (29,000 – 27,000)		(2,000)
Payables (27,000 – 5,000 – 19,000)	3,000	

Finance cost

N50,000 × 12% = N6,000

RETAINED EARNINGS

	N		N
Bonus issue	5,000	B/f	115,000
Income tax	7,000	Net profit for the year (β)	46,000
C/f	149,000		
	161,000		
	161,000		

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Professional Level

Strategic Business Reporting

CHAPTER 28

EARNINGS PER SHARE (EPS): IAS 33

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28 Earnings Per Share (EPS): IAS 33

28.0 Learning objective

This chapter discusses the principles, calculations, presentation and critical appraisal of basic and diluted earnings per share in accordance with IAS 33.

28.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

(a) Define *basic EPS*, *diluted EPS* and *potential ordinary shares*.
(b) Explain the purpose of EPS as a performance measure and recognise its limitations.
(c) Identify the correct profit figure for EPS (continuing operations vs. total).
(d) Adjust profit for preference dividends and after-tax interest/dividends on dilutive instruments.
(e) Compute the weighted-average number of shares, including time apportionment.
(f) Restate comparatives for bonus issues, splits or bonus elements in rights issues.
(g) Apply the treasury-stock method for options and warrants.
(h) Apply the if-converted method for convertible debt and preference shares.
(i) Treat contingently-issuable shares and anti-dilutive instruments correctly.
(j) Rank multiple dilutive instruments and determine the incremental effect on EPS.
(k) Produce a full basic and diluted EPS schedule for single or consolidated entities.
(l) Present basic and diluted EPS on the face of the statement of profit or loss with equal prominence.
(m) Draft the required reconciliations of numerators and denominators in the notes.
(n) Specify additional disclosures for anti-dilutive instruments and post-balance-sheet share changes.
(o) Discuss how EPS trends can inform, and sometimes mislead, investors.
(p) Suggest alternative or supplementary performance metrics when EPS is insufficient.

28.2 P/E ratio and earnings per share (EPS)

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:

$$\text{Price-earnings (P/E) ratio} = \frac{\text{Current market price per share}}{\text{EPS}}$$

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 suggests that investors expect stronger future performance and are willing to pay a larger multiple of past earnings.

A low P / E ratio may indicate undervaluation or limited growth prospects.

Investors monitor both the absolute level of EPS and its trend over time. Reliable comparison is possible only when every entity applies identical rules, hence the need for a formal standard.

EPS should therefore be calculated by all companies in a standard way, so that investors can obtain a reliable comparison between the EPS and P/E ratios of different companies.

28.2.1 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.

28.2.2 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:

(i) different entities in the same reporting period; and
(ii) the same entity for different reporting periods over time.

28.2.3 Scope of IAS 33

IAS 33 applies to entities whose ordinary or potential ordinary shares:

(a) trade in a public market; or
(b) are about to be offered to the public.

When a listed group prepares both consolidated and individual accounts, EPS is disclosed only for the consolidated figures.

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28.2.4 Core Definitions

Term	Explanation	Relevance for EPS
Ordinary share	Equity instrument that ranks after all other equity classes in the distribution of profit and capital.	Forms the denominator in both basic and diluted EPS.
Preference share	Not an ordinary share; usually carries priority dividends.	Dividends on such shares are deducted from profit before calculating EPS.
Potential ordinary share	Instrument or contract that may entitle its holder to ordinary shares in future. Examples: Convertible debentures and preference shares Share options and warrants Contingently issuable shares tied to a business acquisition	Included in diluted EPS if the effect is dilutive.
Dilution	Reduction in EPS that would occur if potential ordinary shares were converted or exercised.	Drives the need for a diluted EPS calculation.
Anti-dilution	Increase in EPS that would arise on conversion.	Such instruments are excluded from diluted EPS.

Ordinary shares versus preference shares in EPS calculations

Only ordinary shares count in the denominator of earnings per share. Ordinary shares share in the entity's residual profit once all prior claims, including preference dividends, have been settled.

Preference shares do not qualify as ordinary shares. They carry preferential rights to dividends or capital, so they are excluded from the share count. Their dividends are treated as a prior distribution of profit and must be deducted when determining earnings that are attributable to ordinary shareholders.

Accordingly, the earnings figure used in EPS is:

Profit after tax − Non-controlling interests − Preference dividends

This adjustment ensures that EPS reflects only the return available to holders of ordinary shares, providing a fair basis for comparison across entities and periods.

28.2.5 Basic and Diluted Earnings Per Share

IAS 33 requires every qualifying entity to disclose two EPS figures:

Measure	Purpose	Key inputs
Basic EPS	Shows performance based on the existing capital structure.	Profit attributable to ordinary equity holders divided by the weighted-average number of ordinary shares outstanding during the period.
Diluted EPS	Shows performance assuming that all dilutive rights to ordinary shares are exercised.	Adjusted profit (after reversing any interest or dividends saved on conversion) divided by the adjusted weighted-average shares, including potential ordinary shares that would reduce EPS.

Basic and diluted EPS will differ only when potential ordinary shares exist and are dilutive. IAS 33 identifies three common categories:

Convertible instruments – financial liabilities or equity instruments that can be converted into ordinary shares, for example convertible debentures or convertible preference shares.

Share options and warrants – contracts that grant the holder the right, without obligation, to buy new ordinary shares in future at a fixed exercise price.

Contingently-issuable shares – shares that will be issued when specified contractual conditions are met, such as completing the purchase of a business or achieving performance targets.

The detailed calculation method for each measure, together with worked examples, is provided later in this chapter.

28.3 Basic EPS

Definition and purpose

Basic earnings per share (Basic EPS) expresses the profit available to ordinary shareholders for each ordinary share in issue. The ratio allows investors to compare performance across entities or across periods without the distortion caused by changes in share capital.

Formula

$$\text{Basic EPS} = \frac{\text{Profit attributable to ordinary equity holders}}{\text{Weighted-average ordinary shares outstanding}}$$

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Key components

Component	Practical guidance for calculation
Profit attributable to ordinary equity holders	Use profit after tax for the period, remove any portion attributable to non-controlling interests, then adjust for preference dividends classified as equity.
Weighted-average ordinary shares	Start with shares outstanding at the beginning of the period, adjust for shares issued or bought back, and weight each change by the actual number of days the shares were outstanding. A simple approximation is acceptable when it yields materially the same result.

28.3.1 Treatment of continuing and discontinued operations

Calculate and present:

(a) Basic EPS on total profit or loss attributable to ordinary shareholders, and
(b) Basic EPS on profit or loss from continuing operations, when that subtotal is shown.

If discontinued operations exist, disclose Basic EPS for those operations in a note rather than on the face of the statement of profit or loss.

Handling Preference Shares
Preference shares are analysed under IAS 32 to determine whether they are equity or liability instruments:

(a) If classified as liability, dividends are recognised in profit or loss as a finance cost, so no further EPS adjustment is needed.
(b) If classified as equity, dividends are recorded directly in equity and must be deducted from profit when computing Basic EPS. Dividends on non-cumulative preference shares are deducted only if declared for the period. Dividends on cumulative preference shares are deducted whether or not they are declared in that period.

Total earnings attributable to ordinary shareholders

Profit/earnings benchmark

Begin with profit after tax for the period. Remove:

(a) Any portion of profit or loss attributable to non-controlling interests.
(b) The after-tax amount of preference dividends that relate to equity-classified preference shares, as described above.

The resulting figure represents the earnings available to ordinary shareholders. This figure includes the entity's share of profit or loss from associates and joint ventures accounted for using the equity method.

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28.3.2 Earnings figure to use when computing basic EPS

The starting point for every EPS calculation is earnings attributable to ordinary shareholders.

IAS 33 adapts that figure to fit four common situations for a single entity and four parallel situations for a group.

Context	Earnings used in basic EPS
Single entity:	
1(a) Profit for the year	The entity has no preference shares, or holds preference shares that are classified as a financial liability under IAS 32 so the dividend is already in finance costs, and no discontinued operations are reported.
1(b) Profit from continuing operations	As 1 (a) but the entity has discontinued operations. Basic EPS must be shown on continuing operations as well as on total profit or loss.
1(c) Profit after tax less preference dividends	The entity has preference shares that are classified as equity, so the dividend is an appropriation of profit and must be removed before calculating EPS.
Group:	
2(a) Consolidated profit for the year	The group has no non-controlling interest (NCI) and no equity-classified preference shares.
2(b) Consolidated profit after tax less NCI	The group has a non-controlling interest but no equity-classified preference shares.
2(c) Consolidated profit after tax less preference dividends (equity-classified) and less NCI	Preference dividends and NCI both reduce the pool of earnings available to ordinary shareholders of the parent.
2(d) Profit from continuing operations less preference dividends and less NCI	Use when the group reports discontinued operations and holds equity-classified preference shares. EPS on continuing operations must be disclosed.

Key reminders for ICAN SBR candidates

Identify the share class correctly:

(a) Preference shares classified as a liability: dividend is already a finance cost, so no EPS adjustment.

(b) Preference shares classified as equity: dividend is an appropriation, so subtract it from earnings.

Exclude non-controlling interests: EPS is based on profit attributable to the parent's ordinary shareholders only.

Present continuing-operations EPS separately when discontinued operations are reported.

Document your adjustments clearly in examination workings; markers award credit for a logical bridge from reported profit to earnings used in EPS.

Illustrative example 1: Simple basic EPS with/without Preference Shares

Arsenal Plc prepares its financial statements to December 31, 2024. The entity has exactly 1 million ordinary shares in issue throughout the financial year and no share transactions occurred during the period. Profit after tax for the year amounts to ₦5,000,000.

You are required to determine the basic earnings per share (EPS) for the year ended December 31, 2024 under each of the following independent assumptions.

No preference share capital is currently in existence

There is an 8% Preference share capital of ₦20,000,000 existing from the beginning of the year till the reporting date, but assume that:

(a) Preference Share Capital treated as Equity with reference to IAS 32; and

(b) Preference Share Capital treated as Financial Liability with reference to IAS 32

Suggested solutions:

Case	Additional capital information	Classification under IAS 32	Required adjustment before computing EPS
(a)	**No preference share capital in issue**	**Not applicable**	**None**
(b)(i)	**₦20,000,000 8 per cent preference share capital, in issue all year**	**Classified as equity**	**Deduct preference dividend from profit after tax**
(b)(ii)	**Same preference share capital as in (b)(i)**	**Classified as financial liability**	**No dividend adjustment because the distribution is already recognised as a finance cost in profit or loss**

Step-by-step solution

Compute the weighted-average number of ordinary shares

Shares outstanding all year: 1,000,000

Weighted-average ordinary shares: 1,000,000

Establish earnings attributable to ordinary shareholders

Case	Profit after tax (₦)	Preference dividend (₦)	Earnings used for EPS (₦)
(a)	5,000,000	Nil	5,000,000
(b)(i)	5,000,000	20,000,000 × 8% = 1,600,000	3,400,000
(b)(ii)	5,000,000	Already reflected in profit figure	5,000,000

Calculate Basic EPS

$$\text{Basic EPS} = \frac{\text{Earnings attributable to ordinary shareholders}}{\text{Weighted-average ordinary shares}}$$

Case	Earnings (₦)	Shares	Basic EPS (₦ per share)
(a)	5,000,000	1,000,000	₦5.00
(b)(i)	3,400,000	1,000,000	₦3.40
(b)(ii)	5,000,000	1,000,000	₦5.00

28.3.3 Issue of Shares at Full Market Price

When new shares are issued for cash at their full market value, the proceeds raise earnings potential. To keep numerator and denominator aligned, those shares are counted in the weighted-average number from the date the consideration becomes receivable.

Procedure

a. Start with the opening number of ordinary shares on January 1.
b. Add each new tranche of shares issued during the year.
c. Apply a time-weighting factor to every share total for the portion of the year it was outstanding.
d. Sum the weighted amounts to derive the weighted-average shares for the period.

Comparatives are unaffected—issues at full market price do not require restatement of prior-year EPS.

Illustrative Example 2: Basic EPS where ordinary shares are issued during the year at full market value

Arsenal Plc had 1,000,000 ordinary shares in issue on December 31, 2023. Profit after tax for the next financial year (ending December 31, 2024) amounted to ₦5,000,000. On April 1, 2024, the company issued 200,000 additional ordinary shares at their full market price of ₦4.25 per share.

Required: Determine the basic earnings per share for the year ended December 31, 2024.

Suggested Solution:

Basic earnings per share with a mid-year issue at full market price

Fact pattern	Amount
Ordinary shares in issue January 1, 2024	1,000,000
New ordinary shares issued April 1, 2024	200,000
Profit after tax for the year	₦5,000,000

Step 1 Determine the weighted-average ordinary shares

Because the new shares were issued part-way through the year, weight them by the fraction of the year they were outstanding.

Approach A: Weighted average # of ordinary shares in issue

CLASS OF SHARES	# Ordinary Shares	Time Span	Time Fraction	Weighted Average # Shares
Existing Shares as of Dec 31, 2018 - Dec 31, 2019	1,000,000 Shares	12 Months	(12/12) = 1	1,000,000
New Shares as of April 1, 2019 - Dec 31, 2019	200,000 Shares	9 Months	(9/12) = 0.75	150,000
				1,150,000

A shortcut yields the same result:

1,000,000 + 200,000 × 9/12 = 1,150,000 shares

Approach B: Weighted Average # of Ordinary Shares in Issue

Periods	# Ordinary Shares	Time Span	Time Fraction	Weighted Average # Shares
January 1, 2019 - March 31, 2019	1,000,000 Shares	3 Months	(3/12) = 0.25	250,000
April 1, 2019 - December 31, 2019	1,200,000 Shares	9 Months	(9/12) = 0.75	900,000
		12 Months	**1.00**	**1,150,000**

Step 2 Compute basic EPS

$$\text{Basic EPS} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Weighted-average ordinary shares}}$$

$$= ₦5{,}000{,}000/1{,}150{,}000 \approx ₦4.35 \text{ per share}$$

Presentation:

Arsenal Plc would disclose basic earnings per share of ₦4.35 for the year ended December 31, 2024 on the face of the statement of profit or loss.

28.3.4 Effect of a Bonus Issue on Basic EPS

A bonus issue distributes additional shares to existing shareholders without changing total equity. Because no new resources flow into the business, IAS 33 treats the bonus shares as if they had been in issue from the start of the earliest period presented.

Steps:

Multiply all share figures before the bonus date by the bonus fraction (for example, two-for-one creates a factor of 3/1).

Recalculate the weighted-average number of shares for the current and comparative periods using the adjusted totals.

Do not adjust reported earnings.

The numerator (profit attributable to ordinary shareholders) is unchanged, while the denominator increases, so basic EPS falls proportionately. This restatement ensures comparability across years and prevents a spurious fall in EPS after the bonus distribution.

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Bonus Issues – Treatment of Comparatives under IAS 33

Bonus shares are issued for no consideration, so they are treated as if they had always been in issue.

No time-apportionment is applied.

To keep earnings per share (EPS) figures comparable:

Action	How to adjust
Current year	**Recalculate the weighted-average shares as though the bonus shares were outstanding from 1 January.**
Prior year (comparative)	**Restate EPS by multiplying both the shares and the previously reported EPS by the inverse of the bonus fraction.**

This uniform share base prevents any artificial distortion between the current and prior-year EPS.

Illustrative Example 3: Basic earnings per share after a bonus Issue

Arsenal Plc reported 1,000,000 ordinary shares in issue at December 31, 2023. Profit after tax for the year ending December 31, 2024 is ₦5,000,000. On April 1, 2024, the board approved and distributed a one-for-ten bonus issue, giving each existing shareholder one additional ordinary share for every ten already held. The originally reported Basic EPS for 2023 (when no share changes occurred) was ₦4.58 per share.

Required: Compute:

a. Basic EPS for the year ended December 31, 2024.

b. The restated EPS for 2023, adjusted to reflect the bonus issue.

Suggested solution:

Fact pattern

a. Ordinary shares in issue on 31 December 2023: 1,000,000
b. Profit after tax for the year ended 31 December 2024: ₦5,000,000
c. Bonus issue approved on 1 April 2024: one new share for every ten shares held (additional 100,000 shares)
d. Previously reported Basic EPS for 2023 (before adjustment): ₦4.58

Step 1 Determine the adjusted number of shares

A bonus issue is treated as if the extra shares had been in issue from the beginning of the period and for all comparative periods.

Component	Shares
Ordinary shares originally in issue	**1,000,000**
Bonus shares (1 million ÷ 10)	**100,000**
Adjusted shares for 2024 and 2023	**1,100,000**

Step 2 Calculate basic EPS for 2024

Basic EPS 2024 = ₦5,000,000/1,100,000 = ₦4.55 per share (rounded)

Step 3 Restate the previously reported EPS for 2023

Adjusted EPS 2023 = Basic EPS (2023) x Bonus adjustment*

= ₦4.58 x 10/11 = ₦4.16 per share (rounded), or

Adjusted EPS 2023 = ₦4.58/1.10 = ₦4.16 per share (rounded)

Summary

Year	EPS Figure to Present	Value (₦)
2024	Basic EPS	4.55
2023	Comparative EPS (restated for the bonus issue)	4.16

The restatement ensures that both years are reported on the same share basis, giving investors a consistent and meaningful comparison.

Working Notes – Bonus issue

Item	Ratio	Ordinary shares
Existing shares before bonus	**10**	**1,000,000**
Bonus shares	**1**	**100,000**
Total after bonus	**11**	**1,100,000**

Approach A – Classify shares and weight by class

Class of shares	Ordinary shares	Time span	Time fraction	Weighted average shares
Pre-bonus existing shares (Dec 31, 2023 – Dec 31, 2024)	**1,000,000**	**12 months**	**(12/12) = 1**	**1,000,000**
Bonus shares (Apr 1, 2024 –Dec 31, 2024)	**100,000**	**12 months***	**(12/12) = 1**	**100,000**
Total weighted average				**1,100,000**

***Bonus shares are treated as if in issue for the whole year.**

Approach B – Split the Year into Periods

Period	Ordinary Shares Outstanding	Time Span	Time Fraction	Weighted Average Shares
Jan 1 – Mar 31 2024	1,100,000	3 months	(3/12) = 0.25	275,000
Apr 1 –Dec 31 2024	1,100,000	9 months	(9/12) = 0.75	825,000
Total weighted average				1,100,000

The share count for both periods already include the bonus shares.

Approach C – Apply a bonus factor to opening shares

Period	Ordinary shares before bonus	Bonus factor	Weighted average shares
Jan 1 – Dec 31 2024	1,000,000	1.10*	1,100,000

Recall: Bonus factor and bonus adjustment are inversely related.

Bonus Factor = (Existing shares + Bonus shares)/Existing shares = 11/10 = *1.10*

All three approaches arrive at the same weighted-average share figure of 1,100,000 for use in the basic EPS calculation.

28.3.5 Effect of a rights issue on basic EPS

A rights issue offers existing shareholders new shares at a price below current market value, creating two components:

Bonus element – the "discount" portion that increases shares without bringing in proportionate resources.

Full-price element – the part paid at market value.

IAS 33 Treatment

Component	Treatment	Impact on EPS
Bonus element	Treat as if in issue from the start of the earliest comparative period; restate prior-year EPS.	Increases denominator; EPS falls proportionately.
Full-price element	Include in weighted-average shares from the date of issue (time-apportioned).	Normal dilution for the current year only.

Earnings (numerator) remain unchanged; only the share count is adjusted. Restating comparatives avoids a misleading decline in EPS merely because of the bonus component embedded in the rights issue.

Rights Issues – Treatment of comparatives (IAS 33)

A rights issue normally offers shares below market price, creating a built-in bonus element. IAS 33 therefore splits the new shares into:

Component	EPS Treatment
Bonus element (discount)	**Assume in issue from the start of the earliest comparative period; restate prior-year EPS.**
Full-price element	**Time-weight from the date of issue in the current year; no adjustment to comparatives.**

Restatement Method

Compute the theoretical ex-rights price (TERP)

TERP = (Old shares × Old price) + (Rights Shares × Rights Price)/Total Shares

Derive the adjustment (Bonus) factor

Factor = Market price immediately before rights/TERP

Multiply all share totals before the rights issue (including the prior year) by this factor

Recalculate EPS; earnings (numerator) remain unchanged.

Result: both current and comparative EPS are stated on a consistent share base, avoiding a misleading fall (or rise) caused solely by the discounted rights issue.

Illustrative example 4: Basic EPS where ordinary shares are issued below market value

Arsenal Plc held 1 million ordinary shares on December 31, 2023. Profit after tax for the year ended 31 December 2024 is ₦5 million. On April 1, 2024 the company issued 200,000 ordinary shares to existing shareholders at ₦4.10 each. Immediately before the issue the market price of an ordinary share was ₦4.50. The basic EPS previously reported for 2023 was ₦4.36.

Required: Determine:

Basic EPS for the year ended December 31, 2024

The comparative EPS for 2023, restated to reflect the rights issue

Suggested solution:

Illustrative Example 4: Basic EPS where a rights issue (below market price) occurs during the year

Key Data	Amount
Ordinary shares in issue at January 1, 2024	**1,000,000**
Profit after tax for year ended December 31, 2024	**₦5,000,000**
Rights issue (April 1, 2024)	**200,000 shares at ₦4.10 each**
Market price immediately before rights issue	**₦4.50**
Basic EPS disclosed for 2023 (before adjustment)	**₦4.36**

Step 1 Determine the Bonus (Rights) actor

Theoretical ex rights price (TERP) = (1,000,000 × ₦4.50) + (200,000 × ₦4.10)/1,200,000 = ₦4.43

Theoretical Ex-rights price (TERP)

Class of shares	Quantity	Issue or market price (₦)	Value (₦)
Existing shares	**1,000,000**	**4.50**	**4,500,000**
Rights shares	**200,000**	**4.10**	**820,000**
Total	**1,200,000**		**5,320,000**

TERP = ₦5,320,000/1,200,000 shares = ₦4.43

Class of shares	Number of shares	Price per share (₦)	Total value (₦)
Existing shares	**5**	**4.50**	**22.50**
Rights shares	**1**	**4.10**	**4.10**
Combined total	**6**		**26.60**

TERP = ₦26.60/6 shares = ₦4.43

Step 2 Compute the weighted-average number of ordinary shares for 2024

Period	Shares in issue*	Fraction of year	Weighted shares
Jan 1 – Mar 31	**1,000,000 × 1.015**	**3/12**	**253,760**
Apr 1 – 31 Dec 31	**1,200,000**	**9/12**	**900,000**
Total WA Shares			**1,153,760**

**The opening share pool is multiplied by the bonus factor because IAS 33 treats the discount element as if the extra shares had been in issue from the start of the year.*

Weighted-average ordinary shares (rights issue below market price)

Period	Ordinary shares on register	Months in period	Fraction of year	Bonus factor	Weighted-average shares
1 Jan – 31 Mar 2024	1,000,000	3	(3/12) = 0.25	*1.0150	253,759
1 Apr – 31 Dec 2024	1,200,000	9	(9/12) = 0.75	1.0000	900,000
Total for 2024		12	1.00		1,153,759

**Bonus factor = Market Price Before Rights/TERP = ₦4.50/₦4.43 ≈ 1.0150*

Rights ratio and bonus factor

Detail	Figure
Rights shares : existing shares	200,000 : 1,000,000 ⇒ 1 : 5
Market price before rights (cum-right)	₦4.50
TERP (from Schedule 2)	₦4.43
Bonus factor (Cum-Right ÷ TERP)	1.0150

The bonus factor is applied to shares outstanding at the start of the year to capture the value element inherent in the rights issue priced below market.

Step 3 Calculate Basic EPS for 2024

Basic EPS 2024 = ₦5,000,000/1,153,760 ≈ ₦4.33 per share

Step 4 Restate 2023 EPS for comparability

Adjusted EPS 2023 = ₦4.36/1.0150 ≈ ₦4.30 per share

Result to present

Year	EPS to disclose	Value (₦)
2024	Basic EPS	4.33
2023	Comparative EPS (restated for rights issue)	4.30

This treatment aligns with IAS 33, which requires restating prior-year EPS whenever a rights issue introduces a bonus element.

28.3.6 Concise principles for EPS under share consolidation and share split

Aspect	Share consolidation (reverse split)	Share split (sub-division)
Nature of event	Several existing shares are exchanged for one new share, reducing the share count.	Each existing share is divided into two or more shares, increasing the share count.
IAS 33 treatment	Treated like a bonus adjustment. Assume the consolidation occurred at the start of the earliest period presented.	Also treated like a bonus adjustment. Assume the split occurred at the start of the earliest period presented.
Adjustment to shares	Divide all share quantities (current and comparative) by the consolidation ratio.	Multiply all share quantities (current and comparative) by the split ratio.
Weighted-average shares	No time weighting, because the event does not change resources received or paid.	No time weighting for the same reason.
Earnings figure	Profit attributable to ordinary shareholders is unchanged.	Profit attributable to ordinary shareholders is unchanged.
Impact on EPS	EPS mechanically increases after the share count is reduced, but comparative EPS is restated so the trend remains consistent.	EPS mechanically decreases after the share count is increased, but comparative EPS is restated so the trend remains consistent.
Disclosure	Present restated EPS for prior periods on the revised share basis, with a brief note explaining the consolidation.	Present restated EPS for prior periods on the revised share basis, with a brief note explaining the split.

Share Split and share consolidation – Impact on basic EPS

Transaction	What happens to share capital	IAS 33 Requirement	Effect on reported eps
Share split (for example, each ₦1 share split into two ₦0.50 shares)	Number of shares multiplies; total equity and earnings remain unchanged.	Restate the weighted-average number of shares for the current period and all comparatives by the split ratio.	Denominator rises, so EPS falls in direct proportion to the split.
Share consolidation / reverse split (for example, every ten ₦0.10 shares consolidated into one ₦1 share)	Number of shares reduces; total equity and earnings remain unchanged.	Restate the weighted-average number of shares for the current period and all comparatives by the consolidation ratio.	Denominator falls, so EPS rises in direct proportion to the consolidation.

No adjustment is made to the profit figure (numerator). Restating comparatives ensures EPS trends remain comparable and are not distorted by purely nominal changes in the share count.

Key takeaway

Both events are treated as if the new share structure had been in place from the beginning of all periods shown. Only the denominator in the EPS calculation changes; the earnings numerator stays the same.

Illustrative example 5: Basic EPS After a share consolidation

Arsenal Plc had 10 million ordinary shares in issue at 1 January 2023.
On 1 July 2024 the company carried out a one-for-five share consolidation (five old shares were exchanged for one new share). No other share transactions occurred in either year.

Year	Profit After Tax (₦'000)
2024	12,000
2023	9,000

Required:

a. Calculate Basic EPS for the year ended December 31, 2024.

b. Restate the 2023 comparative EPS to make it comparable.

Suggested solution:

IAS 33 treats a consolidation as if it had taken place at the beginning of the earliest period presented. Therefore:

Shares in issue after consolidation
10 000,000 shares ÷ 5 = 2,000,000 shares

The consolidated share total of 2 million is used for both 2024 and 2023.

Year	Profit (₦'000)	Shares (millions)	Basic EPS (₦)
2024	12,000	2.0	6.00
2023 (Adjusted)	9,000	2.0	4.50

Alternative:

Basic EPS (2023 - Adjusted) = Basic EPS (2023) x Adjustment Factor*

= (₦9,000,000/10,000,000 shares) x (5 shares/1 share)

= ₦0.90/share x 5 = ₦4.50

**Adjustment Factor = New [Reconstructed] Shares ÷ Existing Shares (Before Reconstruction)*

= 5 shares/1 Share

Illustrative example 6: Basic EPS after a share split

Spurs Plc had 3 million ordinary shares in issue at January 1, 2023. On April 1, 2024 a two-for-one share split was approved, doubling the number of shares. There were no other share movements.

Year	Profit after tax (₦'000)
2024	15,000
2023	11,400

The Basic EPS previously reported for 2023 (before the split) was ₦3.80.

Required:

a. Compute Basic EPS for the year ended 31 December 2024.
b. Determine the adjusted EPS for 2023 that must now be disclosed.

Suggested solution:

Under IAS 33, a split is also applied retrospectively to the earliest period. A two-for-one split multiplies the share base by 2.

Shares in issue after the split
3 000,000 shares × 2 = 6,000,000 shares
Use 6 million shares for both 2024 and the restated 2023 figure.

Year	Profit (₦'000)	Shares (millions)	Basic EPS (₦)
2024	15,000	6.0	2.50
2023 (Restated)	11,400	6.0	1.90

Check: Previously reported 2023 EPS:

Basic EPS (2023 - Adjusted) = Basic EPS (2023) x Adjustment factor*

= ₦3.80/shares x (1 share/2 shares)

= ₦3.80/share x (1/2) = ₦1.90, confirming the restated amount.

Illustrative Example 7:

Basic EPS Under Two Preference-Share Classifications

Year-end: December 31, Year 1

	Amount (₦)
Profit from continuing operations	3,000,000
Profit from discontinued operations	500,000
Profit attributable to ordinary shareholders	3,500,000

Additional facts:

Ordinary dividend paid: ₦150,000 (ignored for EPS)

Preference dividend paid: ₦65,000

Ordinary shares in issue all year: 1,000,000

A. Preference shares treated as liabilities

Dividends are already charged in arriving at profit, so no further adjustment is required.

Earnings Measure	Earnings (₦)	Shares	Basic EPS (₦)
Continuing operations	3,000,000	1,000,000	3.00
Discontinued operations	500,000	1,000,000	0.50
Total	3,500,000	1,000,000	3.50

B. Preference shares treated as equity

Preference dividends are an appropriation of profit and must be deducted.

Earnings measure	Calculation	Earnings (₦)	Shares	Basic EPS (₦)
Continuing operations	3,000,000 − 65,000	2,935,000	1,000,000	2.94
Discontinued operations	unchanged	500,000	1,000,000	0.50
Total	3,500,000 − 65,000	3,435,000	1,000,000	3.44

Key point

Only equity-classified preference dividends reduce the earnings available to ordinary shareholders. Liability-classified preference dividends are already reflected in the profit figure, so no adjustment is needed when calculating EPS.

28.3.7 Cumulative preference shares and their effect on basic EPS

Some preference shares are cumulative. If the company skips a dividend in any period, the unpaid amount accumulates and remains payable in a later period. Because the right to receive the dividend already exists, the dividend must be deducted from profit (or loss) when calculating earnings per share, even if no dividend is declared in the current year.

Illustrative Example 8: Cumulative preference shares

Fact pattern	Amount
Profit after tax from continuing operations (Year 1)	₦3,500,000
Cumulative preference share capital	₦1,000,000
Preference dividend rate	10 %
Ordinary shares in issue all year	1,000,000

Preference dividend

10 % × ₦1,000,000 = ₦100,000 *(This amount is deducted whether or not it was declared)*

Basic EPS calculation

Basic EPS = (₦3,500,000 − ₦100,000)/1,000,000 shares = ₦3.40 per share

The dividend on cumulative preference shares reduces the earnings available to ordinary shareholders, ensuring EPS reflects only the residual profit attributable to them.

28.3.8 Treasury shares and basic EPS

Treasury shares are the entity's own equity instruments that have been repurchased and not cancelled. Under IAS 32 they are shown as a deduction within equity; under IAS 33 they affect EPS as follows:

Aspect	EPS Treatment
Numerator (earnings)	Unchanged – buy-backs do not alter profit attributable to ordinary shareholders.
Denominator (shares)	Treasury shares are excluded from the weighted-average number of ordinary shares outstanding from the settlement date of the repurchase until they are reissued or cancelled.
Impact on EPS	With fewer shares in the denominator, basic EPS increases proportionately after a buy-back and decreases when treasury shares are reissued.
Comparatives	No restatement; the effect is recognised only in the period the treasury shares are held.

Thus, treasury share transactions influence basic EPS solely through changes in the share count, enhancing or diluting per-share earnings without affecting total profit.

Scenario 9: Basic EPS after a share buy-back at full market price

Arsenal Plc reported 1 million ordinary shares in issue at January 1, 2024. Profit after tax for the year ended December 31, 2024 amounted to ₦5 million. On April 1, 2024 the entity bought back 200,000 ordinary shares at the prevailing market price of ₦4.25 per share. No other equity changes occurred.

Required:

Calculate Basic EPS for the year ended December 31, 2024.

Calculation of basic EPS for 2024

Period	Shares outstanding	Fraction of year	Weighted shares
1 Jan – 31 Mar (3 months)	1,000,000	3/12	250,000
1 Apr – 31 Dec (9 months)	800,000	9/12	600,000
Weighted-Average Shares			850,000

$$\text{Basic EPS} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Weighted-average ordinary shares}}$$

$$= ₦5{,}000{,}000/850{,}000 \text{ shares} \approx ₦5.88 \text{ per share}$$

Basic earnings per share for 2019: ₦5.88

Alternatively:

Schedule A – Movement in ordinary shares during 2024

Date	Description	Shares issued (-) / Bought Back (+)	Shares Outstanding
Jan 1, 2024	Opening balance	—	1,000,000
Apr 1, 2024	Buy-back at ₦4.25 each	(200,000)	800,000

Schedule B – Weighted-average ordinary shares for EPS

Period	Shares outstanding	Months in period	Fraction of year	Weighted shares
Jan 1 – Mar 31	1,000,000	3	3/12	250,000
Apr 1 – 31 Dec 31	800,000	9	9/12	600,000
Total weighted-average shares		12	1	850,000

Schedule C – Basic EPS for the year ended Dec 31, 2019

	Amount (₦)
Profit after tax (i)	5,000,000
Weighted-average ordinary shares (ii)	850,000
Basic EPS (iii = i/ii)	₦5.88

Illustrative Example 10: Nia Plc – Share Movement schedule for 2024

Date	Transaction Detail	Shares Outstanding
Jan 1, 2024	Opening balance	170,000
May 31, 2024	New issue for cash	+ 80,000
Dec 31, 2024	Closing balance	250,000

Weighted-average ordinary shares for 2024

Period	Shares in Issue	Months Held	Fraction of Year	Weighted Shares
Jan 1 –May 31 (5 months)	170,000	5	5/12	70,833
Jun 1 –Dec 31 (7 months)	250,000	7	7/12	145,833
Weighted-average shares		12	1	216,666

(Alternative approach: treat the new issue separately – 170,000 for 12 months plus 80,000 for 7 months ÷ 12 – which also gives 216,666 shares.)

28.3.9 Earnings and non-controlling interest

When a group presents consolidated financial statements, basic and diluted earnings per share (EPS) are calculated only on the profit attributable to the ordinary shareholders of the parent company. The profit figures must therefore be adjusted to exclude the share that belongs to the non-controlling interest (NCI).

IAS 1 *Presentation of Financial Statements* requires entities to disclose profit or loss for the period, split into:

profit attributable to owners of the parent, and

profit attributable to non-controlling interests.

These disclosures provide the starting point for the EPS calculation.

Illustrative Example 11: Basic EPS With NCI

Statement of Profit or Loss (Year Ended December 31, Year 1)	₦
Profit from continuing operations	3,000,000
Profit from discontinued operations	500,000
Profit attributable to ordinary shareholders	3,500,000

The NCI owns 20 per cent of the subsidiary's equity. IAS 1 would require the following disclosure:

Profit Attributable To:	₦
Owners of the parent	2,800,000
Non-controlling interests	700,000
Total	3,500,000

To meet IAS 33 *Earnings per Share*, the parent's profit (₦2,800,000) must be analysed between continuing and discontinued operations, because each figure is used in separate EPS calculations.

	Profit for the year ₦	Share of NCI (20 %) ₦	Owners of the parent ₦
Profit from continuing operations	3,000,000	600,000	2,400,000
Profit from discontinued operations	500,000	100,000	** 400,000**
Profit attributable to ordinary shareholders of the parent	3,500,000	700,000	2,800,000

The shaded figure (₦2,800,000) is the earnings numerator used in the basic EPS calculation. Separate EPS figures for continuing and discontinued operations will use ₦2,400,000 and ₦400,000 respectively.

Key points for ICAN SBR candidates

Always exclude the NCI share before computing EPS.

Split owners' profit between continuing and discontinued operations if both exist.

Present the reconciliation clearly - users must see how the EPS numerator is derived.

Earnings And Non-Controlling Interest – Mixed NCI Percentages

When the non-controlling interest (NCI) percentage differs between continuing and discontinued operations, separate splits are required before calculating basic earnings per share (EPS).

Illustrative Example 12: Basic EPS With different NCI Shares

Year ended December 31, Y1	Amount (₦)
Profit from continuing operations	3,000,000
Profit from discontinued operations	500,000
Profit attributable to ordinary shareholders	3,500,000

NCI in continuing operations: 20%

NCI in discontinued operations: 30%

IAS 1 Disclosure (Profit Split)

Profit Attributable To:	₦
Owners of the parent	2,750,000
Non-controlling interests	750,000
Total	3,500,000

Figures used for basic EPS

	Profit for the Year (₦)	NCI Share (20%/30%) (₦)	Attributable To Owners of the Parent (₦)
Profit from continuing operations	3,000,000	600,000	2,400,000
Profit from discontinued operations	500,000	150,000	** 350,000**
Profit attributable to ordinary shareholders of the parent	3,500,000	750,000	2,750,000

₦2,750,000 is the earnings numerator for basic EPS.

For Separate EPS Disclosures:

Continuing-operations EPS uses ₦2,400,000.

Discontinued-operations EPS uses ₦350,000.

Key Reminders for ICAN SBR

Apply the relevant NCI percentage to each component of profit.

Sum the owners' portions to arrive at the EPS numerator.

Present continuing and discontinued figures separately when IAS 33 requires separate EPS.

28.3.10 Changes in share capital during the year

IAS 33 requires earnings per share (EPS) to be based on the weighted-average number of ordinary shares outstanding. Whenever the share capital changes, the timing and nature of the change determine how the new shares are included in that average.

A. Types of capital change

Category	Typical transactions	EPS treatment
Full-price issue / redemption	**New shares (or buy-backs) for cash at fair value.**	**Time-apportion from the date consideration is receivable / payable.**
No-consideration issue	**Bonus issue, share split, reverse split, bonus element in rights issue.**	**Treat as if in issue from the *start* of the comparative period – restate prior-year EPS.**
Rights issue	**Shares issued below market price.**	**Split into:** **• *bonus element* – treated as no-consideration issue;** **• *full-price element* – time-apportioned from date of issue.**

B. Four-step method for complex periods

List the opening shares in issue on January 1.

Record each capital change (date and new total shares).

Multiply each share total by the fraction of the year it existed.

Sum the weighted amounts to obtain the weighted-average shares for EPS.

If a change includes a bonus element, multiply all earlier share totals by the bonus fraction before applying time weights.

Illustrative example 13: Time apportionment only

On January 1, the company had 5,000,000 ordinary shares in issue.

On April 1, 1,000,000 new shares were issued.

On July 1, an extra 1,000,000 shares came into existence

On November 1, 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	Shares in issue	Fraction of year	Weighted shares
Jan 1 –Mar 31	5,000,000	3/12	1,250,000
Apr 1 issue	+1,000,000		
Apr 1 –Jun 30	6,000,000	3/12	1,500,000
Jul 1 issue	+1,000,000		
Jul 1 – Oct 31	7,000,000	4/12	2,333,333
1 Nov 1 issue	+ 500,000		
Nov 1 –Dec 31	7,500,000	2/12	1,250,000
Weighted-average for Year 1			6,333,333

No bonus or rights elements exist, so no retrospective adjustment is needed.

28.3.11 Partly-paid shares – Impact on basic EPS

IAS 33 bases the weighted-average number of ordinary shares on the equivalent number of fully-paid shares. A partly-paid share is therefore counted at the proportion that has been paid-up until the balance is received.

Under IAS 33, the weighted-average share count must reflect only the fully-paid equivalent of each ordinary share:

A partly-paid share is included in the denominator in the same proportion as the cash already paid (e.g. a share paid to 60 % counts as 0.60 of a share).

When a further call is satisfied, the share becomes more "paid-up" from that date; the new fully-paid equivalent is time-weighted for the remainder of the period.

Earnings (numerator) are unchanged by the payment; only the denominator alters, so basic EPS falls progressively as additional calls are paid.

No comparative restatement is required, because the change arises from new consideration, not a bonus element.

Thus, partly-paid shares dilute EPS gradually in line with the proportion and timing of cash received.

Illustrative Example 14: Partly-Paid Shares

Fact Pattern	Details
Opening capital (1 Jan)	6,000,000 ordinary shares in issue, of which 1,000,000 are 75 % paid.
Cash call	On 1 April the company received the remaining 25 % on the partly-paid shares.
Earnings	Profit for Year 1 = ₦24,750,000.
Year-end	December 31.

Step-by-step EPS calculation

Date	No. of Shares in Issue	Time Fraction	Weighted Average Shares
Jan 1 – Mar 31	6,000,000[1]	3 / 12	1,500,000
Balance received on partly-paid shares	+250,000[2]		
Apr 1 –Dec 31	6,250,000	9 / 12	4,687,500
Weighted-Average for the year			6,187,500

The partly-paid shares are treated as fully paid to the extent of the cash received (75 % × 1,000,000 = 750,000 equivalent fully-paid shares).

The cash received on April 1 converts the remaining 25 % into an additional 250,000 fully-paid equivalents (25 % × 1,000,000).

Basic EPS

EPS = Profit /Weighted-Average Shares = ₦24,750,000/6,187,500 = ₦4.00

Key points for ICAN SBR

Count partly-paid shares in proportion to paid-up capital until they become fully paid.

Apply normal time-weighting from the date any further call money is received.

No restatement of comparatives is required, only bonus issues, splits and similar no-consideration events trigger retrospective adjustment.

28.4 Diluted EPS

Meaning of dilution

Dilution describes the reduction in earnings per share that would arise if potential ordinary shares (POS) convert into ordinary shares. POS include instruments such as convertible bonds, convertible preference shares, share options and warrants. When these instruments are exercised or converted, the same profit must be spread over a larger number of shares, thereby reducing (watering down) basic EPS.

In EPS terms *dilution* refers to the reduction in basic earnings per share that would occur if all potential ordinary shares were converted into ordinary shares.

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Examples of potential ordinary shares include:

Potential ordinary share	Conversion trigger
Convertible Bonds	**Bondholder elects to convert debt into equity.**
Convertible Preference Shares	**Holder exchanges preferred shares for ordinary shares.**
Share Options or Warrants	**Holder exercises the right to buy shares at a fixed price.**

When these instruments become ordinary shares, the same earnings must be spread over a larger share base, giving a lower EPS.

IAS 33 – Diluted EPS

IAS 33 requires listed entities to disclose diluted EPS alongside basic EPS for the reporting period and for the comparative year. Diluted EPS is computed only after considering POS that are *actually dilutive*—that is, those that would decrease EPS (or increase loss per share) if they had already been converted.

The calculation involves two key adjustments:

Earnings (numerator)

Add back after-tax dividends on convertible preference shares.

Add back after-tax interest on convertible debt.

Adjust for any other income or expense that would cease on conversion.

Shares (denominator)

Convertibles – add the full number of shares that would be issued on conversion, time-weighted as appropriate.

Options / warrants – apply the treasury-share method: assume exercise, then offset by the number of shares that could be repurchased at the average market price.

Only POS that reduce EPS are included; anti-dilutive instruments are ignored.

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Compute Diluted EPS

Diluted EPS = Adjusted Earnings

Adjusted Weighted-Average Shares

= Earnings (as per Basic EPS) + Increase in Earnings (attributable to Potential Shares)

Shares (as per basic EPS) + Weighted average number of potential Ordinary shares in issue

Earnings adjustment: add back after-tax interest or dividends that relate to convertible instruments and any other income or expense that would not arise if the potential shares were already ordinary shares.

Share adjustment: add the weighted average number of shares that would be issued if dilutive instruments were converted, exercised or otherwise settled in shares during the period.

Only those potential ordinary shares that reduce EPS are included in the calculation.

28.4.1 Diluted earnings per share

An entity must disclose diluted earnings per share (EPS) for the profit or loss that is attributable to ordinary shareholders of the parent. Diluted EPS shows the potential reduction in basic EPS that would occur if all instruments that could be converted into ordinary shares were actually converted during the reporting period. Anti-dilutive instruments are ignored.

Potential ordinary shares

Common instruments that may create additional ordinary shares include:

a. Convertible debt
b. Convertible preference shares
c. Share warrants
d. Share options
e. Share rights
f. Employee share purchase plans
g. Contractual rights to purchase shares
h. Contingent share-based arrangements (for example, in a business combination)

Transactions that Give Rise to Potential Ordinary Shares

Contracts that make the entity contingently issuable shares.

The issue of convertible securities by the entity.

The issue of options or warrants over the entity's shares.

Contracts that can be settled in either shares or cash.

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28.4.2 Convertible Securities and Diluted EPS – Key Points

Nature of convertible instruments: Convertible bonds and convertible preference shares start as liabilities or equity with fixed charges but can be exchanged for ordinary shares if conversion conditions are met.

Why they matter for dilution: Conversion would reduce reported earnings per share because profit would be spread over more shares while interest or preference dividends would cease.

Adjusting the numerator

Add back after-tax bond interest saved on conversion.

Add back preference dividends that would no longer be payable.

Adjusting the denominator

Increase the weighted-average number of shares by the shares that would be issued on full conversion.

Weight any mid-year issues in proportion to the time outstanding.

Dilutive or anti-dilutive test: Compute incremental EPS (interest or dividend saving ÷ potential shares).

If incremental EPS is less than basic EPS, the effect is dilutive and must be included.

If incremental EPS is greater than basic EPS, the effect is anti-dilutive and is ignored.

Overall impact: Including dilutive convertible securities lowers EPS, providing users with a worst-case measure of earnings per share if all conversion rights are exercised.

Illustrative example 15: Basic and diluted eps (convertible securities)

As at December 31, 2023, Uri Plc has:

1,000,000 ordinary shares of ₦1 par value in circulation.

8,000 convertible bonds with a face value of ₦100 each, paying 5% interest.

Each bond can be exchanged for two ordinary shares.

Profit after tax for the year amounts to ₦4.6 million.

The applicable corporate income-tax rate is 40%.

Required:
Determine the basic earnings per share (EPS) and diluted EPS for the year ended December 231, 023.

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Suggested solution:

URI Plc – EPS for the year ended December 31, 2023

	Earnings (₦)	Shares
Basic EPS	**4,600,000**	**1,000,000**
Diluted EPS	**4,600,000 + 24,000[1] = 4,624,000**	**1,000,000 + 16,000[2] = 1,016,000**

After-tax interest saved on conversion

- Bond interest = 8,000 bonds × ₦100 × 5% = ₦40,000
- Net of tax (40 %) = ₦40,000 × 60% = ₦24,000

Potential ordinary shares

- 8,000 bonds × 2 shares per bond = 16,000

	Formula	EPS (₦)
Basic EPS	**4,600,000 ÷ 1,000,000**	**₦4.60**
Diluted EPS	**4,624,000 ÷ 1,016,000**	**₦4.55**

Both figures are rounded to the nearest kobo.

Alternatively,

Sanchez Ltd – EPS Analysis (year ended December 31, 2023)

	Figure/Detail
Ordinary shares in issue	**1,000,000 shares**
After-tax profit	**₦4,600,000**
Convertible bonds	**8,000 notes of ₦100 each**
Coupon rate	**5 % p.a.**
Nominal bond value	**₦800,000**
Income-tax rate	**40 %**
Conversion ratio	**2 ordinary shares per bond**

Basic EPS

Basic EPS = ₦4,600,000/1,000,000 = ₦4.60

Diluted EPS

(a) Increase in Earnings

Calculation	Amount (₦)
Bond interest (₦800,000 × 5%)	40,000
Less tax @ 40%	(16,000)
Net interest saved	24,000

(b) Potential Ordinary Shares

Detail	No. of Shares
Bonds × conversion rate (i)	8,000 × 2 = 16,000
Weighted-average factor (ii)	12 / 12
Weighted potential shares (i/ii)	16,000

(c) Diluted EPS

Diluted EPS = ₦4,600,000 + ₦24,000)/(1,000,000 Shares + 16,000 Shares)

= ₦4,624,000/1,016,000 ≈ ₦4.55

Dilution test

Change in EPS if conversion occurred:

$$\Delta EPS = \frac{\text{Increase in earnings (attributable to potential shares)}}{\text{Weighted average number of potential ordinary shares in Issue}}$$

ΔEPS = ₦24,000/16,000 = ₦1.50

Since *ΔEPS* of ₦1.50 < Basic EPS of ₦4.60, the convertible bonds are Dilutive and are therefore included in the diluted EPS calculation.

Illustrative example 16: Basic and Diluted EPS (Convertible Securities – "Multiple Conversion Dates)

On December 31, 2024, FARA Plc had 1 million ordinary shares in issue of a par value of ₦1. The Company equally has 8% ₦10 million convertible debentures been in issue since 2024, with an option to convert to ordinary shares on the following basis:

2026 – ₦1000 Debenture Note convertible to 35 shares
2027 – ₦1000 Debenture Note convertible to 55 shares
2028 – ₦1000 Debenture Note convertible to 40 shares
2029 – ₦1000 Debenture Note convertible to 30 shares

The after-tax profit for the period is ₦1.8 million. The income tax rate is 30%.

Required:

Calculate basic EPS and Diluted EPS for December 31, 2024

Suggested solution:

FARA Plc – EPS for the year ended December 31, 2024

	Basic EPS	Diluted EPS*
Earnings numerator (₦) (i)	**1,800,000**	**1,800,000 + 560,000[1] = 2,360,000**
Share denominator (ii)	**1,000,000**	**1,000,000 + 550,000[2] = 1,550,000**
EPS (₦) [i/ii]	**1.80**	**1.52**

**The most dilutive conversion alternative (55 shares per ₦1,000 debenture) is used; all other options either give a higher EPS (less dilution) or are anti-dilutive.*

Supporting calculations

After-tax interest saved on conversion

Face value of convertible debt = ₦10 million

Interest at 8% = ₦800,000

Tax relief @ 30% = ₦800,000 × 30% = ₦240,000

Net interest added back = ₦800,000 – ₦240,000 = ₦560,000

Potential ordinary shares

Notes in issue = ₦10 million ÷ ₦1,000 = 10,000

Conversion ratio (2027 option, 55 shares per note) = 10,000 × 55 = 550,000 shares

Keynotes:

The 55-share option produces the lowest EPS (₦1.52) and is therefore the basis for diluted EPS.

The 30-share option would raise EPS above the basic figure, so it is anti-dilutive and ignored.

Alternatively;

FARA Plc – Extracted EPS Worksheet (Year ended Dec 31, 2024)

Heading	Figure/Description
Ordinary shares in issue	**1,000,000 shares (par ₦1)**
Profit for the year	**₦1,800,000**
Convertible debenture loan stock	**Face value ₦10,000,000 (10,000 notes × ₦1,000)**
Coupon/interest rate	**8% p.a.**
Income-tax rate	**30%**

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Conversion ratio used	**55 ordinary shares per ₦1,000 note (most dilutive option)**

Basic EPS

Component	Result
Earnings attributable (i)	**₦1,800,000**
Weighted-average shares (ii)	**1,000,000**
Basic EPS (i/ii)	**₦1.80**

Diluted EPS

	Calculation	Amount
Interest on bonds	**₦10,000,000 × 8%**	**800,000**
Less tax relief (30%)	**800,000 × 30%**	**(240,000)**
Net interest saved (added back to earnings)		**₦560,000**
Adjusted Earnings	**1,800,000 + 560,000**	**₦2,360,000**
Potential ordinary shares	**10,000 notes × 55**	**550,000**
Adjusted shares	**1,000,000 + 550,000**	**1,550,000**
Diluted EPS	**2,360,000 ÷ 1,550,000**	**₦1.52**

Dilution Test

Change in EPS if conversion occurs:

$$\Delta EPS = \frac{\text{Increase in Earnings (attributable to Potential Shares)}}{\text{Weighted Average Number of Potential Ordinary Shares in Issue}}$$

$$= 560{,}000 / 550{,}000 = ₦1.02$$

Since the Basic EPS of ₦1.80 exceeds *ΔEPS* of ₦1.02, the convertible debentures are dilutive and are therefore included in the diluted EPS computation.

Illustrative Example 17: Basic EPS and Diluted EPS (with respect to Convertible securities)

Given the information in Illustrative 16 above, the 8% ₦10 million convertible debentures were issued during the reporting period (i.e. issued on April 1, 2024).

Suggested solution:

EPS where the convertible debentures were issued on April 1, 2018

Data	Amount/Detail
Ordinary shares in issue all year	1,000,000
Profit after tax	₦1,800,000
8% convertible debentures (₦1,000 notes)	Face value ₦10 million
Issue date	1 April 2018 (in issue 9/12 of the year)
Shares on conversion	55 shares per note → 10,000 notes × 55 = 550,000
Income-tax rate	30%

Basic EPS

Basic EPS = ₦1,800,000/1,000,000 = ₦1.80

Diluted EPS

(a) Adjusted Earnings

	Calculation	₦
Interest for 9 months	10,000,000 × 8% × 9⁄12	600,000
After-tax interest saved	600,000 × (1 – 0.30)	420,000
Adjusted earnings	1,800,000 + 420,000	2,220,000

(b) Adjusted Shares

	Calculation	Shares
Potential shares	550,000 × 9⁄12	412,500
Adjusted denominator	1,000,000 + 412,500	1,412,500

(c) Diluted EPS

Diluted EPS = ₦2,220,000/1,412,500 ≈ ₦1.57

Result

Measure	EPS (₦)
Basic EPS	1.80
Diluted EPS	1.57

The convertible debentures are dilutive because the calculated diluted EPS is lower than the basic EPS.

Alternatively;

Key figures extracted from calculations (issue of convertibles on April 1, 2024)

Section	Data/Result
Input Facts	Ordinary shares in issue all year = 1,000,000 Profit after tax = ₦1,800,000 8% convertible debenture loan stock (₦1,000 notes) issued Apr 1, 2018 Face value of loan stock = ₦10,000,000 (10,000 notes) Conversion rate = 55 ordinary shares per note Income-tax rate = 30%
Basic EPS	Earnings ÷ shares = ₦1,800,000 ÷ 1,000,000 = ₦1.80
Dilution – earnings adjustment (X)	Interest for 9 months = ₦10,000,000 × 8% × 9/12 = ₦600,000 Less tax relief (30 %) = ₦600,000 × 30% = ₦180,000 Net interest saved (added back) = ₦420,000
Dilution – share adjustment (Y)	Potential shares if converted = 10,000 × 55 = 550,000 Time weighting (9/12) = 550,000 × 0.75 = 412,500
Dilution test	Change in EPS (*ΔEPS*) if converted = ₦420,000 ÷ 412,500 ≈ ₦1.02 Because ₦1.80 > ₦1.02, convertibles are dilutive and are included.
Diluted EPS	Adjusted earnings = ₦1,800,000 + ₦420,000 = ₦2,220,000 Adjusted shares = 1,000,000 + 412,500 = 1,412,500 Diluted EPS = ₦2,220,000 ÷ 1,412,500 = ₦1.57

Illustrative example 18: Basic and diluted EPS involving convertible securities

Gbemski Plc has the following capital structure during 2024:

Ordinary shares – 5,000,000 shares of 25 kobo each, in issue throughout the year.

14% convertible loan stock – ₦1 million principal, convertible in three years at two ordinary shares for every ₦10 of loan stock.

10% convertible loan stock – ₦2 million principal, convertible in one year at three ordinary shares for every ₦5 of loan stock.

The profit after tax for 2024 is ₦1,750,000, and the corporate income-tax rate is 35%.

Required:

Determine Gbemski Plc's basic earnings per share and diluted earnings per share for the year ended 31 December 2024.

Suggested Solution:

Gbemski Plc – EPS for the year ended 31 December 2024

	Earnings (₦)	Shares
Basic EPS	**1,750,000**	**5,000,000**

Basic EPS= ₦1,750,000/5,000,000 Shares = ₦0.35

Dilution Analysis

Convertible loan stock	Face value (₦)	Coupon (₦)	Net interest saved [1] (₦)	Potential shares [2] (₦)	Incremental EPS (₦)	Dilutive?
14% stock (three-year option, 2 shares per ₦10)	1,000,000	140,000	91,000	200,000	0.46	No
10% stock (one-year option, 3 shares per ₦5)	2,000,000	200,000	130,000	1,200,000	0.11	Yes

Interest × (1 – 35% tax)
Face value ÷ conversion price × shares per unit

Only the 10% loan stock is dilutive.

Diluted EPS

	Amount
Adjusted Earnings	**1,750,000 + 130,000 = ₦1,880,000**
Adjusted Shares	**5,000,000 + 1,200,000 = 6,200,000**

Diluted EPS = 1,880,000/6,200,000 = ₦0.30

Summary

Measure	EPS (₦)
Basic EPS	**0.35**
Diluted EPS	**0.30**

The 14% convertible loan stock is excluded because its incremental EPS (₦0.46) exceeds the Basic EPS (₦0.35) and would therefore be anti-dilutive.

Alternatively;

Extracted Working Schedule
(all figures in Nigerian Naira unless otherwise stated)
Core Data (2024)

Ordinary shares in issue (fully-paid)	**5,000,000 shares**
Profit after tax	**₦1,750,000**
Corporate tax rate	**35%**

	14% Convertible loan stock	**10% Convertible loan stock**
Principal (nominal) value	**₦1,000,000**	**₦2,000,000**
Nominal price per note	**₦10**	**₦5**
Number of notes	**100,000**	**400,000**
Coupon rate	**14%**	**10%**
Conversion terms	**2 ordinary shares for each ₦10 of stock**	**3 ordinary shares for each ₦5 of stock**

Basic EPS

$$\text{Basic EPS} = \frac{\text{Earnings attributable to ordinary shareholders}}{\text{Weighted-average ordinary shares}}$$

$$= ₦1{,}750{,}000/5{,}000{,}000 \text{ Shares} = ₦0.35$$

Dilution Tests

	Interest Saved	**Tax (35%)**	**Net Saving (X)**	**Potential Shares (Y)**	**Incremental EPS (X ÷ Y)**	**Result**
14% stock	**₦140,000**	**₦49,000**	**₦ 91,000**	**100,000 notes × 2 = 200,000**	**₦0.46**	**Anti-dilutive (ignored)**
10% stock	**₦200,000**	**₦70,000**	**₦130,000**	**400,000 notes × 3 = 1,200,000**	**₦0.11**	**Dilutive (included)**

Rule applied – include only if incremental EPS (ΔEPS) < Basic EPS (₦0.35).

Diluted EPS

	Amount
Adjusted Earnings	**1,750,000 + 130,000 = ₦1,880,000**
Adjusted Shares	**5,000,000 + 1,200,000 = 6,200,000 shares**

Diluted EPS = ₦1,880,000/6,200,000 Shares = ₦0.30

Summary

Measure	EPS (₦)
Basic EPS	**0.35**
Diluted EPS	**0.30**

Only the 10% convertible loan stock is dilutive; the 14% issue is anti-dilutive and therefore excluded from the diluted-EPS calculation.

28.4.3 Options and Warrants – Impact on Diluted EPS

Potential ordinary shares: Employee or executive options and trade warrants give holders the right to subscribe for new shares at a fixed price, increasing the share count if exercised.

Treasury share approach (IAS 33): Assume the proceeds from exercise are used to repurchase shares at the average market price for the period.

New shares issued on exercise: exercise price multiplied by the number of options, divided by par value.

Shares hypothetically repurchased: cash proceeds divided by the average market price.

Net increase in shares (added to the denominator) equals options issued minus shares repurchased.

Earnings adjustment: No change to the earnings figure because options and warrants do not affect profit.

Dilution test: Compare the exercise price with the average market price.

If the exercise price is below market, options are in the money and dilutive.

If the exercise price equals or exceeds market, options are out of the money and anti-dilutive, so they are excluded.

Net effect: Dilutive options and warrants increase the weighted-average shares, lowering diluted EPS. The adjustment reflects the potential transfer of value from existing shareholders if the rights are exercised.

Illustrative Example 19: Basic EPS and Diluted EPS (with Options/Warrants)

FinPolNomics Plc has 2 million ordinary shares in issue as of 30 June 2024. The earnings for the year ended June 30, 2024 was ₦3 million. The Company has presently issued an option of 100,000 ordinary shares written in favour of management staff sometime in 2022. The average market price of the company shares as of June 30, 2024 was ₦5, while the exercise/strike price of the Company's shares was ₦2.

Required:

Calculate basic EPS and diluted EPS for June 30. 2024

Suggested solution:

FinPolNomics Plc – EPS for the year ended June 30, 2024

	Result
Profit attributable to ordinary shareholders	**₦3,000,000**
Weighted-average ordinary shares in issue	**2,000,000 shares**

Basic EPS

Basic EPS = ₦3,000,000/2,000,000 Shares = ₦1.50 *per Share*

Diluted EPS (Treasury-Share Method for Options)

Options in Issue:
100,000 Options – Exercise/Strike Price ₦2; Average Market Price ₦5.

Step	Workings	Shares
(a) New shares on assumed exercise	**100,000**	**100,000**
(b) Shares that could be repurchased with the proceeds	**100,000 × (₦2/₦5)**	**(40,000)**
(c) Incremental shares	**100,000 – 40,000**	**60,000**

Diluted Share Base: 2,000,000 + 60,000 = 2,060,000 Shares

Diluted EPS = ₦3,000,000/2,060,000 ≈ ₦1.46

Summary

Measure	EPS (₦)
Basic EPS	**1.50**
Diluted EPS	**1.46**

The option package is dilutive because the strike price (₦2) is below the average market price (₦5), generating incremental shares that reduce EPS.

Alternatively;

Extracted calculation sheet (options/warrants)

(all figures in Nigerian Naira, ₦ unless otherwise stated)

Section	Detail/Working	Figure
Ordinary shares – 30 Jun 2024	**In issue**	**2,000,000 shares**
Profit for the year	**Earnings attributable to ordinary shareholders**	**3,000,000**
Options/Warrants outstanding	**Number of options granted**	**100,000 options**
	Average market price (year)	**₦5.00**
	Exercise / strike price	**₦2.00**
	Method used	***Treasury-share (IFRS 2 & IAS 33)***

Basic EPS

Basic EPS = Profit/Weighted Average Ordinary Shares

= ₦3,000,000/2,000,000 = ₦1.50

Diluted EPS

Step	Description	Shares/Amount
X – Increase in earnings	**Options give no interest or dividend saving → ₦0**	
Y – Weighted-average potential ordinary shares		
1	**Proceeds if all 100,000 options exercised (100,000 × ₦2)**	**₦200,000**
2	**Shares re-purchased with those proceeds (₦200,000 ÷ ₦5)**	**40,000 shares**
3	**Incremental shares issued free to option-holders (100,000 – 40,000)**	**60,000 shares**
4	**Weighted-average factor (full year)**	**× 1.00**
	Incremental shares (Y)	**60,000 shares**

Diluted EPS = $\frac{\text{Profit (₦3,000,000) + X (₦0)}}{\text{Ordinary Shares (2,000,000) + Y (60,000)}}$

= ₦3,000,000/2,060,000 Shares = ₦1.46

Dilution Test

Change in EPS =X/Y = ₦0 ÷ 60,000 = ₦0.00

Since Basic EPS (₦1.50) > Change in EPS (₦0.00), the options are dilutive — therefore they are included in diluted EPS.

Summary

Metric	Amount
Basic EPS	**₦1.50**
Diluted EPS	**₦1.46**

The presence of in-the-money staff options reduces earnings per share by ₦0.04 when potential dilution is considered.

28.4.4 Contingently Issuable Shares and Diluted EPS — The Essentials

Aspect	What ias 33 says	Practical effect on diluted eps
Definition	Ordinary shares that will be issued only if specified future conditions (profit, market-price, service, etc.) are satisfied.	They are treated like options with a zero exercise price once the performance hurdle looks achievable.
Inclusion rule	Include them in the diluted EPS denominator whenever, on the basis of results up to the reporting date, the condition *would be met* (IAS 33).	The share count rises immediately in the dilution test, even before the formal measurement date, because "as-if-converted" accounting is applied.
Earnings adjustment	None – shares are issued for no consideration, so profit attributable to ordinary shareholders is unchanged.	All dilution stems from the larger denominator; the numerator is the same as for basic EPS.
Ranking order	Contingently issuable shares are ranked after options/warrants but before convertibles when testing incremental dilution.	Ensures the most dilutive instruments are reflected first; anti-dilutive instruments are excluded.
Basic EPS	Added to basic EPS only when the condition has already been satisfied by the reporting date.	Until then, basic EPS ignores them; diluted EPS anticipates them.

Bottom line: once interim performance shows the target is on track, contingently issuable shares are pulled into the diluted-EPS denominator, lowering (diluting) the figure even though no extra earnings or cash flow arise.

Illustrative Example 20: Contingently-Issuable Shares (Profit Target)

EPS with Contingently Issuable Shares

Faramade Plc has 1 million ordinary shares outstanding at 31 December 2024.

Profit after tax for 2024 is ₦5 million.

On 1 January 2023 management promised each Regional Managing Director 10,000 shares on 1 January 2026 if the average profit for 2023 - 2025 reaches ₦6 million or more.

By 31 December 2024 (two of the three years completed) cumulative profit for 2023 - 2024 is ₦9 million.

Suggested Solution:

Item	Note	Amount
Ordinary shares in issue (31 Dec 2024)	*given*	1,000,000
Profit after tax (2024)	*given*	₦5,000,000

Basic EPS (2024)

Basic EPS = $\frac{\text{Profit attributable to ordinary shareholders}}{\text{Weighted-average ordinary shares}}$

= ₦5,000,000/1,000,000 = ₦5.00

Diluted EPS – Are the contingent shares included?

Contingent arrangement: *Promise:* each Regional Managing Director will receive 10,000 shares on January 1, 2026 if the average profit for 2023 - 2025 ≥ ₦6 million.

IAS 33 rules: Potential ordinary shares based on a profit (or other performance) condition are included in diluted EPS only if the condition is satisfied at the reporting date, using results to date only (IAS 33).

Status at Dec 31, 2024

Cumulative profit 2023 - 2024: ₦9 million

Average to date: ₦9 million ÷ 2 years = ₦4.5 million

The target ₦6 million average has not yet been met. Because the condition is unsatisfied, the contingent shares are anti-dilutive (effectively zero).

Result: The share-based contingency is ignored in both basic and diluted EPS for 2024.

Diluted EPS (2024)

With no other dilutive instruments and the contingent shares excluded:

Diluted EPS (2024) = ₦5.00

Key takeaway:

Contingently issuable shares tied to future performance are brought into diluted EPS only when the performance condition has been satisfied based on information available at the reporting date.

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Illustrative Example 21: Contingently issuable shares (profit target)

EPS with contingently issuable shares

Faramade Plc has 1 million ordinary shares outstanding at December 31, 2024.

Profit after tax for 2024 is ₦5 million.

On January 1, 2023 management promised each Regional Managing Director 10,000 shares on January 1, 2026 if the average profit for 2023 - 2025 reaches ₦4 million or more.

By December 31, 2024 (two of the three years completed) cumulative profit for 2023 - 2024 is ₦9 million.

Suggested Solution:

Fact Pattern	Data
Ordinary shares in issue (at 31 Dec 2024)	**1,000,000**
PAT for 2024	**₦5,000,000**
Contingent award (agreed 1 Jan 2023)	**10,000 shares for each Regional MD if the three-year average PAT 2023 - 2025 ≥ ₦4,000,000**
Cumulative PAT 2023 - 2024	**₦9,000,000 ⇒ average to date ₦,4,500,000 (≥ threshold)**

Note: The question does not tell us how many Regional Managing Directors (RMDs) are eligible.

Let M = number of RMDs. THEN, Total contingent shares = 10,000 × M.

(a) Basic EPS – year-ended Dec 31, 2024

IAS 33 includes contingently issuable shares in Basic EPS only when the performance condition is already satisfied as at the reporting date. Because the target covers 2023 - 2025, it cannot yet be met at Dec 31, 2024 (*one year still to run*).

$$\text{Basic EPS} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Weighted-average ordinary shares}}$$

$$= ₦5{,}000{,}000/1{,}000{,}000 = ₦5.00$$

No adjustment is made for the potential shares.

(b) Diluted EPS – year-ended 31 Dec 2024

For diluted EPS IAS 33 says contingently issuable shares are treated as if issued at the beginning of the period *whenever* the performance condition would be met based on results to-date.

Average PAT so far = ₦9,000,000 ÷ 2 years = ₦4,500,000 ≥ ₦4,000,000 ⇒ the condition *would* be met if the test date were Dec 31, 2024.

Therefore, the shares are assumed to have been in issue for the full year for diluted EPS.

There is no change in earnings (PAT does not change when shares are issued for no consideration).

Diluted-share denominator

Weighted-average shares (diluted) = 1,000,000 + 10,000M

Diluted EPS

Diluted EPS = ₦5,000,000

(1,000,000 + 10,000M) Shares

Given that there is only one RMD, then M = 1:

Contingent shares	**10,000 × 1 = 10,000 Shares**
Diluted shares	**1,000,000 + 10,000 = 1,010,000**
Diluted EPS	**₦5,000,000 ÷ 1,010,000 = ₦4.95 *(rounded)***

Key points for the exam

Basic EPS – include contingently-issuable shares only when the condition is already met at the reporting date.

Diluted EPS – include them if the condition would be met based on performance up to the reporting date.

No earnings adjustment is required because the shares will be issued for no consideration (i.e., no interest/dividend savings).

28.5 IAS 33: Presentation and Disclosure Requirements

IAS 33 – Presentation & Disclosure of Earnings Per Share
(Put to work in practice)

What Must Appear on the Face of the Statement of Profit or Loss

Line Item	Who Sees It?	How It Should Be Shown
Basic EPS and Diluted EPS for: the profit (or loss) attributable to ordinary shareholders the profit (or loss) from continuing operations	**Single entities & consolidated groups**	**• Display both figures with equal prominence for the current year and the comparative year. • Put them at the foot of the statement of profit or loss (or the separate "income statement" if you present two statements).**
EPS for a discontinued operation (if one exists)	**Same**	**Either: • a third EPS line on the face of the statement, or • tuck it into a clearly-labelled note.**
Negative EPS?	**Everyone**	**Even a loss per share must still be presented – no omissions allowed.**

Tip for groups – use the profit attributable to the *owners of the parent* (after NCI) in all EPS calculations.

The note that supports the EPS lines
IAS 33 expects a concise "audit trail" that lets users recompute each EPS figure without guessing.

Numerators (earnings figures)
Show the amounts used for basic and diluted EPS, and a reconciliation to the profit after tax in the statement of profit or loss.
Adjustments such as interest on convertibles or preference-share dividends must be visible.

Denominators (share counts)
Disclose the weighted-average number of ordinary shares for basic and diluted EPS, plus a cross-check that links the two counts.

Hidden Diluters
List any instruments – including contingently-issuable shares – that were anti-dilutive this year and therefore left out of the diluted EPS calculation.

Significant Share Changes After the Reporting Date
Briefly describe share issues, conversions, buy-backs, option exercises, etc., that would have materially changed the number of shares in issue had they occurred before year-end.

Technical Note – IAS 33 lets you quote additional "per-share" metrics (for example, EPS before exceptional items). Do so only in the notes, and provide a reconciliation back to the statutory EPS line.

3 Alternative EPS Measures – The House Rules

If you want to highlight an *adjusted* or *headline* EPS:

Reconcile the adjusted earnings figure to the statutory profit after tax.

Use exactly the same weighted-average number of shares as IAS 33.

Disclose both an adjusted basic EPS and an adjusted diluted EPS, side-by-side.

Keep the alternative EPS out of the primary statement – it belongs in the notes.

How to Use This Guidance in Practice

Before you sign off the financial statements:

Run the final EPS workbook – check that the face-statement lines and the supporting note agree to the cent.

Tick back every reconciling item (interest on convertibles, preference dividends, fair-value gains reversed, etc.) to general-ledger totals.

Scan the events-after-reporting-date log for share transactions – these often slip through the cracks.

Write plain-English labels: users should understand the EPS lines without flipping pages.

Follow these steps and your IAS 33 presentation will survive both audit scrutiny and shareholder scrutiny.

28.6 Earnings Per Share as a Performance Measure

28.6.1 EPS Trends – Why Users Focus on Them

Investors, analysts and lenders tend to track the direction of EPS rather than the absolute profit figure. Profit for a single period can be distorted by:

one-off gains or losses;

results of operations that have been discontinued;

volatile items such as fair-value movements.

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EPS trends often provide a cleaner signal because:

Continuing-operations only – Basic and diluted EPS are presented after stripping out discontinued operations, so they concentrate on the activities that will drive future cash flows.

Alternative (adjusted) EPS – Management may publish an "underlying" or "headline" EPS that removes large or unusual items; IAS 33 permits this as long as it is reconciled to the statutory figure.

Investor perspective – EPS is already stated per ordinary share, hence:

preference dividends are deducted;

share issues and buy-backs are factored in.

Diluted EPS as an 'early-warning' – Including options, warrants and other potential shares shows what each present share could earn if all dilutive instruments were converted.

28.6.2 Limitations of EPS

Limitation	Why it matters for analysis
Accounting policy diversity	**Two companies can report identical EPS growth with very different revenue-recognition or depreciation methods – comparability is impaired.**
Ignores inflation	**EPS growth in a high-inflation economy may simply reflect rising prices rather than real performance.**
Narrow measure of performance	**EPS is a profit-based metric; it says nothing about cash generation, liquidity or balance-sheet strength.**
Susceptible to manipulation	**Management may engage in "earnings management" (e.g. timing gains or losses) or structure transactions to improve the denominator (share buy-backs).**
Diluted EPS is still historical	**Although it alerts investors to future share dilution, the numerator remains current-period earnings – not a forecast – so it may fail to predict future EPS accurately.**

Exam tip – Always discuss EPS alongside other indicators (operating cash flow per share, ROE, gearing, etc.) and governance disclosures to give a rounded view of performance.

Presentation and disclosure reminders (IAS 33)

Show basic and diluted EPS on the face of the Statement of Profit or Loss with equal prominence for:

profit (or loss) attributable to ordinary shareholders; and

profit (or loss) from continuing operations.

If a separate Statement of Profit or Loss is presented, EPS goes only there, not in OCI.

For discontinued operations, disclose basic and diluted EPS for that component either on the face or in the notes.

In the notes, reconcile:

Numerators – from profit for the period to the figures used for basic and diluted EPS.

Denominators – from the weighted-average shares for basic EPS to those for diluted EPS.

List any anti-dilutive instruments excluded from the calculation.

Describe significant share transactions after the reporting date that would have affected the calculation (issues, redemptions, conversions, exercises, etc.).

Any alternative EPS must:

use the same weighted-average shares as IAS 33;

be reconciled to IAS 33 profit;

appear only in the notes, not on the face of the statement.

28.7 Chapter review

Area	What you must remember
Core definitions	**Basic EPS = *profit attributable to ordinary shareholders ÷ weighted-average ordinary shares in issue*. Diluted EPS adjusts both profit and shares for the effect of dilutive potential ordinary shares.**
Numerator rules	**⇨ Start with profit for the period (continuing operations for the trend figure). ⇨ Deduct preference dividends (non-cumulative as declared, cumulative for the year whether declared or not). ⇨ Add back after-tax interest/dividends on dilutive instruments when testing dilution.**
Denominator rules	**⇨ Time-weight every change in ordinary shares at *full* market price. ⇨ Restate *all* periods for bonus issues & splits. ⇨ Use the treasury-stock method for options/warrants and the if-converted method for convertibles.**
Dilution tests	**Rank potential shares from most to least dilutive by incremental EPS.** **Include each tranche until EPS stops falling.** ***Anti-dilutive* instruments are ignored.**
Presentation	**Show basic & diluted EPS for (a) total profit and (b) profit from continuing operations on the face of the SPL; include EPS for discontinued operations in a note or on the face.**
Disclosure	**Reconcile numerators & denominators; list excluded anti-dilutive instruments; describe major share changes after the reporting date.**

28.8 End of chapter questions and suggested solutions

28.8.1 Questions

Question 1

Scenario data: Dynamics Nigeria Plc (year ended Dec 31, 2020)

Item	Figure	Notes
Issued ordinary share capital	₦3,000,000 (par 50 kobo each)	Nominal value in issue at Dec 31, 2020
Profit after tax (2020)	₦18,000,000	Earnings attributable to ordinary shareholders before dilution adjustments
Average market price of ordinary shares (2020)	₦70 per share	Used for treasury-share test on options

Potential Ordinary-Share Instruments in Issue

Ref	Instrument	Principal/Units	Key terms
(i)	Share options	800,000 options	Exercise (strike) price ₦52.50 per share
(ii)	5% convertible bonds	Nominal ₦6,000,000 outstanding	Convertible in 2025 at 30 ordinary shares for every ₦100 bond nominal
(iii)	8% convertible preference shares	200,000 preference shares (issue price ₦10 each)	Convertible in 2024 at 1 ordinary share for every 25 preference shares held

Company income-tax rate: 30%
Assume all options are exercised when testing for dilution.

Required:
Rank the above potential ordinary-share instruments from most to least dilutive.
Compute the diluted earnings per share (EPS) for the year ended 31 Dec 2020.

Question 2:

Faramola Plc's reporting date is March 31, 2020.

At April 1, 2019 there were 1,000,000 ordinary shares in issue.

Profit after tax for the year ended 31 March 2020 is ₦5 million.

Capital changes during the year:

Date	Transaction	Details
July 1, 2019	**New issue**	**100,000 ordinary shares at ₦4.10 (full market price).**
July 31, 2019	**Treasury purchase**	**Company bought back 20,000 ordinary shares (same dividend rights as other shares).**
September 30, 2019	**Rights issue**	**2-for-5 offer to existing holders at ₦3.90 when the market price was ₦4.35.**
January 1, 2020	**Bonus issue**	**1-for-10 bonus shares to shareholders on the December 31, 2019 register.**

Additional potential ordinary shares:
October 1, 2019 – 50,000 employee share options granted, exercisable any time up to 31 March 2022 at a strike price of ₦3.20.

Required
Compute Basic EPS for the year ended 31 March 2020.

Assuming the share options are the only dilutive instruments, compute the Diluted EPS for the same period.

Question 3
Company M has 12,000,000 ordinary shares in issue. As at December 31, Year 2, there have been no new issues of shares or bonds for several years.

Company M acquired a new business during Year 1. As part of the purchase agreement, Company M would issue a further 1,000,000 shares to the vendor on June 30, Year 3 if the share price was ₦500 at that date. The share price was ₦600 on December 31, Year 2. Earnings for the year to December 31, Year 2 were ₦100,000,000.

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28.8.2 Suggested solutions

Solution 1

Step 1 – Basic EPS

Earnings attributable to ordinary shareholders	**₦ 18,000,000**
Number of ordinary shares (₦3 m ÷ ₦0.50 par)	**6,000,000**
Basic EPS	**₦ 3.00**

Step 2 – Test each potential ordinary-share instrument

Ref	Instrument	Earnings Add-Back (Net of Tax)	Extra Shares	Incremental EPS (Add-Back ÷ Extra Shares)	Status
(i)	800 000 options	₦0 (treasury-share method)	200,000[1]	₦ 0.00	*Most dilutive*
(ii)	5 % convertible bond (₦6 m)	Interest = ₦6 million × 5% = ₦300,000 Tax 30% ⇒ add-back ₦ 210,000	1,800,000[2]	₦ 0.12	Dilutive
(iii)	8 % convertible preference shares (200 000 × ₦10)	Dividend = ₦160,000 (no tax effect)	8,000[3]	₦ 20.00	Anti-dilutive (exclude)

1. Treasury-share method:

- *Proceeds = 800,000 × ₦52.50 = ₦42,000,000*
- *Shares buy-back = ₦42,000,000 ÷ ₦70 = 600,000*
- *Incremental shares = 800,000 – 600,000 = 200,000*

2. Shares on conversion: ₦6,000,000 ÷ ₦100 = 60,000 bonds; 60,000 × 30 = 1,800,000 shares

3. Shares on conversion: 200,000 preference shares ÷ 25 = 8,000 shares

Ranking (from most to least dilutive)

Options (i)

5% convertible bond (ii)

8% convertible preference shares (iii): *anti-dilutive – ignored*

Step 3 – Diluted EPS Calculation

	Earnings (₦)	Shares
Basic	18,000,000	6,000,000
+ Options	+ 0	+ 200,000
Subtotal	18,000,000	6,200,000
+ 5% bond	+ 210,000	+ 1,800,000
Diluted totals	18,210,000	8,000,000

Diluted EPS = ₦18,210,000/8,000,000 shares = ₦2.28 (rounded)

Summary

Measure	EPS (₦)
Basic EPS	₦ 3.00
Diluted EPS	₦ 2.28

Only the options and the 5% convertible bond lower EPS; the 8% convertible preference shares are anti-dilutive and therefore excluded from the diluted-EPS computation.

Alternatively;

Source Data Lifted Exactly from the Working Spreadsheet

	Figure/Description
Issued share capital (par ₦0.50)	₦ 3,000,000
Ordinary shares at 31 Dec 2020	6,000,000 shares
Profit for the year	₦18,000,000
Average market price (2020)	₦70 per share
Income-tax rate	30%

Potential ordinary-share instruments

Ref	Instrument	Key Terms
A	Options / Warrants	800,000 options; exercise (strike) price ₦ 52 .50
B	5% convertible bonds	Nominal ₦6,000,000 in ₦100 notes (60,000 notes) ⇒ 30 shares per ₦100 bond (1,800,000 shares)
C	8% convertible preference shares	200,000 preference shares of ₦10 par; 1 ordinary share for each 25 preference shares (8,000 shares)

Basic EPS

Earnings attributable to ordinary shareholders (i)	₦18,000,000
Weighted-average ordinary shares (ii)	6,000,000
Basic EPS (i/ii)	₦3.00

Dilution testing and ranking

A. Options (treasury-share method)

Step	Calculation	Result
Proceeds on exercise	800,000 × ₦52.50	₦42,000,000
Shares repurchased with proceeds	₦42,000,000 ÷ ₦70	600,000 shares
Incremental shares	800,000 – 600,000	200,000 shares
Incremental earnings	₦ 0 (options add no earnings)	
Incremental EPS	0 ÷ 200,000 = ₦ 0.00 *(most dilutive)*	

B. 5% Convertible bonds

	Working	Amount
Bond interest	₦ 6,000,000 × 5%	₦300,000
After-tax add-back	₦ 300,000 × (1 – 30%)	₦210,000
New shares	60,000 notes × 30	1,800,000
Incremental EPS	₦210,000 ÷ 1,800,000 = ₦ 0.12 *(dilutive)*	

C. 8% Convertible preference shares

	Working	Amount
Pref dividend	200,000 × ₦10 × 8%	₦160,000
Tax effect	*None – dividends not tax-deductible*	
Incremental earnings add-back	₦160,000	
New shares	200,000 ÷ 25	8,000
Incremental EPS	₦160,000 ÷ 8,000 = ₦20.00 *(anti-dilutive – exclude)*	

Dilution ranking (low → high incremental EPS)

Options (₦ 0.00)

5% bonds (₦ 0.117)

8% prefs (₦ 20.00) ← anti-dilutive, omitted

Diluted EPS Computation

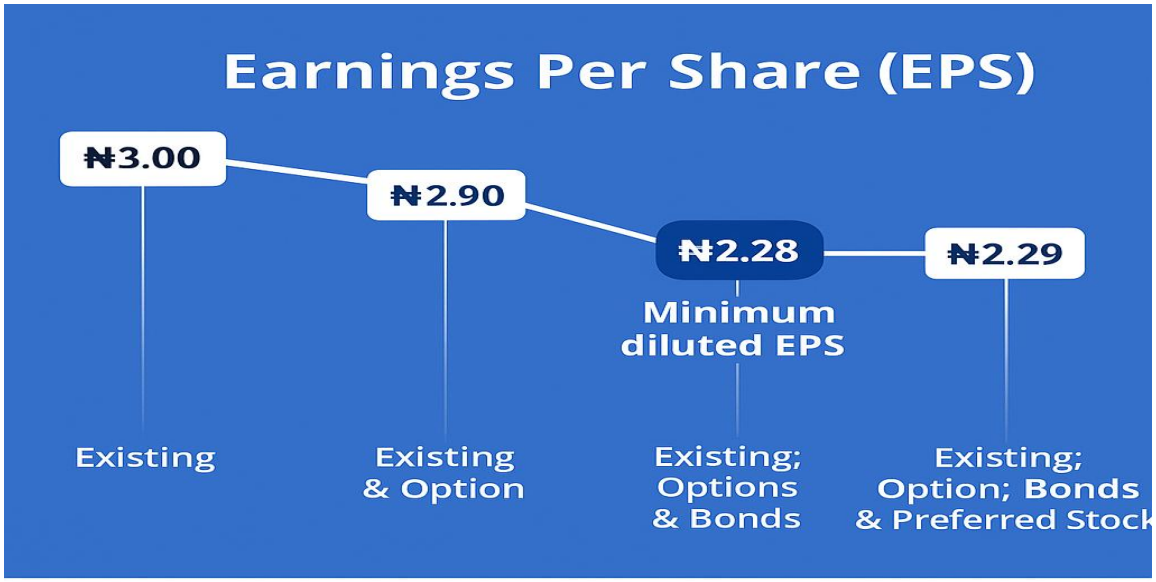
	Earnings (₦)	Shares
Basic totals	18,000,000	6,000,000
+ Options	+ 0	+ 200,000
Sub-total	18,000,000	6,200,000
+ 5 % bonds	+ 210,000	+ 1,800,000
Diluted totals	18,210,000	8,000,000

Diluted EPS = ₦18,210,000 ÷ 8,000,000 = ₦2.28

Final EPS figures

Metric	EPS
Basic EPS	₦ 3.00
Diluted EPS	₦ 2.28

Only the options and the 5 % convertible bond are included in diluted EPS; the 8 % convertible preference shares are anti-dilutive and therefore excluded.



The effect of potential new stock issuance is a **ladder of diminishing (or diluting) EPS** amounts, with the lowest "diluted" EPS assuming maximum dilution from all potential ordinary shares.

visual aid for chapter: effect of successive potential ordinary shares on EPS

How to read the diagram

Stage	Composition of share capital assumed in calculation	EPS (₦)	What this tells you
1	***Existing*** **ordinary shares only**	3.00	Basic EPS starting point.
2	Existing + options (treasury-method)	2.90	Options are in-the-money, so incremental shares lower EPS.
3	Existing + options + convertible bonds (if-converted method)	2.28	Full conversion of bonds produces the minimum diluted EPS—the worst-case dilution.
4	Existing + options + bonds + convertible preference shares	2.29	Preference shares add earnings back (no tax shield) and only a small share increase, nudging EPS up slightly from the minimum.

Key teaching point:

Diluted EPS is the *lowest* value along the "ladder" of increasingly dilutive instruments, but each instrument must still pass the *dilution test* (change-in-EPS vs. basic EPS). Anti-dilutive steps are ignored.

28.8.2 Suggested solutions:

Solution 1

Complex EPS Calculation – Faramola Plc (year-end 31 March 2020)

Timeline	Event	Shares in issue (legal)	Months in period	Time-weight	*Adjusting factors*[1]	Adjusted shares	WA contribution
1 Apr – 30 Jun 19	Opening balance	1,000,000	3	3/12	Rights × Bonus = 1.03046 × 1.10	1,133,502	283,376
1 Jul – 30 Jul 19	New issue @ full price (+100 000)	1,100,000	1	1/12	1.03046 × 1.10	1,246,853	103,904
31 Jul – 29 Sep 19	Treasury re-purchase (– 20,000)	1,080,000	2	2/12	1.03046 × 1.10	1,224,183	204,030
30 Sep – 31 Dec 19	2-for-5 rights[2] (+432,000)	1,512,000	3	3/12	Bonus 1.10	1,663,200	415,800
1 Jan – 31 Mar 20	1-for-10 bonus[3]	1,663,200	3	3/12	–	1,663,200	415,800
	Weighted-Average Shares (WANOS)						1,422,910

1. Rights "bonus fraction" = 4.35 ÷ 4.2214 = 1.03046.
2. Rights issued at ₦3.90 when market ≈ ₦4.35 (TERP ≈ ₦4.2214).
3. IAS 33 treats a bonus as if outstanding from the beginning of the period.

(i) Basic EPS

Profit after tax = ₦5,000,000
Basic EPS = ₦5,000,000/1,422,910 ≈ ₦3.51

(ii) Diluted EPS (50 000 employee share options Oct 1, 19)

Treasury-Stock Method
Average market price (Oct–Mar) = ₦4.35
Exercise price = ₦3.20
Proceeds = 50,000 × ₦3.20 = ₦160,000
Shares that could be re-purchased = 160,000 ÷ 4.35 ≈ 36,782 Shares
Incremental shares = 50,000 – 36,782 ≈ 13,218 Shares
6/12 time-weighting → 13,218 × 0.5 ≈ 6,609 Shares

Diluted denominator = 1,422,910 + 6,609 = 1,429,519 Shares

No earnings adjustment is required for options (X = 0).

Diluted EPS = ₦5,000,000/1,429,519 ≈ ₦3.50

Result

Measure	EPS (₦)
Basic EPS	3.51
Diluted EPS	3.50

Because the incremental EPS (*ΔEPS*) effect (₦0.00) is less than Basic EPS, the options are dilutive and are therefore included in the diluted EPS calculation under IAS 33.

Solution 3:

Contingently Issuable Shares *(extracted details)*

	Figure/Fact
Ordinary shares in issue	12 million
Contingent shares (purchase agreement)	1 million shares to vendor if share price ≥ ₦500 on 30 Jun Y3
Share price at Dec 31, Y2	₦600 (condition already met → include in diluted EPS)
Earnings for Y2	₦100 million

Basic EPS (Y2)
Basic EPS= ₦100,000,000/12,000,000 Shares = ₦8.33 per share

Diluted EPS (Y2)

	Number of shares	Earnings (₦)	EPS (₦)
Basic EPS figures	12,000,000	100,000,000	8.33
Dilution – contingently issuable shares	+ 1,000,000	—	—
Adjusted (diluted) figures	13,000,000	100,000,000	7.69

Diluted EPS = ₦100,000,000/13,000,000 Shares = ₦7.69 per share

Professional Level

Strategic Business Reporting

CHAPTER 29

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

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29 Analysis and Interpretation of Financial Statements

29.0 Learning objective

This chapter discusses analysis and interpretation of financial statements.

29.1 Learning outcomes

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

a. Prepare and interpret common-size statements (vertical, horizontal and trend formats) to reveal structural changes in the statement of profit or loss and statement of financial position.
b. Compute, de-compose and appraise profitability, efficiency, liquidity, gearing and investor ratios, including ROCE, ROSC, working-capital days, interest cover and P/E.
c. Link ratio movements to underlying business drivers, strategy, pricing, cost behaviour, financing mix and macro-economic factors such as inflation, and articulate their implications for shareholders, lenders and other user groups.
d. Rebase historical data for inflation or currency effects to distinguish nominal from real performance.
e. Construct and critique the working-capital (cash) cycle, identifying over-investment or liquidity stress.
f. Identify red-flags in financial statements (creative accounting, off-balance-sheet finance, related-party bias) and discuss how these limit comparability and forward-looking analysis.
g. Apply examination technique: select ratios relevant to a stated user, present calculations clearly, and integrate narrative explanations with numeric evidence.
These outcomes refine and expand the original list for the higher-order skills expected at SBR level

29.2 Introduction to financial analysis

Introduction to Interpretation

Financial statements are used to make decisions. They are used by a number of different groups including shareholders and investors, and also by lenders, as well as by management.

The financial statements contain a large number of figures, but the figures themselves do not necessarily have much meaning to a user of the financial statements. However, there are techniques of analysis that can be used to interpret the information.

Two key techniques are:

(a) common size analysis; and
(b) ratio analysis.

Techniques can be used in different ways to provide:

(i) vertical analysis;
(ii) horizontal analysis; and
(iii) trend analyses (a form of horizontal analysis).

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Analysis by Comparisons

Making sensible comparisons sit at the heart of financial analysis. There are different types of comparisons that might be made including:

(a) Comparisons within financial statements. (For example if revenue has increased by 10% it might be expected that gross profit increased by a similar amount). (Vertical analysis).

(b) Comparisons over a number of years. By looking at the ratios of a company over a number of years, it might be possible to detect improvements or deterioration in the financial performance or financial position of the entity. Ratios can therefore be used to make comparisons over time, and to identify changes or trends. (Horizontal analysis).

(c) Comparisons with the similar ratios of other, similar companies or to industry averages for the same period or over the same periods. (Vertical and horizontal analysis).

Users and their Information needs

There are several groups of people who may use financial statements. They include:

a. investors and potential investors;
b. lenders;
c. employees;
d. suppliers;
e. customers;
f. government and government agencies; and
g. the general public.

Each user group has different information needs, but as a general rule financial statements prepared in accordance with IFRSs should provide all user groups with most of their needs. Each group is interested in financial performance, financial position and cash flows, but some users are mainly interested in performance and profitability, while others may be more interested in liquidity and gearing or other matters.

For example:

A private investor needs to know whether to continue to hold shares or to sell them. He or she will tend to be most interested in profitability ratios (such as gross and net profit margin and return on capital employed) and investor ratios (such as earnings per share, dividend cover and price earnings ratio).

A potential acquirer needs information about an entity's profitability and probably also information about whether or not the entity is managed efficiently. The acquirer's management is likely to focus on profit margins, return on capital employed, asset turnover and working capital ratios.

A bank that has been approached to lend money to an entity needs to know whether it will receive interest payments when these are due and whether the money that it lends will eventually be repaid. A bank manager will normally be most interested in cash flows and liquidity ratios (current ratio, acid test ratio) gearing and interest cover. A potential lender will also be interested in predicting future performance as without sales there will be no cash.

Any analysis should focus on the needs of the user. What do they need to know? What are they interested in? What decision do they need to make?

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The table below lists the user groups, indicates the information that they require from published reports and accounts, and suggests which items in the financial statements will be of most interest to each group.

USER	INFORMATION NEEDS	ITEMS OF INTEREST
Investors/potential investors	Risks and returns relating to their investment Security of dividend payments Information to make decisions about buying, selling or holding shares Future growth prospects.	Trend analysis: changes in revenue, costs and profits over the past few years Dividend cover Events and announcements after the reporting period Share price Corporate governance reports. Narrative business review.
Employees	Stability of the company (job security and job prospects) Information about the company's ability to pay bonuses or higher salaries.	Profitability and cash position Increases in salaries (%) relative to increases in profit and dividends Directors' remuneration
Lenders (banks, etc.)	Whether the entity has sufficient cash flow to repay loans The entity's ability to pay interest The adequacy of collateral/ security for loans and bonds	Cash flow Total borrowing by the entity: financial gearing Interest cover New charges created over the entity's assets
Suppliers	The entity's ability to settle its liabilities The entity's ability to survive and continue as a customer	Net current assets Growth record
Customers	The entity's ability to survive and continue as a supplier	Growth record Cash flow
Government	The entity's contribution to the economy Regulation of activities Taxation Obtaining government statistics	Revenue and profit Market share

USER	INFORMATION NEEDS	ITEMS OF INTEREST
General public	Environmental and social awareness Contributions to the local economy	Environmental and social reports Directors' report Narrative business review

Management is not included as a user group because they should have access to much more detailed information about the company's financial position and performance, from internal reports and budgets.

29.3 Common size analysis

Introduction to common size analysis

Common size analysis involves expressing each line in a financial statement as a percentage of the base amount for that period.

The common base amount in the statement of financial position is total assets. A statement of financial position can be constructed showing all lines as a percentage of that number.

The common base amount in the statement of profit or loss is revenue. A statement of profit or loss can be constructed showing all lines as a percentage of that number.

The analysis helps to understand the impact of each item on the financial statements and its contribution to the resulting figure.

Common size analysis can be conducted in two ways:

(a) vertical analysis – analysis of specific line items in relation to a base item within the same financial period; and

(b) horizontal analysis – analysis of specific line items with comparison to the same line item in the previous or subsequent financial period.

Illustrative Example 1: Vertical analysis of statement of profit or loss

	Year 1 ₦' 000	*As% of Revenue*	Year 2 ₦' 000	*As% of Revenue*
Revenue	1,500	*100.0%*	1,600	*100.0%*
Cost of sales	(500)	*(33.3%)*	(700)	*(43.8%)*
Gross profit	1,000	*66.7%*	900	*56.3%*
Distribution costs	(400)	*(26.7%)*	(450)	*(28.1%)*
Administrative expenses	(300)	*(20.0%)*	(310)	*(19.4%)*
Net profit	300	*20.0%*	140	*8.8%*

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Revenue has increased in year 2 by ₦100,000. However, in year 1 the cost of sales was only 33.3% of revenue giving a gross margin of 66.7% and in year 2 the cost of sales grew to 43.8% of the sales figure leading the gross margin to fall to 56.3%.

Distribution costs as a percentage of sales are slightly higher in Year 2 and administrative expenses slightly lower but the reduction in gross margin has fed through to a big reduction in net margin (20% to 8.8%).

Illustrative Example 2: Horizontal analysis of statement of profit or loss

	Year 1	Year 2	*Percentage Change from*
	₦' 000	**₦' 000**	***Year 1 to year 2***
Revenue	**1,500**	**1,600**	***6.7%***
Cost of sales	**(500)**	**(700)**	***40.0%***
Gross profit	**1,000**	**900**	***(10.0%)***
Distribution costs	**(400)**	**(450)**	***12.5%***
Administrative expenses	**(300)**	**(310)**	***3.3%***
Net profit	**300**	**140**	***(53.3%)***

Revenue has increased in year 2 by 6.7%. However, the cost of sales has increased by 40.0%. Furthermore, both distribution costs and administrative expenses have increased disproportionately to sales. The overall effect is a 53.3% fall in net margin.

The vertical and horizontal analysis taken together can provide powerful insights in changes in performance.

Illustrative Example 3: Vertical analysis of statement of financial position

	Year 1	*As% of* Total	Year 2	*As% of* Total
	₦' 000	**Asset**	**₦' 000**	**Asset**
Non-current assets	**4,000**	***50.0%***	**5,000**	***60.2%***
Current assets				
Inventories	**1,000**	***12.5%***	**1,500**	***18.1%***
Receivables	**2,000**	***25.0%***	**1,000**	***12.0%***
Cash	**1,000**	***12.5%***	**800**	***9.6%***
	4,000	***50.0%***	**3,300**	***39.8%***
Total Assets	**8,000**	***100.0%***	**8,300**	***100.0%***
Share capital and reserves	**3,500**	***43.8%***	**2,800**	***33.7%***
Non-current liabilities	**2,000**	***25.0%***	**2,500**	***30.1%***
Current liabilities	**2,500**	***31.3%***	**3,000**	***36.1%***
Total Equity and Liabilities	**8,000**	***100.0%***	**8,300**	***100.0%***

Non-current assets have increased as a percentage of total assets from 50.0% to 60.2%. As a percentage of the total assets this is an increase of 10.2%.

The increase of 1,000 has been funded in part by new long term debt which has increased from 25% of net assets to 30.1%. As a percentage of the total assets this is an increase of 5.1%.

The rest of the investment in non-current assets has been funded by an increase in current liabilities which have increased from 31.3% of total assets to 36.1%.

There working capital situation is deteriorating with inventory increasing and receivables and cash both decreasing as a percentage of total assets.

The figures also indicate a loss for the year as share capital and reserves have fallen by 700.

Illustrative Example 4: Horizontal analysis of statement of financial position

	Year 1	Year 2	*Percentage Change from Year 1 to Year 2*
	₦' 000	₦' 000	
Non-current assets	4,000	5,000	*25.0%*
Current assets			
Inventories	1,000	1,500	*50.0%*
Receivables	2,000	1,000	*(50.0%)*
Cash	1,000	800	*(20.0%)*
	4,000	3,300	*(17.5%)*
Total Asset	8,000	8,300	*3.8%*
Share capital and reserves	3,500	2,800	*(20.0%)*
Non-current liabilities	2,000	2,500	*25.0%*
Current liabilities	2,500	3,000	*20.0%*
Total Equity and Liabilities	8,000	8,300	*3.8%*

Non-current assets have increased by 25% in the year. Both non-current liabilities and current liabilities have increased.

The working capital situation seems to have deteriorated (Note that we would need to see the statement of profit or loss figures to be certain). The figures indicate a possible worrying increase in inventory levels compared to previous years. However, receivables seem to have been collected more quickly. The cash position has worsened.

The figures indicate poor financial performance as share capital and reserves have fallen by 20%.

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Making reported earnings comparable

Sometimes, in order to make information more comparable it might be necessary to adjust figures onto a common basis.

Illustrative Example 5: Adjustment to Take Account of Inflation

The following figures show the revenue of a company at two year-ends

Revenue analysis at two year-ends

Year-End	Reported Revenue (₦'000)	Growth Rate
20X4	**1,000**	
20X5	**1,200**	**20%**

Observation:

At first glance, the revenue shows a 20% increase from ₦1,000,000 to ₦1,200,000 between 20X4 and 20X5.

Adjustment for Inflation:

Inflation in 20X5 was 15%.

Therefore, to compare the revenues meaningfully, 20X4 revenue should be restated in 20X5 price terms.

Rebased Revenue Calculation:

Adjusted 20X4 revenue = ₦1,000 × 1.15 = ₦1,150,000

Year-End	Rebased Revenue (₦'000)	Growth Rate
20X4	**1,150**	
20X5	**1,200**	**4.3%**

Conclusion:

The real (inflation-adjusted) growth rate is only 4.3%, not 20%.

Insight: Nominal revenue growth can be misleading in periods of high inflation; always adjust for inflation to assess real performance.

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29.4 Introduction to Ratio Analysis

Ratio Analysis as a Tool

It is difficult to assess a company's financial performance by analysing the financial results for one year. Better information is obtained by making comparisons with financial performance in the previous year, or perhaps over several periods (trend analysis).

Ratio analysis is a key tool used for performance analysis, because ratios summarise financial information, often by relating two or more items to each other, and they present financial information in a more understandable form. Ratios also identify significant relationships between different figures in the financial statements

Illustrative Example 6: Good or Bad?

For example, knowing that the profit of a company is ₦50,000 is not particularly useful information on its own, because the expected amount of profit should be dependent on the size of the business and the amount of its sales turnover.

If the company generated a profit of ₦50,000 from ₦150,000 of sales, then it has performed well.

However, if a profit of ₦50,000 has been made from sales of ₦5 million, then the profit level is much weaker.

The profit margin (the ratio of profit to sales) is a basic and widely-used ratio for analysing the strength of a company's financial performance.

A ratio on its own does not provide useful information. Ratios are useful because they provide a basis for making comparisons. Comparisons might indicate that performance or the financial position is better or worse than it should be, or is getting better or worse than in the past.

Illustrative Example 7: Comparisons

For example, suppose that a company measures its profit margin in the current year as 20%. Is this good or bad? To evaluate performance, the current year profit margin of 20% should be interpreted, by comparing it with:

last year's profit margin, or the company's profit margin for the past few years

the budgeted profit margin (available to investors, perhaps, through company announcements)

the industry average (the average profit margin for companies in the industry)

the profit margin reported by individual competitors.

For example, if the budgeted profit margin was 25%, an actual profit margin of 20% might suggest that management have under-performed in the period

Note that a ratio does not explain why any under-performance or out- performance has occurred. Ratios are used to indicate areas of good or weak performance, but management then have to investigate to identify the cause.

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Illustrative Example 8: Possible Explanations

A company achieved a profit margin of 6% in the year just ended. This was less than the budgeted profit margin of 10%, and less than the profit margin in the previous year, which was 8%.

The actual profit margin of 6% indicates disappointing performance, but management should investigate the cause or causes.

For example, they might find that any of the following reasons might explain the low profit margin:

Increased competition has forced down sales prices and so reduced profit margins.

Advances in technology have lowered costs but prices have come down even more.

Raw material costs have risen and the higher costs could not be passed on to the customers.

There have been higher employment costs due to pay rises for manufacturing employees, but these could not be passed on to the customers.

The company buys most of its supplies from foreign countries, and adverse movements in exchange rates for its purchases have increased costs and reduced profit margins.

There has been a change in the company's sales mix, and the company has sold a larger proportion of cheaper and lower-margin products than expected.

Categories of Financial Ratios

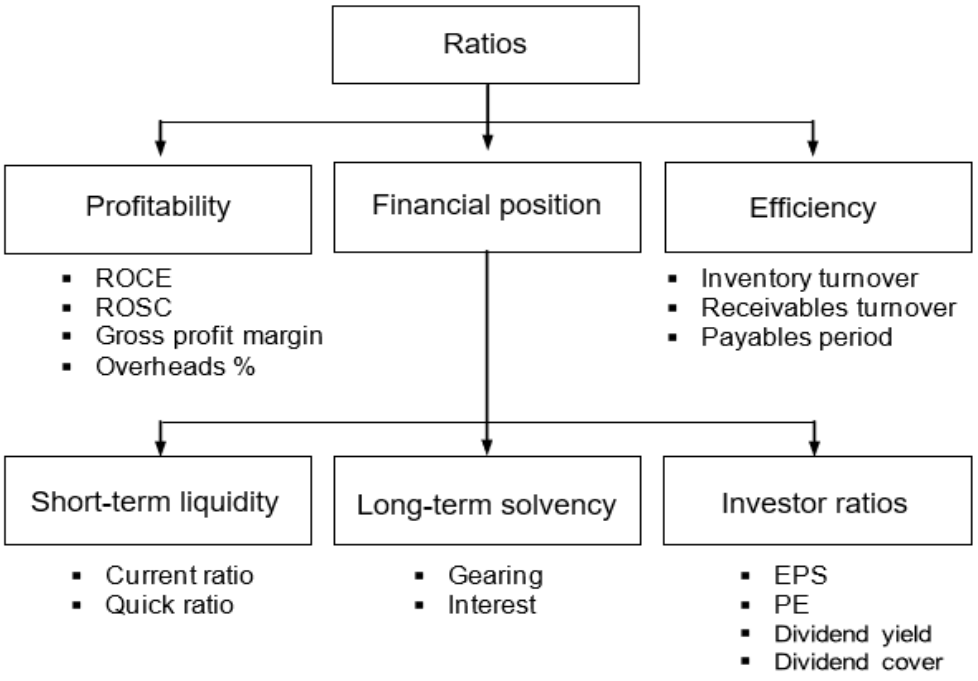
Financial ratios can help the user of the financial statements to assess:

(a) the financial position of the entity; and

(b) its financial performance.

The basic financial ratios should already be familiar to you. Ratios can be divided into five categories

Illustration:



The main ratios will be considered in more detail. For the purpose of your examination, you need to know how to calculate each ratio, but you must also understand why each ratio, or each category of ratios, might be of particular interest to a specific user group.

An examination question may ask you to provide an analysis of financial statements for a particular user. It will not tell you which ratios to calculate. Instead, you will have to decide for yourself which ratios may provide useful information for that user. Therefore, you should learn to identify and select the appropriate ratios for each user group, and then analyse what the ratio appears to show, from the point of view of that user.

29.5 Return on Capital, Profitability and Asset Turnover

Return on Capital Employed

The aim of 'profitability ratios' is to assess the financial performance of a profit- making entity and the return that it makes on the capital invested.

Profit-making companies should try to make a profit that is large enough in relation to the amount of money or capital invested in the business. The most important profitability ratio is probably return on capital employed or ROCE.

For a single company:

Formula:

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{(Share capital and reserves + long-term debt capital + preference share capital)}} \times 100\%$$

Capital employed is the share capital and reserves, plus long-term debt capital such as bank loans, bonds and loan stock.

Where possible, use the average capital employed during the year. This is usually the average of the capital employed at the beginning of the year and end of the year.

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Illustrative Example 9: 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 income taxes	210,000
Income tax expense	(65,000)
Profit	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%

Profit Before Interest and Tax	₦
Profit before income taxes	210,000
Add back: interest deducted	30,000
Profit before interests and taxes	240,000

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

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This ROCE figure can be compared with the ROCE achieved by the company in previous years, and with the ROCE achieved by other companies, particularly competitors.

Groups of Companies and ROCE

To calculate the ROCE for a group of companies, it is necessary to decide what to do with any non-controlling interest (minority interest). Since capital employed includes all the debt capital in the group, it makes sense to include the non- controlling interest (minority interest) in the capital employed.

ROCE should therefore be measured as profit before interest and tax as a proportion of total capital employed, including the non-controlling interest.

Return on Shareholder Capital

Return on shareholder capital (ROSC) measures the return on investment that the shareholders of the company have made. This ratio normally uses the values of the shareholders' investment as shown in the statement of financial position (rather than market values of the shares).

Formula: Return on shareholder capital

$$\text{ROSC} = \frac{\text{Profit after taxation and preference dividend}}{\text{Share capital and reserves}} \times 100$$

The average value of shareholder capital should be used if possible. This is the average of the shareholder capital at the beginning and the end of the year.

Profit after tax is used as the most suitable measure of return for the shareholders, since this is a measure of earnings (available for payment as dividends or for reinvestment in the business).

Illustrative Example 10: 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 income taxes	210,000
Income tax expense	(65,000)
Profit	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%

Shareholders' Capital	₦
Shareholders' Capital at the beginning of the year	800,000
Shareholders' Capital at the end of the year	900,000
	1,700,000
	÷2
Average Shareholders' Capital	850,000

Groups of Companies and ROSC

When calculating the ROSC for a group of companies, the main focus of attention is normally the return on the investment of the shareholders in the parent company. The ROSC should therefore be calculated as:

Formula: Return on shareholder capital of a group

$$\text{ROSC} = \frac{\text{Profit after taxation and non-controlling interest}}{\text{Equity attributable to equity holders of the parent company}} \times 100$$

The share capital and reserves should not include the non-controlling interest in the equity reserves.

Using ROCE or ROSC

It is not necessary to calculate both these ratios. The ratio that you calculate should be the ratio that is of the greatest interest to the particular user or user group. For example, management may be most interested in ROCE, but an equity investor would be interested in ROSC.

ROCE or ROSC could be compared to real interest rates that are currently available to investors in the market. For example, if a company has a ROCE of 3% when interest rates of 5% are available in the bond markets, a shareholder might be advised to consider selling his shares. However, it is important to remember that bond yields are returns calculated from the market price of bonds; whereas ROCE and ROSC are calculated from financial statements and are not market rates of return.

Bank overdrafts might be included as part of capital employed in the ROCE ratio, because many companies 'roll over' their overdraft facility and use it as long-term funding. When a bank overdraft is large, the interest cost of the overdraft might be high, and it would therefore be appropriate to include the bank overdraft 'below the line' in capital employed, because the overdraft interest is included 'above the line' in profit before interest and taxes.

A company may be able to 'manipulate' its ROCE or ROSC ratios by using accounting policies or financing strategies, such as:

using operating leases or finance leases;

choosing to re-value non-current assets or choosing the historical cost model;

timing the acquisition of non-current assets or the timing of new financing so as to have the minimal adverse impact on ROCE.

Return on Assets

$$\textbf{ROA} = \frac{\textbf{Profit before interest and taxes}}{\textbf{Total Assets}} \times 100\%$$

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.

Analysing Return: Profitability and Asset Utilisation

The size of the return on capital employed, or the size of the return on shareholders' capital, depends on two factors:

the profitability of the goods or services that the entity has sold;

the volume of sales that the entity has achieved with the capital and assets it has employed: this is known as asset utilisation or asset turnover.

Profit/Revenue Ratio (and Cost/Revenue Ratios)

The profit/sales ratio is the ratio of the profit that has been achieved for every ₦1 of Revenue (or Sales).

Formula: Profit/sales ratio

$$\text{Profit/sales ratio} = \frac{\text{Profit}}{\text{Sales}} \times 100$$

Profit/sales ratios are commonly used by management to assess financial performance, and a variety of different figures for profit might be used.

The definition of profit can be any of the following:

Profit before interest and tax

Gross profit (Revenue minus the cost of sales) = 'Gross profit ratio'

Net profit (profit [after tax]) = 'Net profit ratio'.

It is important to be consistent in the definition of profit, when comparing performance from one year to the next.

The gross profit ratio is often useful for comparisons between companies in the same industry, or for comparison with an industry average.

It is also useful to compare the net profit ratio with the gross profit ratio. A high gross profit ratio and a low net profit ratio indicate high overhead costs for administrative expenses and selling and distribution costs.

Illustrative Example 11: 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:

If profit is defined as profit before interest and tax:

= 240,000 (W1)/5,800,000 x 100 = 4.14%

If profit is defined as profit after interest and tax:

= 145,000 (W1)/5,800,000 x 100 = 2.5%

Profit Before Interest and Tax	₦
Profit before tax	210,000
Add back interest deducted	30,000
Profit before interests and taxes	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:

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Cost of sales/Sales) × 100%

Administration costs/Sales) × 100%

Selling and distribution costs/Sales) × 100%

Asset Turnover Ratio

The asset turnover ratio is the ratio of sales to capital employed.

It measures the amount of sales achieved during the period for each ₦1 of investment in assets.

Formula: Asset turnoverratio

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Share capital + reserves + long term debt}} \times 100$$

It is measured as a multiple (so many times a year).

The asset turnover ratio is also the ratio of sales to (assets – current liabilities). This is because capital employed = total assets minus liabilities excluding long- term debt.

Example: Asset turnover ratio

The following figures relate to Company X for Year 1.

Average capital employed (as given before) ₦1,200,000

Profit before interest and tax = 240,000 (as given before)

Sales during the year were₦5,800,000.

ROCE = 240,000 /1,200,000 × 100 = 20% (as given before)

Asset turnover

Asset turnover ratio = ₦5,800,000/₦1,200,000 = 4.83 times.

Note that: ROCE = Profit/sales ratio × Asset turnover ratio (where profit is defined as profit before interest and taxation).

Using the figures shown earlier:

ROCE	=	Profit/sales	×	Sales/capital employed
$\frac{240,000}{1,200,000}$	=	$\frac{240,000}{5,800,000}$	×	$\frac{5,800,000}{1,200,000}$
20%	=	4.14%	×	4.83 times

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%.

29.6 Working Capital Efficiency Ratios

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).

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.

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.

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.

Illustrative Example 13: 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] × 365 days = 66.9 days

Average time to pay = [165,000/1,800,000] × 365 days = 33.5 days.

Workings:

Average inventory = [₦300,000 + ₦360,000]/2 = ₦330,000

Average trade receivables = [₦400,000 + ₦470,000]/2 = ₦435,000

Average trade payables = [₦150,000 + ₦180,000]/2 = ₦165,000.

Turnover Ratios (Multiples)

Turnover ratios can be used as an alternative way of telling the same story as the efficiency ratios. These show the number of times a balance in the statement of financial position is *turned over* in the period.

They are multiples which provide the same insight as the efficiency ratios but in a different way.

Formulae: Working capital turnover ratios

$$\text{Receivables turnover} = \frac{\text{Credit sales}}{\text{Trade receivables}}$$

$$\text{Inventory turnover} = \frac{\text{Cost of sales Inventory}}{\text{Inventory}}$$

$$\text{Payables turnover} = \frac{\text{Purchases}}{\text{Trade payables}}$$

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Cash Operating Cycle/Working Capital Cycle

The cash operating cycle or working capital cycle is the average time of one cycle of business operations:

from the time that suppliers are paid for the resources they supply;

to the time that cash is received from customers for the goods (or services) that the entity makes (or provides) with those resources and then sells.

A cash cycle or operating cycle is measured as follows.

Illustration: Cash operating cycle

	Days/weeks/ months
Average inventory holding period	X
Average trade receivables collection period	X
	X
Average period of credit taken from suppliers	(X)
Operating cycle	X

The working capital ratios and the length of the cash cycle should be monitored over time. The cycle should not be allowed to become unreasonable in length, with a risk of over-investment or under-investment in working capital.

Ilustrative Example 14: Constructing a Cash Operating Cycle

Statement of Profit or Loss	**₦**
Sales (i)	**1,200,000**
Cost of sales:	
Opening inventory	**250,000**
Purchases	**1,000,000**
Cost of goods available for sale	**1,250,000**
Closing inventory	**(250,000)**
Cost of sales (ii)	**1,000,000**
Gross profit (i – ii)	**200,000**
Statement of Financial Position Trade receivables	**400,000**
Trade payables	**166,667**

The following figures have been extracted from a company's accounts:

Average Inventory Holding Period

$$\text{Average Inventory Holding Period} = \left(\frac{\text{Average Inventory}}{\text{Annual Cost of Sales}}\right) \times 365 \text{ days}$$

$$= \left(\frac{250,000}{1,000,000}\right) \times 365 = 91 \text{ days}$$

Average Receivables Collection Period

$$\text{Average Receivables Collection Period} = \left(\frac{\text{Average Trade Receivables}}{\text{Annual Sales}}\right) \times 365 \text{ days}$$

$$= \left(\frac{400,000}{1,200,000}\right) \times 365 = 122 \text{ days}$$

Average Payables Period

$$\text{Average Payables Period} = \left(\frac{\text{Average Trade Payables}}{\text{Annual Purchases}}\right) \times 365 \text{ days}$$

$$= \left(\frac{166,667}{1,000,000}\right) \times 365 = 61 \text{ days}$$

	Days
Cash Operating Cycle:	
Average inventory holding period	**91**
Average trade receivables collection period	**122**
Average period of credit taken from suppliers	**(61)**
	152

29.7 Liquidity Ratios

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:

current ratio

quick ratio, also called the acid test ratio.

The more suitable ratio for use depends on whether inventory is considered a liquid asset that will soon be used or sold, and converted into cash from sales.

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), but may be arbitrary to some industry. Hence, industry benchmark and comparisons is a suitable basis to set a threshold.

However, this is not necessarily true, and, in some industries, much lower current ratios are normal. It is important to assess the liquidity ratios by considering:

changes in the ratio over time

the liquidity ratios of other companies in the same period

the industry average ratios.

Liquidity should be monitored by looking at changes in the ratio over time.

Quick Ratio or Acid Test Ratio

The quick ratio or acid test ratio is the ratio of current assets excluding inventory to current liabilities. Inventory is excluded from current assets on the assumption that it is not a very liquid item.

Formula: Quick ratio

$$\text{Quick ratio} = \frac{\text{Current assets excluding inventory}}{\text{Current liabilities}}$$

The amounts of current assets and current liabilities in the statement of financial position at the end of the year may be used. It is not necessary to use average values for the year.

This ratio is a better measurement of liquidity than the current ratio when inventory turnover times are very slow, and inventory is not a liquid asset.

It is sometimes suggested that there is an 'ideal' quick ratio of 1.0 times (1:1).

However, this is not necessarily true and, in some industries, much lower quick ratios are normal. As indicated earlier, it is important to assess liquidity by looking at changes in the ratio over time and comparisons with other companies and the industry norm.

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.

29.8: Debt Ratios

Debt ratios are used to assess whether the total debts of the entity are within control and are not excessive.

Gearing Ratio (Leverage)

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.

A high level of gearing may indicate the following:

The entity has a high level of debt, which means that it might be difficult for the entity to borrow more when it needs to raise new capital.

High gearing can indicate a risk that the entity will be unable to meet its payment obligations to lenders, when these obligations are due for payment.

The gearing ratio can be used to monitor changes in the amount of debt of a company over time. It can also be used to make comparisons with the gearing levels of other, similar companies, to judge whether the company has too much debt, or perhaps too little, in its capital structure.

Gearing and Consolidated Accounts

The gearing ratio for a group of companies is difficult to interpret, because the debt will be spread over several entities in the group.

When measuring gearing, the total capital or equity capital (the denominator in the ratio) should include non-controlling interests (minority interests).

Interest Cover Ratio

Interest cover measures the ability of the company to meet its obligations to pay interest.

Formula: Interest cover

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges in the year}}$$

Profit before interest and taxation is calculated by adding the interest charges for the year to the figure for profit before taxation.

An interest cover ratio of less than 3.0 times is considered very low, suggesting that the company could be at risk from too much debt in relation to the amount of profits it is earning.

Illustrative Example 15: Gearing Ratios

The following information is available for Company Z for Year 6

At 31 December Year 6	
	₦' 000
Total Assets	**5,800**
Share capital	**1,200**
Reserves	**2,400**
Total Equity	**3,600**
Long-term liabilities (Bank loans)	**1,500**
	5,100
Current liabilities	**700**
Total Equity and Liabilities	**5,800**
For the year to 31 December Year 6	**₦' 000**
Profit before interests and taxes	**700**
Interests	**(230)**
	470
Income taxes	**(140)**
Profit	**330**

The following ratios can be calculated to shed light on the company's gearing in Year 6 (compared to previous years or to other companies).

Gearing Ratio: 1,500/5,100 x 100 = 29.4%

Debt to equity ratio: 1,500/3,600 x 100 = 41.7%

Interest cover: 700/230 = 3.04 times

29.9 Investor Ratios

Investor ratios are of interest to investors in shares and bonds and their advisers. Some of these measure stock market performances. Earnings per share (EPS) and the price earnings ratio (P/E ratio) were described in an earlier chapter.

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Earnings Per Share (EPS)

EPS is normally viewed as a key measure of an entity's financial performance. It measures the profit earned for each equity share of the entity

Basic EPS is calculated as follows:

Formula: Basic EPS

$$\frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

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

$$\text{P/E ratio} = \frac{\text{Market value of share}}{\text{Earnings per share}}$$

Dividend Yield

The dividend yield measures the dividend paid by an entity in relation to its price. It is calculated as follows:

Formula: Dividend yield

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Current market price per share}} \times 100$$

This is a measure of the return that a shareholder can obtain (the dividend received) in relation to the current value of the investment in the shares (the price of the shares). A high dividend yield might seem attractive to investors, but in practice companies with a high dividend yield might have a relatively low share price.

There are two things to note:

Dividend yield reflects the dividend policy of the entity, not its actual performance. Management decides on the amount of the dividend and this may not only depend on earnings, but on the amount that must be retained for future investment in EPS growth.

The ratio is based on the most recent dividend, but the current share price may move up and down in response to the market's expectations about future dividends. This may lead to distortion in the ratio.

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.

Illustrative Example 16: Dividend Yield and Dividend Cover

The following amounts relate to Entity Q.

The current market price of its equity shares is ₦5.50 per share.

Profit for the most recent period was ₦1.4 million and equity dividends paid were ₦450,000.

There are 1.2 million ₦1 equity shares in issue.

$$\text{Earnings per share} = \frac{1{,}400{,}000}{1{,}200{,}000} = ₦1.17.$$

$$\text{P/E ratio} = \frac{5.50}{1.17} = 4.7$$

$$\text{Dividend per share} = \frac{450{,}000}{1{,}200{,}000} = 0.38c$$

$$\text{Dividend yield} = \frac{0.38}{5.50} \times 100\% = 6.9\%$$

$$\text{Dividend cover} = \frac{1{,}400{,}000}{450{,}000} = 3.1 \text{ times or } \frac{1.17}{0.38} = 3.1 \text{ times}$$

29.10: Limitations of Interpretation Techniques

Introduction

There are several limitations or weaknesses in the use of interpretation techniques for analysing the financial position and financial performance of companies. Some of these are limitations of ratio analysis (the method of interpretation most often used) and some are limitations of financial statements and financial information.

Most of the data for calculating financial ratios comes from the financial statements:

The reliability of ratios is therefore affected by the reliability of the financial statements themselves.

In addition, when ratios are used to compare different companies, the comparability is affected if companies use different accounting policies to prepare their financial statements.

In addition, when comparing a ratio against that of a competitor or the industry average, it is important to remember that, even within an industry, companies can have different characteristics. It is very important to remember this when you are analysing the financial statements of a company, and possibly comparing its performance and financial position with other companies.

Differences in Accounting Policy

One of the uses of financial ratios is to compare the financial position and performance of one company with those of similar companies for the same period.

Comparisons between companies might not be reliable, however, when companies use different accounting policies, or have different judgements in applying accounting policies or making accounting estimates. For example:

Entities might have different policies about the revaluation of non-current assets.

Entities might use different methods of depreciation.

Entities might use different judgements in estimating the expected profitability on incomplete construction contracts.

Entities might use different judgements in assessing whether a liability should be treated as a provision or a contingent liability.

IAS 8 states that an entity should not change its accounting policies unless the change is required by an accounting standard or it will result in more relevant and reliable information. Therefore, changes should not happen often.

Where there has been a change in an accounting policy, IAS 8 also requires comparative figures to be restated and information to be disclosed. However, changes in accounting policies and accounting estimates can still make it difficult to compare the financial statements of an entity over time, particularly if analysis is based on extracts rather than the full published financial statements.

Current Cost Accounting (CCA) and Current Purchasing Power Accounting (CPPA)

Historical cost accounts can also be misleading because they do not accurately show the effects of inflation over time. They do not take into consideration changes in the real value of money.

The biggest problem is the valuation of non-current assets. Companies have different policies towards the revaluation of non-current assets. Some companies revalue some categories of non-current assets regularly, and in particular land and buildings. However, not all categories of non-current assets are revalued.

When the rate of inflation is quite high, many non-current assets are probably under-valued in the financial statements, in comparison with their current net replacement value.

In addition, when the rate of inflation is high, the reported profit with historical cost accounting will be higher than it would be using an 'inflation accounting' system such as current cost accounting (CCA) or current purchasing power (CPP) accounting.

With CCA and CPP accounting, particularly during a period of high inflation:

The reported profit will be less (or the loss will be higher) than with historical cost accounting (HCA).

The asset turnover or asset utilisation will be lower, because asset valuations are higher with CCA and CPP than with historical cost accounting (even when some non-current assets are re-valued in HCA).

The return on capital employed will be lower, because the reported profit will be lower and the value of capital employed will be higher.

Other Limitations in the Use of Financial Ratios

There are other problems with the use of financial ratios, particularly where these are used to compare the performance and position of different entities or of an entity with an industry average.

It is possible to calculate the same ratio in different ways. For example, there are several variations of return on capital employed (ROCE) and gearing. Comparisons can be misleading if different calculations are used.

Even where two entities operate in the same industry, comparisons can be misleading. Entities can operate in different markets (for example, high volume/low margin sales and low volume/high margin sales). The size of an entity can affect the way it operates and therefore its ratios. For example, large entities can often negotiate more favourable terms with suppliers than small ones.

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Financial statements are published infrequently. If ratios are used to study trends and developments over time, they are only useful for trends or changes over one year or longer, and not changes in the short term.

Ratios can only indicate possible strengths or weaknesses in financial position and financial performance. They might raise questions about performance, but do not provide answers. They are not easy to interpret, and changes in financial ratios over time might not be easy to explain.

It can be argued that financial position and financial performance should be analysed using market values rather than accounting values. For example, it can be argued that investment yield is more relevant for the assessment of financial performance than return on capital employed.

Using Historical Information

Financial statements are often used to predict the future performance of an entity. Where comparative figures are available for several years it may be possible to extrapolate trends and to base forecasts on these. If comparative figures are only available for one or two years, predictions may be unreliable.

There may be some limited information about future transactions in the notes to the financial statements. For example, details of contingent liabilities and non- adjusting events after the reporting period must be disclosed. However, published financial statements present historical information.

Generally, financial statements do not reflect future transactions or events. They do not anticipate the effect of significant changes to the entity after the financial statements have been authorised for issue. These may include events beyond the control of management (for example, the liquidation of a major customer) or events that could not possibly have been foreseen at the time the most recent financial statements were issued.

It should also be remembered that financial statements are not normally published until several months after the year end. The financial statements are often out of date by the time that they become available.

Creative Accounting

Management may use various forms of creative accounting to manipulate the view given by the financial statements while complying with all applicable accounting standards and regulations.

Some of the techniques that can be used have been discussed in earlier chapters. They include:

Window dressing: an entity enters into a transaction just before the year end and reverses the transaction just after the year end. For example, goods are sold on the understanding that they will be returned immediately after the year end; this appears to improve profits and liquidity. The only reason for the transaction is to artificially improve the view given by the financial statements.

'Off balance sheet' finance: transactions are deliberately arranged so as to enable an entity to keep significant assets and particularly liabilities out of the statement of financial position (= 'off balance sheet'). This improves gearing and return on capital employed. Examples include sale and repurchase agreements and some forms of leasing.

Changes to accounting policies or accounting estimates: for example, an entity can revalue assets (change from the cost model to the revaluation model) to improve gearing or change the way in which it depreciates assets to improve profits.

Profit smoothing: manipulating reported profits by recognising (usually) artificial assets or liabilities and releasing them to profit or loss as required.

Aggressive earnings management: artificially improving earnings and profits by recognising sales revenue before it has been earned.

Capitalising expenses: recognising 'assets' which do not meet the definition in the IASB Conceptual Framework or the recognition criteria. Examples include: human resources, advertising expenditure and internally generated brand names.

Most of these are now effectively prevented by accounting standards. However, management may still attempt 'creative accounting', especially if the entity is suffering falling profits or poor cash flow.

If directors' salaries or bonuses are based on profits or on particular measures, (such as earnings per share), they may try to manipulate that particular measure so that it is as favourable to them as possible.

Related Party Relationships and Transactions

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

transactions have taken place that were not at 'arm's length', or

there are parties that could enforce transactions on the entity that are not on an 'arm's length' basis.

For example, an entity might sell an asset such as a property to another company owned by one of its directors on more favourable terms than it would sell to a third party.

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

Related parties of an entity can include:

(a) parents, subsidiaries and fellow subsidiaries
(b) associates
(c) key management personnel (such as directors)
(d) close family members of any of the above.

A related party transaction is:

(i) a transfer of resources, services, or obligations between related parties
(ii) whether or not a price is charged.

Examples of related party transactions include:

purchases or sales of goods

purchases or sales of property and other assets

rendering or receiving of services

leases

finance arrangements (such as loans or contributions to equity).

Related party relationships and transactions are a normal part of business and there is nothing wrong with entering into them. However, a related party relationship can have an effect on the profit or loss, or on the financial position of an entity, because related parties might enter into transactions with each other on terms that other entities or individuals (unrelated parties) would not. For example, where an entity sells goods to a related party, its profits may not be comparable with those of a similar entity that only trades with third parties on normal commercial terms.

Using Figures from the Statement of Financial Position

In practice, ratio calculations are often based on figures in the year-end statement of financial position. These may be very similar to average values for the period, but this is not always the case.

Some businesses are seasonal and make a high proportion of their sales at a specific time of year (for example, in the few months before a national holiday period). Seasonal businesses often arrange their year-ends so that they fall when inventories and receivables are at their lowest (probably just after the main period for sales). Where this happens, ratios such as inventory turnover will be lower than they would be if they were based on the average figure for the year. This means that ratios may not be strictly comparable with those of other businesses or with industry averages.

Major purchases of assets can have a significant effect on figures in the statement of financial position and on ratios if they take place near the end of the accounting period.

The carrying value of non-current assets is unusually high, because cost has increased, but a full year's depreciation has not been charged.

Return on capital employed and asset turnover are reduced, because assets have increased but revenue and profits have not. New assets should generate increased profits, but they have not yet been owned for long enough to do so.

Non-Financial Information

One of the most serious limitations of traditional financial statements is that they only reflect the financial effects of transactions. Items are not recognised unless they can be measured reliably in money terms.

There are two problems here:

Businesses and the transactions that they enter into are becoming increasingly complex. Much information that is relevant to users cannot be expressed easily in monetary terms or in numbers.

Businesses increasingly accept that they are not only accountable to investors and lenders, but to a much wider group of people, or stakeholders. Stakeholders can include customers, suppliers, employees, the local community as a whole and (for some large public entities) society as a whole. These groups are often more interested in the non-financial effects of an entity's activities, (for example, its effect on the natural environment), than in its financial performance.

Most large and listed entities now include a Business Review, or an Operating and Financial Review (sometimes called Management Discussion and Analysis) in their published financial statements. This is a narrative report which sets out management's analysis of the business. Such a review is a legal requirement for many companies within the European Union.

At present entities reporting under IFRSs do not have to publish any non-financial information of this kind. Recently the IASB issued a non-mandatory "Practice Statement on Management Commentary". It is up to companies or individual legal jurisdictions to decide whether to follow this guidance.

Useful Non-Financial Information

Useful non-financial information could include the following:

a description of the business, objectives and strategies of the entity

a narrative review of the performance of the business during the period

a description of the main risks and uncertainties facing the entity and the ways in which these risks are managed

details of any significant factors or events that may have an impact on the entity's performance in future

details of any significant factors or events that may have an impact on the entity's cash flows in future

information about key relationships with other entities and transactions with related parties, including management

a description of the entity's research and development activities (if any) and of any material intangible assets, including internally generated intangible assets that have not been recognised in the balance sheet

additional explanations of amounts included in the financial statements, where appropriate (for example, where these are based on estimates)

information about the entity's policies in relation to environmental matters, in relation to its employees and on social and community issues.

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Other information

Size of Company

Large companies should be able to benefit from economies of scale and so should be more profitable than smaller companies in the same industry and market. Larger companies should also attract better management, so (in theory) the business should be run more efficiently, and so should achieve higher profit margins.

Market Area

Companies operating in the same industry may achieve very different results because they operate in different sectors or segments of the market. For example, two companies selling furniture might have very different profit margins because they operate in different parts of the market. One company may be selling antique furniture at high profit margins and the other may be selling self- assembly furniture in larger volumes but with lower profit margins.

Stage in the Supply Chain

Companies operating in the same industry may operate at different stages in the supply chain. A supplier of raw materials, a manufacturer and a retailer would be expected to have very different financial ratios, even though they may operate in the same industry.

For example, it would be difficult to compare the financial ratios of a timber supplier, a furniture manufacturer and a furniture retailer.

Timing of transactions

The timing of a key transaction can distort financial ratios. For example, a company may acquire a subsidiary at the end of the financial year. The subsidiary would then be consolidated in the group statement of financial position but its profits would not be included in group profit or loss because they are all pre-acquisition profits.

Ratios that compare profit figures with items in the statement of financial position will therefore be distorted, unless a suitable adjustment is made to allow for the transaction.

Year-End Date

In most countries, companies are allowed to decide for themselves what their financial year-end date should be. The choice of dates can affect the financial ratios. For example a manufacturer of ski equipment will probably have some very busy trading months (during the ski-ing holiday season) and some very quiet months. If it selects the end of the high-selling season as its year-end, its inventory levels will be abnormally low and its receivables balance may be abnormally high.

Such 'distortions' in the financial statements can be eliminated by calculating ratios using a monthly average for any measures taken from the statement of financial position, such as inventory, receivables and trade payables.

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Management strategy

Financial ratios should be interpreted in the context of all other relevant information that is available about the company. For example, management may have decided on a strategy of cutting profit margins in the short term in order to win market share. This would affect the current profit margin, but in the long run should result in higher sales and more profits.

29.11 Financial Ratios and Examination Technique

Introduction

Examination questions on financial ratio analysis usually require sound examination technique to construct a good answer. The following guidelines suggest the approach you should take and indicate the mistakes and pitfalls to avoid.

At this level, you are unlikely to get a question that asks you just to calculate ratios. It is more likely that you will get a question that asks you to consider the accounting treatment of particular items in the financial statements and the effect that this will have on the entity's ratios.

For example, if an entity has incorrectly treated a sale and repurchase transaction as a 'genuine' sale and not as a loan secured on an asset, then there will be a significant effect on the entity's ratios. For example, the gearing ratio will not show the true position of the entity's debt as it will exclude the secured loan. Return on capital employed will also be affected as the incorrect treatment of the transaction removes the asset from the statement of financial position, thus increasing ROCE.

Additionally, consider the points below which provide specific guidance on aspects of the question that you may have to answer.

Approach to Questions

Analyse the Requirement

Start by recognising the person or organisation who has asked for the financial analysis.

Who is the user?

What information is the user interested in? Why has the user requested the report?

How should the information be presented to the user – in the form of a memo or a more formal report? Don't forget there are presentation marks available for well-presented reports.

Background Information

Establish some of the basic 'background' information.

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What industry does the company operate in?

Note the financial year end. This may possibly be significant.

Is the business seasonal? If so, seasonal trading may 'distort' the year-end figures in the statement of financial position, particularly for inventory, receivables, cash and payables.

Have there been any key transactions during the year that may affect comparisons with previous years? For example, has the company raised a substantial amount of new finance, or has it acquired a major new subsidiary, entered a new market with a new product, or disposed of a business operation?

Review of the Financial Information

Before calculating any financial ratios, perform a thorough review of the financial information provided. Look for items that will affect the measurement of key financial ratios.

Statement of Financial Position:

Non-Current Assets:

Have there been any revaluations? Check the revaluation reserve. Has it changed since the previous year? (This can also be checked by looking at the statement of profit or loss and other comprehensive income.)

Capital expenditure. Has the company incurred significant capital expenditure? Look at the increase in non-current assets since the previous year. How has the expansion been financed? Look at share capital and reserves, and at levels of debt.

Investments:

Has the company invested in a new industry?

Has the company acquired a new subsidiary or invested in a new associate or joint venture? If so, consider the timing of the acquisition

if an acquisition happened in mid-year the subsidiary's profits will have been included in profit or loss for only six months but it will be included in full in the year-end group statement of financial position.

Working Capital:

Has the total working capital increased or decreased in proportion with the increase or decrease in sales turnover (compared with the previous year)?

Look at the amounts of current assets and current liabilities. Does the company have net current assets or net current liabilities?

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Loans:

Have any loans been repaid in the year?

If so, how was the repayment financed?

Share Capital and Reserves:

Have there been any new issues of shares during the year? If so, is it clear why the new shares were issued? For example, have new shares been issued to raise money to repay debt? Or to finance an expansion of the business?

Have there been any significant changes in reserves during the year?

Statement of Profit or Loss

Compare sales growth with profit growth. Are they about the same rates of growth? If not, you may need to think about reasons for the different growth rates.

Interest. Is the interest charge high in relation to the amount of debt in the statement of financial position? If it is high, has any debt been repaid in the year?

Dividends. Look at the amount of dividend payments, the dividend cover, and the trend in dividend payments over the past few years.

Did the company make a profit or a loss?

Are there any unusual 'one-off' items in profit or loss? If so, what are they?

You should have an expectation in your mind about the measurements and ratios that you should expect to find. If the actual measurements or ratios are different from what you expect, you may need to think about the reasons for the unexpected results.

For example, you may expect the company to be profitable. If it made a loss, you will need to look for the reasons.

Calculate Financial Ratios

Having reviewed the financial information, you should calculate relevant key ratios:

Present the ratios you have calculated as an appendix to your memo or report.

Show the formulae and numbers you have used to calculate the ratios. Do not just write down the ratio by copying it from your calculator. The examiner will want to see where your figure came from, to make sure that you understand what you are doing.

Be selective. Only calculate a ratio if it will add to your answer. Do not simply calculate as many ratios as possible.

Go for variety in the ratios you select.

If the examination question provides some financial ratios, look for ratios that have not been given. Could any of the 'missing' ratios be significant?

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Further Information

An examination question might ask for suggestions about what further information might be helpful. If so, set up your answer as an appendix to your memo or report, and build your answer as you work through your answer to the question. Examples of information that might be 'missing' include the following:

Additional information to calculate further ratios, such as the share price for calculating the P/E ratio or dividend yield

Segmental analysis

Industry average figures, for making comparisons with similar companies in the same industry

Changes in management policy (such as changes in the credit terms offered to customers)

The accounting policies used

Reasons for specific changes not explained by the information given in the question.

Writing Your Answer

Make comments that are relevant to the question. Always think about the requirements of the question when you write your answer. You will not earn marks for anything that is not relevant:

Make sure you answer all the requirements of the question. If you don't you will lose marks.

Use short sentences and bullet points.

Avoiding Pitfalls:

There are a number of common mistakes in writing answers to an interpretation question:

Most marks in the exam are likely to be for specific, relevant comments rather than solely for computations. Do not calculate too many ratios as it is time-consuming and you will not have time to write your answer. Be selective and only calculate a ratio if it will add value to your answer.

Good points can be identified by looking at absolute changes in the figures between one year and the next. For example, if sales have increased 25%, it would be expected that inventory, receivables and payables should have increased in line with the increase in sales.

Use all the information. Some valuable information about the company is usually given in the introductory paragraph in an examination question. Make sure that you read and use this information.

When making comparisons, make sure that the 'benchmark' you select for the comparison is suitable. For example, if two companies are being compared:

Are they the same size?

Do they operate in exactly the same area of the market?

Are their financial statements for the same time period?

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When making an observation about differences (such as differences in comparison with another company, or the previous year), suggest reasons for the difference. Don't just make an observation without making a comment. For example, stating that "There has been a fall in non-current asset" has no value on its own. A better answer would be "Non-current assets have decreased despite a rise in sales." You might then go on to comment that non-current assets are being over-used and are not being replaced, perhaps because of the poor cash position of the company.

The highest marks will be awarded for linking together the information that you analyse. For example: "Interest charges have remained more or less the same as in the previous year, despite a decrease in the debt in the statement of financial position. This may be explained by the company repaying a large amount of debt shortly before the year end."

Structure your answer around each of the requirements in the question. In many cases, profitability and long-term solvency could be used as main headings within your answer.

Use the company name in your answer. This will help you to focus your mind on the circumstances of the company and avoid writing about financial ratios in general terms (and so failing to answer the question).

29.12 End of Chapter Review

Use the checklist below to confirm mastery, then attempt the practice questions at the end of the chapter:

S/N	COMPETENCY
1	**Can I convert a full set of financial statements into common-size form and spot the key variances?**
2	**Can I calculate all five ratio families (profitability, efficiency, liquidity, gearing, investor) from exam-style data without templates?**
3	**When ROCE changes, can I separate the effect of margin v. asset-turnover using the Du Pont framework?**
4	**Can I map working-capital ratios into a coherent cash-conversion cycle and suggest operational fixes?**
5	**Am I able to reconcile an apparently strong headline growth rate with underlying inflation-adjusted performance?**
6	**Can I draft a concise report for a specified stakeholder, e.g., equity analyst or lender, selecting only the ratios and narrative they care about?**
7	**Do I understand at least three limitations of ratio analysis and how to mitigate them in practice?**
8	**Have I practised ICAN past-exam requirements that mix calculation with discussion, time-management and layout?**

Tip for Revision – replicate the chapter's illustrative examples with different numbers, then challenge yourself to explain what each new set of ratios means for profitability, cash flow, solvency and market perception. Compare your reasoning with the model answers given in the Chapter's practice section and the ICAN examiner's reports

ILLUSTRATIVE EXAMINABLE QUESTIONS

QUESTION 1 – Scenario-based discussion

Pimento Plc **operates in the fast-moving consumer goods sector. The board is puzzled because** headline revenue grew by 18% in 2015, yet the share price has stagnated. A quick review reveals:

A 15% devaluation of the local currency against the USD during 2015.

A sale-and-leaseback of its head office that generated a one-off gain of ₦3 billion.

Reclassification of a loss-making subsidiary as held for sale under IFRS 5.

A switch from FIFO to weighted-average cost for inventory valuation.

A sharp rise in the *effective* tax rate after the expiry of a pioneer-status incentive.

Required:

(a) Explain how each of the five events above affects the interpretation of profitability, liquidity and gearing ratios for 20X5 compared with 2014. (12 marks)
(b) Discuss three inherent limitations of ratio analysis that the board should bear in mind before reaching a conclusion about market perception. (8 marks)

Suggested Solutions:

Part	Outline Solution
(a)	**Currency devaluation inflates revenue in local currency but not necessarily volumes ⇒ misleading growth, ROCE may rise artificially.** **Sale-and-leaseback increases profit & cash but lifts gearing (right-of-use liability) in future years; impacts interest cover.** **Held-for-sale reclassification removes loss-making assets, flattering margins; liquidity improves as assets move to current.** **Inventory method change alters gross margin & working-capital days, reducing comparability.** **Tax incentive expiry lowers PAT margin & EPS despite stable pre-tax profit. Candidates should link each item to at least two ratio categories.**

(b)	**Any three well-explained limitations (e.g., historical cost, window-dressing, industry differences, inflation, differing accounting policies, one-off items).**

Examiner Guidance

Award full credit only when candidates explain the directional impact on ratios, not just list them.

Quality of discussion > quantity; concise links to principles score higher.

Question 2: Computation, interpretation and advice

The extracts below relate to *Cassava Ltd*.

(i) Summarised statement of profit or loss

	2014 (₦'m)	2015 (₦'m)
Revenue	**800**	**960**
Cost of sales	**(560)**	**(672)**
Operating expenses	**(120)**	**(162)**
Finance costs	**(20)**	**(27)**
Profit before taxes	**100**	**99**

(ii) Summarised statement of financial position

	31 Dec 2014 (₦'m)	31 Dec 2015 (₦'m)
Non-current assets	**540**	**620**
Current assets	**260**	**340**
Inventories	**110**	**150**
Trade receivables	**90**	**110**
Cash & cash equivalents	**60**	**80**
Equity	**380**	**435**
Non-current borrowings (10% pa)	**250**	**300**
Trade payables	**110**	**125**
Tax payable	**60**	**80**

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Additional information

Credit terms: customers 30 days; suppliers 45 days.

Dividend paid in 20X5 = ₦44 million.

Required:

Calculate for 2014 and 2015 (round to one decimal place):

a. Gross profit margin
b. Operating profit margin
c. Return on capital employed (ROCE) – use closing capital employed
d. Inventory days
e. Receivables days
f. Payables days
g. Interest cover
h. Gearing ratio (debt ÷ [debt + equity])

Interpret the movements in the eight ratios, identifying at least four key business drivers.

Draft three concise strategic recommendations for senior management to enhance performance in 20X6. (7 marks)

Suggested solutions:

(a) Ratio Calculations

Ratio	20X4	20X5
Gross margin	**(800-560)/800 = 30%**	**(960-672)/960 = 30%**
Operating margin	**(100-20)/800 = 10.0%**	**(99-27)/960 = 7.5%**
ROCE	**100/(380+250) = 15.4%**	**99/(435+300) = 12.6%**
Inventory days	**110/560 × 365 = 71.7**	**150/672 × 365 = 81.4**
Receivables days	**90/800 × 365 = 41.1**	**110/960 × 365 = 41.8**
Payables days	**110/560 × 365 = 71.7**	**125/672 × 365 = 67.9**
Interest cover	**100/20 = 5.0 ×**	**99/27 = 3.7 ×**
Gearing	**250/(250+380) = 39.7%**	**300/(300+435) = 40.8%**

(b) Interpretation

Operating margin down despite flat gross margin ⇒ overheads not controlled; possible cost inflation or marketing push.

ROCE falls – heavier asset base (capex) funded largely by debt.

Worsening inventory days suggests over-stocking; receivables lag unchanged ⇒ cash tied up; yet payables support shortened.

Interest cover falling close to 3 × covenant level; gearing creeping up – increased financial risk.

(c) Recommendations

Tighten SKU rationalisation & JIT to cut inventory days back towards 60.

Launch cost-reduction programme for admin expenses to restore 10% operating margin.

Re-finance part of the loan via equity or convertible debt to protect interest cover.

Guidance Notes

Award full marks in (b) for connected narrative (ratio movement → cause → consequence).

Bullet-point recommendations acceptable if impact explained.

Question 3: Adjustments and report writing

Nutmeg Co has provided you with the following draft figures for the year ended 30 September 30, 2015 (₦' 000):

	Draft	Adjustments (Notes)
	(₦'000	
Revenue	**1,200,000**	
Cost of sales	**(840,000)**	**A**
Administrative expenses	**(180,000)**	**B**
Profit before finance costs and income taxes	**180,000**	
Finance costs	**(36,000)**	
Profit before taxes	**144,000**	
Property, plant & equipment (PPE)	**620,000**	**B**
Right-of-use (ROU) asset	**–**	**C**
Inventory	**230,000**	**A**
Trade receivables	**190,000**	
Cash	**70,000**	
Equity	**540,000**	
Lease liability	**–**	**C**
Bank loan (12%)	**300,000**	
Trade payables	**240,000**	

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Adjustment notes

A year-end inventory count discovered obsolete goods costing ₦25 million whose NRV is ₦5 million.

PPE includes an item with a carrying amount of ₦60 m that is now impaired to a recoverable amount of ₦45 million.

Nutmeg signed a five-year building lease on 1 Oct 1, 2014; annual payment ₦22 million in arrears; incremental borrowing rate 8%. No entry has been made.

Required

a. Prepare the necessary journal entries for adjustments A–C. (10 marks)
b. Compute the revised:
c. Gross profit margin
d. ROCE
e. Current ratio
f. Gearing (using lease liability as debt)
g. Compare each revised ratio with the draft ratio (no adjustment) and explain the impact in no more than 120 words.
h. Draft a business report (maximum 350 words) to the Finance Director that:
i. Summarises the financial effects of the adjustments;
j. Highlights two risks to future performance; and
k. Recommends one financing and one operational action to mitigate those risks.

Suggested solutions

Nutmeg Co – Briefing to the Finance Director
Year ended September 30, 20X5 (all figures ₦ million)

Executive summary

Post-audit adjustments cut profit before tax by ₦35 million and add a lease liability of ≈ ₦88 million. As a result, profitability, liquidity and gearing ratios all weaken. Immediate remedial action is required to protect banking covenants and sustain investor confidence.

Impact of Adjustments (5)

S/N	Headline effect	Financial consequence	Ratio impact*
1	Inventory write-down (₦20 million)	CoS ↑, closing inventory ↓	Gross margin 30 % → 27.8 %; current ratio 2.0 → 1.6
2	PPE impairment (₦15 million)	PPE ↓, equity ↓	ROCE 18.3 % → 14.9 %
3	IFRS 16 lease recognition (PV ≈ ₦88 million)	ROU asset ↑, lease liability ↑	Gearing 35.7 % → 48.2 %; interest cover will fall c. 0.5 × once finance charge booked

Revised figures per earlier workings.

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Key Risks

Demand downturn – Lower margins and slower stock-turn leave little cushion if sales soften; further write-downs could follow.

Covenant breach – The leverage covenant (maximum 45 %) is now exceeded; interest cover is drifting toward the 3 × threshold.

Liquidity squeese – Weaker current ratio and new lease outflows compress headroom on the overdraft facility.

Recommendations

Action	Rationale
Renegotiate lease terms (e.g., extend tenor or obtain payment holiday)	**Lowers annual cash burden and may permit covenant re-set with the bank.**
Accelerate receivables collection (early-payment discounts, tighter credit checks)	**Frees up cash to rebuild working-capital buffer and reduce reliance on short-term borrowing.**
Review product portfolio – discontinue slow-moving lines	**Cuts future obsolescence risk and restores gross margin trajectory.**

Professional Presentation

Prepared in accordance with IFRS, based on post-adjustment figures audited to draft completion. All recommendations include measurable levers for management follow-up.

Best Regards

WORKINGS:

1. Journal Entries

A. Inventory Write-Down		₦'000	
Debit:	Cost of sales	20,000	
Debit:	Accumulated impairment		20,000 *(if separate)*
Credit:	Inventory		20,000

(Based on NRV reduction 25 – 5 = 20)

B. PPE Impairment		₦'000
Debit:	Impairment loss (P&L)	15,000
Credit:	PPE	15,000

Credit: Initial lease recognition (PV ₦95 million, assumed)

		₦'000
Debit:	ROU asset	95,000
Credit:	Lease liability	95,000

(Discount Factor 3.993; payment 22 million)

2. Revised Ratios

Ratio	Draft	Revised
Gross margin	**30%**	**27.8%**
ROCE	**18.3%**	**14.9%**
Current ratio	**2.0 : 1**	**1.6 : 1**
Gearing	**35.7%**	**48.2%**

(Credit for workings and reasonableness)

3. Explanation

Obsolete inventory & PPE impairment cut profit and capital employed, squeezing both margin and ROCE. Recognising the lease inflates debt and total assets, worsening gearing and liquidity. Net effect: profitability *and* solvency picture both deteriorate, signalling heightened covenant strain.

4. Business report (15 marks)

Indicative structure (marks in brackets):

Executive summary *(2)*

Impact of adjustments – explain 3 headline effects *(5)*

Risks – demand downturn, covenant breach *(3)*

Recommendations – renegotiate lease terms; accelerate receivables collection *(3)*

Professional presentation *(2)*

Guidance notes

Cap at 350 words; penalise verbosity.

Reward clear headings, concise insight, stakeholder focus.

General examiner advice

Show all workings; label each ratio.

Use *concise, stakeholder-oriented language* in narrative answers.

Cross-link ratios to demonstrate integrated thinking – this is where high-level SBR marks sit.

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Professional Level

Strategic Business Reporting

CHAPTER 30

First Time Adoption of IFRS (IFRS 1)

Contents

30.0 Learning objective

30.1 Learning outcomes

30.2 Accounting for the Transition to IFRS

30.3 Presentation and Disclosure

30.4 Chapter Review

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30 First Time Adoption of IFRS (IFRS 1)

30.0 Learning objective

This chapter discusses IFRS 1 – First Time Conversion to IFRS.

30.1 Learning outcomes

On successful completion of this chapter, readers should be able to:

a. Define the core transition terms – *first IFRS financial statements, opening IFRS statement of financial position and date of transition*.
b. Prepare an opening IFRS statement of financial position that recognises, derecognises, measures and classifies assets and liabilities in full accordance with current IFRS.
c. Apply full retrospective restatement and distinguish clearly between *permitted exemptions* and *mandatory exceptions* under IFRS 1.
d. Select and justify optional exemptions (e.g. deemed cost for PPE, cumulative translation reset, business-combination relief) in a cost-beneficial manner.
e. Execute the three mandatory reconciliations (equity at transition, equity at comparative period-end, total comprehensive income for the comparative year) and explain their purpose to users.
f. Draft compliant presentation and disclosure – extra statement of financial position, dual-year primary statements and detailed reconciliation notes – that meet IAS 1 and IFRS 1 requirements.
g. Evaluate the impact of transition adjustments on key ratios, covenants and investor perception, and recommend communication strategies for first-time adopters.

30.2 Accounting for the Transition to IFRS

Introduction and Terminology

Changing from one GAAP to another is a major undertaking which has wide reaching implications for the company undertaking this step.

IFRS 1 First Time Adoption of International Financial Reporting Standards explains how the transition to IFRS should be accounted for.

Definitions

First time adopter: An entity that, for the first time, makes an explicit and unreserved statement that its general purpose financial statements comply with IFRSs.

First IFRS financial statements: The first annual financial statements in which an entity adopts IFRS by an explicit and unreserved statement of compliance with IFRS.

The first IFRS financial statements will include the current year, which is the first period published entirely according to IFRS and comparatives, which were originally published under previous GAAP, and have been restated into IFRS.

A first-time adopter must prepare an opening statement of financial position according to IFRS as at the date of transition to IFRS.

Definitions

Date of transition to IFRSs: The beginning of the earliest comparative period for which an entity presents full comparative information under IFRS in its first IFRS financial statements.

Opening IFRS statement of financial position: An entity's statement of financial position at the date of transition to IFRSs.

In Nigeria, the date of transition was established by the provisions in the *National Road Map on adoption of IFRS*.

The opening IFRS statement of financial position is prepared by full retrospective application of all IFRS extant at the first IFRS reporting date.

First IFRS reporting date: The latest reporting date covered by the entity's first IFRS financial statements.

Opening IFRS Statement of Financial Position

An entity shall prepare and present an opening IFRS statement of financial position at the date of transition to IFRSs. This is the starting point for its accounting in accordance with IFRSs.

Accounting Policies

An entity shall use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the end of its first IFRS reporting period

An entity shall not apply different versions of IFRSs that were effective at earlier dates. An entity may apply a new IFRS that is not yet mandatory if that IFRS permits early application.

Illustrative Example 1: Consistent Application of Latest Version of IFRSs

Background

The end of entity A's first IFRS reporting period is 31 December 20X8. Entity A decides to present comparative information in those financial statements for one year only. Therefore, its date of transition to IFRSs is the beginning of business on 1 January 20X7 (or, equivalently, close of business on 31 December 20X6). Entity A presented financial statements in

accordance with its previous GAAP annually to 31 December each year up to, and including, 31 December 20X7.

Application of Requirements

Entity A is required to apply the IFRSs effective for periods ending on 31 December 20X8 in:

preparing and presenting its opening IFRS statement of financial position at 1 January 20X7; and

preparing and presenting its statement of financial position for 31 December 20X8 (including comparative amounts for 20X7), statement of comprehensive income, statement of changes in equity and statement of cash flows for the year to 31 December 20X8 (including comparative amounts for 20X7) and disclosures (including comparative information for 20X7).

If a new IFRS is not yet mandatory but permits early application, entity A is permitted, but not required, to apply that IFRS in its first IFRS financial statements.

Full Retrospective Application of IFRS

Full retrospective restatement means that all of the figures from the previous GAAP statement of financial position should be restated to what they would have been if IFRS had always been applied.

This means that in the opening IFRS statement of financial position, a first-time adopter must:

recognise all assets and liabilities whose recognition is required by IFRSs;

not recognise assets or liabilities if IFRSs do not permit such recognition;

re-classify items recognised under the previous GAAP as one type of asset, liability or component of equity if IFRSs require that they should be classified differently;

apply IFRSs in measuring all assets and liabilities.

These adjustments are made at the date of transition and lead to restructuring of the comparative statement of financial position

Full retrospective restatement is a difficult task. IFRS must be applied in its entirety from the date of transition but there are two categories of exception to full retrospective restatement before this.

These are:

(a) exceptions which are permitted; and

(b) exceptions which are mandatory.

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Permitted exceptions to full retrospective application of IFRS

A first-time adopter may elect to use one or more available exemptions from the application of IFRSs.

There are over twenty possible exemptions to full retrospective application in a number of areas including the following:

(a) business combinations;

(b) cost of non-current assets (deemed cost);

(c) cumulative translation differences;

(d) investments in subsidiaries, associates and joint ventures (IAS 27); and

(e) designation of previously recognised financial instruments.

Business Combinations

The "business combination" exemption is actually a series of exemptions relating to:

IFRS 3: Business combinations;

Consolidation, equity accounting and joint arrangements (IFRS 10, IFRS 11 and IAS 28);

IAS 21: The effects of Changes in Foreign Exchange Rates

The rules on business combinations must be applied to all transactions arising after the date of transition but do not have to be applied retrospectively.

However, IFRS 1 allows the rules to apply from any date before the date of transition. In effect, this means that a company could pick any date before the date of transition from which to start applying IFRS and if this is the case both IFRS 3 and IFRS 10 must be applied to all subsequent combinations.

This is not allowed in Nigeria. All subsidiaries must be accounted for under Nigerian GAAP until the date of transition.

Alternative rules apply if IFRS 3 is not applied retrospectively (Appendix C to IFRS 1). These include:

(a) assets and liabilities recognised under previous GAAP forms the basis for the recognition of assets and liabilities under IFRS at the date of transition (subject to adjustments);
(b) the carrying amount of assets and liabilities under previous GAAP is deemed cost for IFRS;
(c) goodwill written off is not reinstated;
(d) goodwill at transition is subject to impairment test.

IAS 21 requires that goodwill and fair value adjustments arising on acquisition of a foreign operation are retranslated at each reporting date. IFRS 1 allows that this requirement does not have to be applied to business combinations before the date of transition.

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Deemed Cost

This exemption applies to:

Property, plant and equipment;

Intangible assets (conditions apply);

Investment property; and

Exploration and evaluation assets for oil and gas under IFRS 6, and assets recorded in respect of rate-regulated activities

It might be difficult to retrospectively construct the IFRS cost of non-current assets at the date of transition.

IFRS 1 allows the use of one of the following to establish the IFRS cost of an asset at the date of transition:

(a) fair value;

(b) cost adjusted by changes in an inflation index;

(c) a fair value established at a date before the date of transition in accordance with previous GAAP;

(d) cost as determined under previous GAAP (oil and gas, rate-regulated activities).

In Nigeria, a previous revaluation can only be used to as a deemed cost if it was carried out by duly certified and professionally qualified/registered valuer.

Cumulative Translation Differences

IAS 21 requires cumulative translation differences (CTDs) arising on translation of foreign operations to be classified as a separate component of equity and recycled through the statement of profit or loss on disposal of the subsidiary.

A first time adopter does not have to identify CTDs that arose before the date of transition

Investments in Subsidiaries, Joint Ventures and Associates

If an entity prepares separate financial statements *IAS 27* Separate *Financial Statements* requires it to account for investments in subsidiaries, jointly ventures and associates either:

(a) at cost; or

(b) in accordance with IFRS 9;

IFRS 1 allows one of the following amounts to be used to establish a cost for IFRS in the separate opening IFRS financial statements:

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(a) cost determined in accordance with IAS 27; or

(b) deemed cost;

(c) fair value (in accordance with IFRS 9) at the date of transition; or

(d) previous GAAP carrying amount at that date

Designation of Previously Recognised Financial Instruments

IFRS 9 Financial Instruments allows classification on initial recognition of:

(a) a financial asset as fair value through profit or loss (conditions); and

(b) a financial liability as fair value through profit or loss (conditions) IFRS 1 allows such designation to be made at the date of transition

Mandatory Exceptions to Full Retrospective Application of IFRS

IFRS 1 prohibits the retrospective application of some IFRSs for the opening IFRS statement of financial position.

Exceptions that must be used concern the following:

(a) derecognition of financial assets and liabilities;

(b) hedge accounting;

(c) non-controlling interests;

(d) classification and measurement of financial assets;

(e) impairment of financial assets;

(f) embedded derivatives; and

(g) government loans

Derecognition

If an asset was derecognised under previous GAAP but would not have been under IFRS, full retrospective application would bring it back onto the statement of financial position. This is not allowed by IFRS 1.

The IFRS 9 derecognition rules must be applied prospectively for transactions occurring on or after the date of transition to IFRSs.

non-derivative financial assets and liabilities derecognised in a period beginning before transition are not re-recognised; however

an entity may apply the rules retrospectively from any date of its choosing but only if the information needed was obtained at the date of the transaction.

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Note that some financial assets that were derecognised before the date of transition might still be brought back onto the opening IFRS statement of financial position due to the rules requiring consolidation of special purpose vehicles. If a financial asset had been derecognised in a sale or transfer to an entity which would be defined as a subsidiary under IFRS, that financial asset would be brought back into the opening IFRS statement of financial position by consolidation.

Hedge accounting

(a) Hedge accounting relationships cannot be designated retrospectively at transition;

(b) all derivatives are measured at fair value;

(c) deferred gains/losses previously reported as assets and liabilities are eliminated;

(d) hedge accounting can only be used if the hedge qualifies under rules in IFRS.

Non-controlling interests

IFRS 10 contains rules:

a. on accounting for changes in ownership of a subsidiary that do and do not result in a loss of control; and

b. that require total comprehensive income to be attributed to the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

These rules must be applied prospectively from the date of transition. If a first-time adopter elects to apply IFRS 3 retrospectively to past business combinations, it must also apply IFRS 10 from the same date.

30.3 Presentation and disclosure

Presentation by a first time adopter

IFRS 1 requires that a first-time adopter must include at least one year of comparative information in its first IFRS financial statements. (This is why the date of transition to IFRS cannot be later than the beginning of the previous financial year).

Presentation:

To comply with IAS 1 the first IFRS financial statements must include at least:

Statements of financial position:

a. Current year (the date to which the first IFRS financial statements are prepared);

b. Last year (the comparatives to the first IFRS financial statements which were originally published under the previous GAAP);

c. Start of last year (date of transition).

Sstatements of profit and loss and other comprehensive income (current year with comparatives);

a. statements of cash flows (current year with comparatives);
b. statements of changes in equity (current year with comparatives); and
c. sets of related notes to the financial statements (current year with comparatives).

Disclosure by a first-time adopter

The company must explain how the transition to IFRS affected its reported:

(a) financial position;
(b) financial performance; and
(c) cash flows.

IFRS 1 requires that a company publish reconciliations of amounts in the previous GAAP financial statements to those in the IFRS financial statements.

The first IFRS financial statements must include:

a. reconciliations of equity (net assets):
b. at the date of transition; and
c. at the end of latest period presented under previous GAAP; and

a reconciliation of the profit or loss for the latest period presented under previous GAAP.

What has to be reconciled under IFRS 1

Required reconciliation	What you show	Why
Equity at the date of transition (Jan 1, 2014 in this example)	Previous-GAAP equity → IFRS equity	Explains opening adjustments recognised directly in reserves.
Equity at the end of the comparative period (Dec 31, 2014)	Previous-GAAP equity → IFRS equity	Allows users to bridge from last published GAAP figures to IFRS.
Total comprehensive income (or profit/loss) for the comparative period (year to Dec 31, 2014)	Previous-GAAP TCI → IFRS TCI	Shows the effect of IFRS on performance measures.

IFRS 1 also requires disclosure of any material errors identified in the course of transition and an explanation of accounting policy choices made on first-time adoption.

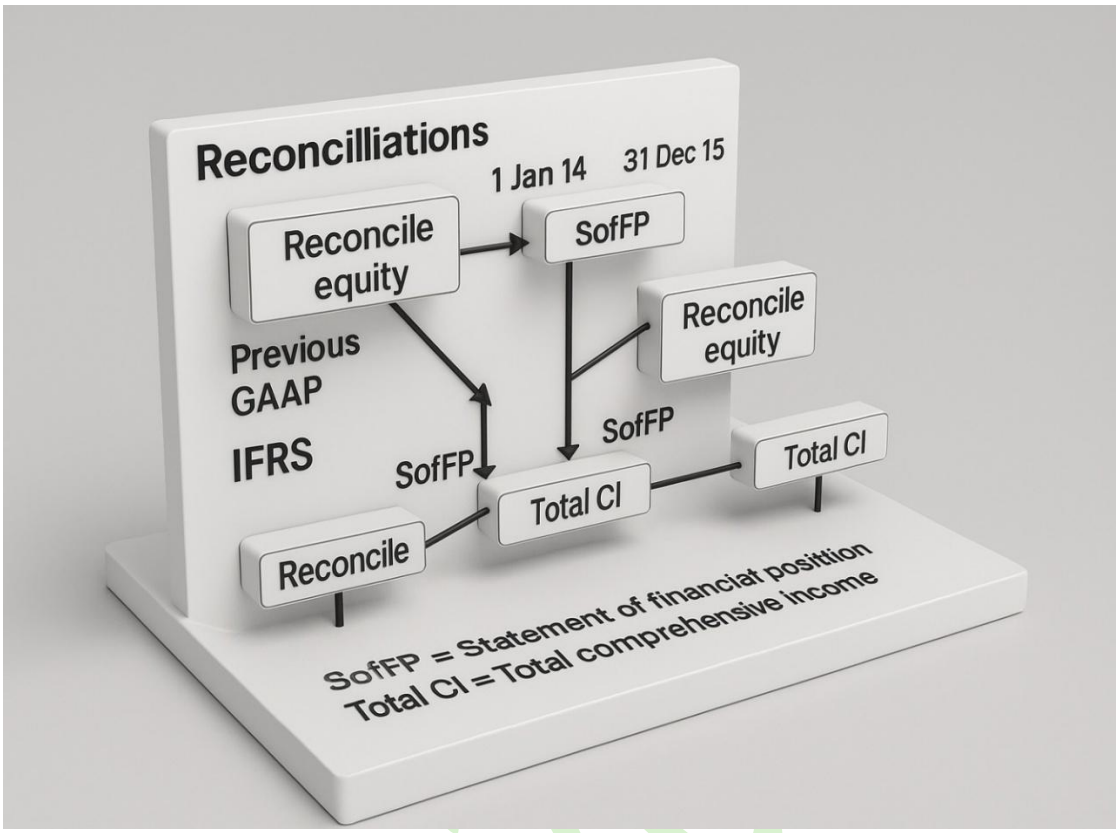
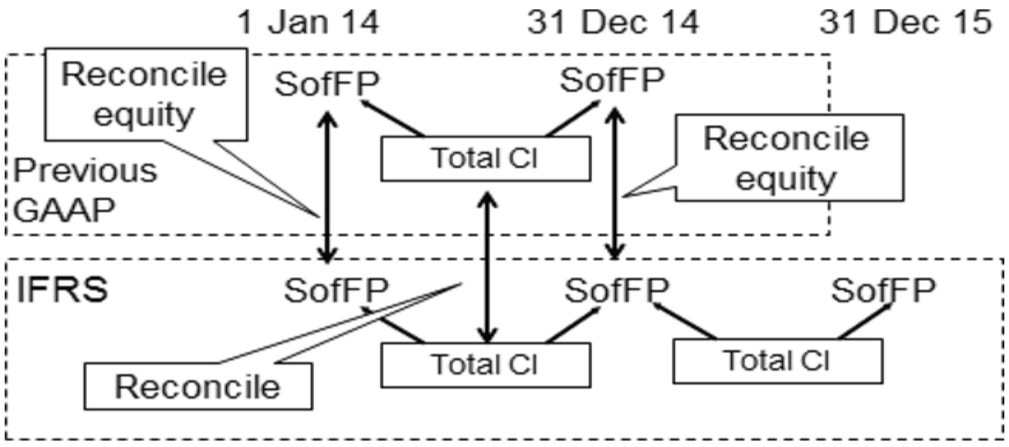


Illustration: Reconciliations

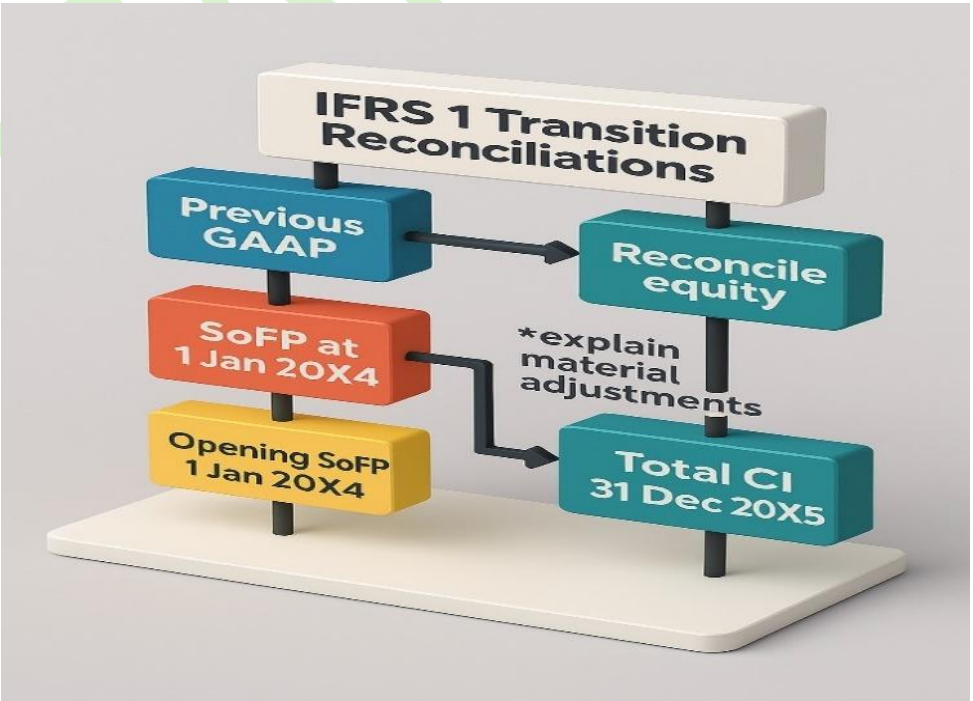


SofFP = Statement of financial position
Total CI = Total comprehensive income

Illustrative example 2: Reconciliation of equity

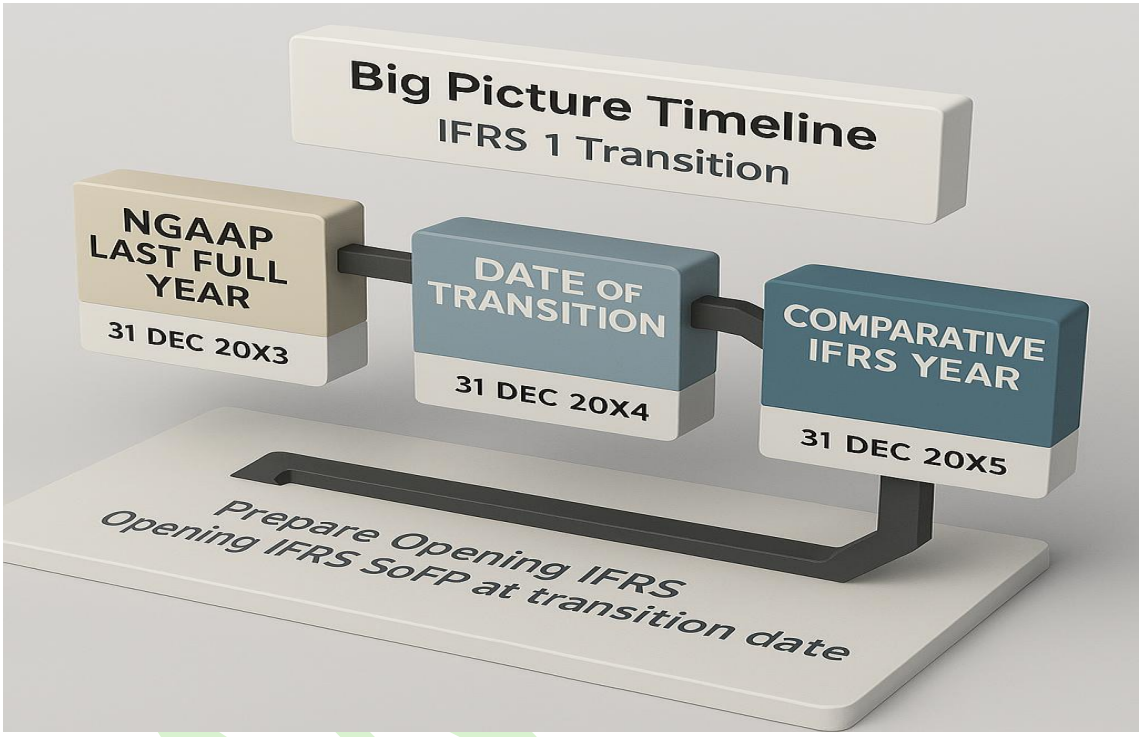
A simplified example of a reconciliation of equity is shown below:

	Previous GAAP	IFRS Adjustments	IFRSs
Property, plant and equipment	**2,000**	**300**	**2,300**
Intangible assets	400	(50)	350
Total Non-Current Assets (i)	2,400	250	2,650
Trade and other receivables	1,200	0	1,200
Inventory	800	(70)	730
Cash	50	0	50
Total Current Assets (ii)	2,050	(70)	1,980
Total Assets	4,450	180	4,630
Loans	800	0	800
Trade payables	415	0	415
Current tax liability	30	0	30
Deferred tax liability	25	220	245
Total Liabilities	1,270	220	1,490
Total Assets *less* Total Liabilities	3,180	(40)	3,140
Issued capital	1,000	0	1,000
Revaluation reserve	0	190	190
Retained earnings (balance)	2,180	(230)	1,950
Total Equity	3,180	(40)	3,140



Illustrative Example 3: A pragmatic, exam-useful illustration of a transition from Nigerian GAAP (NGAAP) to IFRS

1. The Big Picture Timeline



** Date of Transition = start of the earliest comparative period presented under IFRS (IFRS 1).*

2. What IFRS 1 requires you to reconcile

At the First IFRS Reporting Date (Dec 31, 2015) you must present:

Reconciliation	Bridge From	Bridge To	Purpose
Equity at Date of Transition (Jan 1, 2014)	NGAAP equity	Opening IFRS equity	Shows cumulative adjustments taken directly to reserves.
Equity at Comparative Period End (Dec 31, 2014)	NGAAP equity	IFRS equity	Aligns last published NGAAP balance sheet with IFRS comparatives.

Total Comprehensive Income (Year toDec 31, 2014)	NGAAP profit/CI	IFRS profit/CI	Explains performance impact of IFRS restatements.
**(If errors discovered) Separate disclosure distinguishing correction of error from IFRS policy change.*			

3. Practical conversion workflow (10-Step)

a. Define reporting perimeter (entities, reporting currency, group structure).
b. Collect NGAAP trial balances at: last NGAAP year-end, transition date, comparative year-end.
c. Map NGAAP chart of accounts to IFRS line items (use a conversion matrix).
d. Identify mandatory IFRS 1 adjustments (e.g., derecognise certain financial assets/liabilities, hedge accounting, estimates).
e. Decide on IFRS 1 optional exemptions (e.g., deemed cost for PPE, cumulative translation reset, share-based payment retrospective scope, business combinations exemption).
f. Perform technical adjustment journals (see common Nigeria-specific areas below).
g. Build Opening IFRS SoFP at transition date.
h. Roll forward to comparative period; compute IFRS Profit/Loss & OCI.
i. Prepare equity & CI reconciliations with clear adjustment columns.
j. Draft disclosures & transition narrative (governance, policy elections, key judgements).

4. Common NGAAP → IFRS adjustment areas (Nigeria experience)

Area	Typical NGAAP Treatment	IFRS Treatment & Impact	Ratio Sensitivity
PPE & Revaluation Reserves	Historical cost or sporadic revals under SAS; capitalised exchange gains sometimes included.	Choose *deemed cost* at transition (fair value or NGAAP carrying value). Remove capitalised items not qualifying under IAS 16.	ROCE, gearing.

Area	Typical NGAAP Treatment	IFRS Treatment & Impact	Ratio Sensitivity
Depreciation/Componentisation	Often straight-line on gross cost; little component split.	Break into significant components; may accelerate expense.	Profitability, asset turnover.
Leases	Operating vs finance split varied; many "rentals" off-balance.	IFRS 16 brings ROU asset & lease liability on-balance.	EBITDA ↑, leverage ↑, current ratio ↓.
Employee Benefits (Gratuity, Pension)	Pay-as-you-go accrual; actuarial gains rarely recognised.	IAS 19 full defined benefit obligation; OCI actuarial items.	Equity, profit volatility.
Provisioning/Contingencies	Conservative general provisions common.	IAS 37 requires present obligation + reliable estimate; reversals may lift equity.	Current liabilities, profit.
Financial Instruments	Limited fair value; classification narrow.	IFRS 9 measurement categories (FVTPL/FVOCI/AC); ECL impairment.	Equity swings; P/L volatility.
Foreign Currency Translation	Mixed rates; translation reserves not tracked.	IAS 21 functional currency discipline; IFRS 1 option to reset CTA to zero.	Equity rebase; future OCI.

5. Worked Mini-Example (illustrative ₦'million)

NGAAP Equity at Jan 1, 2014

Share capital		1,000
Reserves	1,800	
Total NGAAP equity	2,800	

Adjustments to IFRS:

PPE deemed-cost uplift +120

Remove capitalised start-up costs −(40)

Recognise lease liability (net ROU impact on equity) −(85)

IAS 19 defined benefit obligation −(60)

Deferred tax on above +18

Net Adjustment −47

Opening IFRS Equity = 2,753

Reconciliation – Total Comprehensive Income (Year to Dec 31, 2014)

	NGAAP PBT	Adj't	IFRS PBT
Reported profit before tax	**320**		**320**
Extra depreciation on PPE components		**(12)**	**308**
Lease accounting (interest & depn v. rent)		**+5**	**313**
Inventory write-down under IAS 2		**(8)**	**305**
Defined benefit current service + interest		**(6)**	**299**
Tax effect (30%)		**+6**	**305 PBT → PAT 214**

Add OCI items (actuarial loss, FVOCI) to arrive at Total CI; reconcile to NGAAP retained earnings movement.

6. Template disclosure snippet (narrative style)

Transition to IFRS: The Group adopted IFRS effective January 1, 2015, with a date of transition of January 1, 2014. The Opening IFRS Statement of Financial Position was prepared using the following IFRS 1 elections: (i) *deemed cost* for property, plant and equipment based on fair values at transition; (ii) resetting the cumulative foreign currency translation reserve to zero; (iii) applying IFRS 2 to equity-settled share-based awards granted after January 1, 2013 only. Comparative information for the year ended December 31, 20X4 has been restated. Reconciliations of equity at January 1, 2014 and December 31, 2014, and of total comprehensive income for the year ended December 31, 2014, are presented below.

30.4 Chapter review

Self-Check List

At the end of this chapter, check that you can confidently do the tasks on the table below.

S/N	Competency
1	**Explain *first IFRS financial statements*, *opening IFRS SoFP* and *date of transition*.**
2	**Set up an opening IFRS SoFP, applying full retrospective rules where required.**
3	**List at least five optional exemptions and describe when each is advantageous.**
4	**Identify the seven mandatory exceptions that override retrospective restatement.**
5	**Prepare the three IFRS 1 reconciliations with clear adjustment columns.**
6	**Draft the additional statement of financial position and dual-year primary statements required in the first IFRS set.**
7	**Analyse how transition adjustments affect ROCE, gearing, liquidity and earnings volatility.**
8	**Communicate transition effects and policy elections clearly in management or investor reports.**

If any box remains unticked, revisit the relevant section before attempting the practice questions that follow.

30.5 End of chapter questions and suggested solutions

30.5.1 Questions

Question 1 – Core principles and elections

IFRS 1 provides principles, elections and exemptions when converting from existing GAAP to IFRS by reporting entities.

Required

a. State two objectives of IFRS 1 and explain how they shape the standard's transition rules.

b. Distinguish between an IFRS 1 exception and an IFRS 1 optional exemption, giving one example of each.

c. A Nigerian entity adopts IFRS on 1 January 20X7. Outline the three mandatory reconciliations it must include in its first IFRS financial statements, and *why* each is needed.

QuestioN 2 – Numerical restatement and commentary

Sunrise Ltd prepares NGAAP accounts to Dec 31, 2014 and converts to IFRS with a date of transition of Jan 1, 20X4. Extracts (₦' million):

Item (Jan 1, 20X4)	NGAAP Carrying Amount	Notes
Property, plant & equipment	**800**	**A**
Accumulated depreciation	**(320)**	**8-year life, 4 years used**
Software (capitalised)	**60**	**B**
Deferred tax (net liability)	**–**	**C**
Retained earnings	**200**	

Notes

Fair value of PPE at DoT is ₦620 million; entity elects *deemed cost* exemption.
IAS 38 disallows ₦60 million start-up software; to be expensed at DoT.

Temporary difference on PPE fair-value uplift. Tax rate 30 %. Ignore deferred tax on software.

Required:

a. Prepare Sunrise's opening IFRS statement of financial position at Jan 1, 2014, clearly showing adjustment columns.

b. Compute the net adjustment to equity and explain, in not more than 80 words, *how* it would be disclosed in the reconciliation of equity.

c. Briefly discuss two ratio impacts (profitability and gearing) arising from these adjustments when Sunrise presents its 2014 comparative figures

Question 3 – Complex transition &and report writing

Alpha Group, listed on NGX, will publish its first IFRS financial statements for year ending Dec 31, 2016 (DoT = Jan 1, 20X5). Extracts from draft NGAAP figures for the comparative year (2015) are below (₦' million):

	NGAAP 20X5	Further Information
Revenue	**4,800**	**–**
Cost of sales	**(3,360)**	**–**
Finance cost (loan)	**(80)**	**–**
Profit before tax	**320**	**–**
PPE (NBV)	**2,100**	**D**

	NGAAP 20X5	Further Information
Goodwill	**–**	**E**
Investment property	**0**	**F**
Bank loans	**900**	**–**
Share capital	**500**	**–**
Retained earnings	**1,270**	

Notes:

D. Componentisation – Fair value of significant roof component: cost 200, remaining useful life 10 yrs out of 20. Not separately depreciated under NGAAP.

E. Business combination in 2014 – NGAAP recorded goodwill of 150 and amortised 30 in 20X5. Under IFRS 3 exemption not taken; combination is restated. Fair-value goodwill 250. No impairment.

F. Alpha adopts fair value model (IAS 40) for investment property previously held within PPE at NBV 180; fair value at Jan 1, 2015 = 240; at Dec 31, 2015 = 260.

Tax rate 30 %. Ignore deferred tax on goodwill.

Required:

Part A – Technical Adjustments

Prepare *journal entries* at Jan 1, 2015 for each IFRS 1 adjustment (roof component, goodwill restatement, investment property transfer).

Show the *impact on equity* at transition and at Dec 31, 2015 (OCI where appropriate).

Part B – Analytical discussion

Explain how these IFRS adjustments would affect *earnings quality* and *statement of financial position presentation* in the 2015 comparatives.

Part C – Board report (maximum 400 words)

Draft a professional report to the Audit Committee that:

i. Summarises key transition adjustments and their quantitative impact.

ii. Highlights two strategic risks (earnings volatility, fair-value measurement).

iii. Provides one policy recommendation to manage investor communication during the first-time adoption year.

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30.5.2 Suggested solutions

Solution 1

Part	Key points
(a)	Objectives (IFRS 1.1 & 2): *ensure transparency & comparability* and *cost-beneficial transition*. Explain influence on "one-off" adjustments and presentation.
(b)	Exception: mandatory rule overriding IAS/IFRS (e.g., past estimates *cannot* be revisited – IFRS 1.14). Exemption: voluntary relief (e.g., deemed cost for PPE – App'x D).
(c)	Reconcile (i) equity at DoT, (ii) equity at end of comparative year, (iii) total comprehensive income for comparative year (IFRS 1.23–25) + rationale (user bridge).

Solution 2

1. Opening IFRS SoFP (₦' million)

	NGAAP	Adjustment	IFRS
PPE	800-320 = 480	+140 (a)	620
Software	60	−60 (b)	–
Deferred tax liability	–	−42 (c)	(42)
Net Assets/Equity	480 + 60 + 200 = 740	+38	778

(a) Fair-value uplift 140 (620-480)
(b) Derecognise software
(c) 140 × 30 %

2. Equity impact

Net increase = +140 (PPE) − 60 (software write-off) − 42 (deferred tax) = +38 million.
Reconciliation disclosure: "Retained earnings at Jan 1, 2014 increased by ₦38 million, driven primarily by the deemed-cost fair-value uplift on PPE net of a software derecognition charge and related deferred tax."

3. Ratio Commentary (Indicative)

ROCE likely to fall in 2014 comparatives because capital employed rises (620 vs 480) while operating profit is unchanged in year of transition.

Gearing improves (equity +38 m) provided external debt is constant; hence debt-to-equity declines, easing covenant headroom.

Solution 3: IFRS 1 - Complex transition

All amounts in ₦ million unless stated otherwise.
Tax rate = 30 %. IFRS paragraph references given in brackets.

Part A – Technical adjustments

A(i) Journal Entries at Jan 1, 2015 (Date of Transition – DoT)

	Description	Debit	Description	Credit
1 Roof Componentisation (IAS 16 & IFRS 1)	Roof component – cost	200	PPE – main asset	200
	Accum. dep'n (main)	100	Accum. dep'n (roof)	100
2 Goodwill Restatement (IFRS 3 & IFRS 1)	Goodwill	250	Retained earnings (RE)	250
3 Investment Property – Change to FV Model (IAS 40 & IFRS 1)	Investment property (FV)	240	PPE	180
			Retained earnings	60
4 Deferred Tax on FV Uplift (IAS 12)	Retained earnings	18	Deferred tax liability	18

Net Equity Uplift at DoT = +250 (2) + 60 − 18 = +292

A(ii) Equity Bridge 1 Jan 20X5 ➔ 31 Dec 20X5

	Assets ↑/(↓)	Equity ↑/(↓)	DTL ↑	P/L 20X5 effect*
Opening adjustments (above)	+250 Goodwill +60 FV uplift	+292	+18	–
20X5: Reverse NGAAP goodwill amortisation	–	+30	–	+30
20X5: IP FV gain (260 - 240)	+20	+14	+6	+20 (pre-tax)
Cumulative Δ by 31 Dec 20X5	+330	+336	+24	+50 on IFRS PBT

**Profit/Loss figures show incremental effect vis-à-vis NGAAP. Goodwill amortisation reversal and FV gain both boost IFRS earnings.*

Part B – Analytical discussion

Aspect	Effect on 2015 Comparatives	Implication for Users
Earnings Quality	**IFRS profit is ₦50 million higher (+16 %) – one-off uplift (FV gain) and perpetual uplift (no goodwill amortisation). Volatility rises because FV gains flow through profit.**	**Analysts must strip out non-cash FV gains and monitor future goodwill impairment risk.**
Balance-Sheet Presentation	**Goodwill +250 m appears as an indefinite-life asset; Investment property +260 m shown separately at FV; Lease component split improves PPE transparency. Equity up 26 %, but leverage ratios will fall only if lenders' covenants treat goodwill as tangible equity.**	**Improves relevance of asset values but reduces comparability with prior NGAAP data; lenders may adjust ratios for intangibles.**

Part C – Board (Audit-Committee) Report

ALPHA GROUP – IFRS 1 Transition brief

To: Audit Committee Date: May 15, 2016

1 Executive summary

The conversion from NGAAP to IFRS increases opening equity by ₦292 million and comparative-year profit by ₦50 million. Key drivers are fair-value re-measurement of our investment property and recognition of previously unrecorded goodwill. Deferred tax liabilities of ₦24 million arise on the revaluation surplus.

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2A. Principal adjustments

Adjustment	Balance-Sheet impact	2015 Profit/loss impact
Goodwill restated to FV 250 million	**Assets +250/Equity +250**	**+30 (amortisation reversal)**
Investment property at FV	**Assets +80*/Equity +56/DTL +24**	**+20 FV gain**
Componentisation of roof	**Reclassification only**	**Nil**
Uplift 60 at DoT + 20 year-end gain.		

B. Discussion points

Goodwill no longer amortised → higher EBIT but potential future impairments.

Component depreciation raises CoS steadily, smoothing maintenance spikes; enhances asset accuracy.

FV gains move to Profit/loss or OCI, increasing volatility; however balance sheet shows market-relevant values.

C. Report

Should cover: headline adjustments (goodwill +100, IP FV +60, roof component nil net), risks (earnings swings, valuation subjectivity) and recommendation (early investor education, non-GAAP measures).

3 Risks identified

Earnings volatility: Future FV movements on the investment property will funnel directly through profit, potentially masking underlying operating trends.

Impairment sensitivity: The large goodwill balance will be tested annually under IAS 36; an economic downturn could trigger a material write-down.

4 Recommended actions

Investor communication – Publish a reconciliation slide deck and hold an analyst call to explain one-off transition effects versus recurring performance.

Policy election review – Consider the cost-model option for investment property once market values stabilise, to dampen earnings swings.

Covenant management – Engage lenders early to confirm whether goodwill is excluded from equity calculations; if so, negotiate revised thresholds to preserve headroom.

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Guidance notes

Area	Examiner focus
Journals	Correct debits/credits, narrative, tax where relevant.
Equity bridges	Clarity of reconciliation columns (NGAAP → IFRS).
Discussion	Link adjustment ➔ effect ➔ implication; avoid generic statements.
Report	Professional tone, logical headings, ≤400 words. Bullet points acceptable but coherent.

5 Conclusion

The IFRS transition materially enhances the relevancy of our statements but introduces new volatility and disclosure burdens. Pro-active engagement with stakeholders will be critical to maintain confidence through the first IFRS reporting cycle.

Prepared by: Group Reporting Manager (Chartered Accountant)

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STUDY TEXT



THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA