CIMA

Paper F2

Advanced Financial Reporting

Notes

CONTENTS

Chapter 1

Long-term finance

Outcome

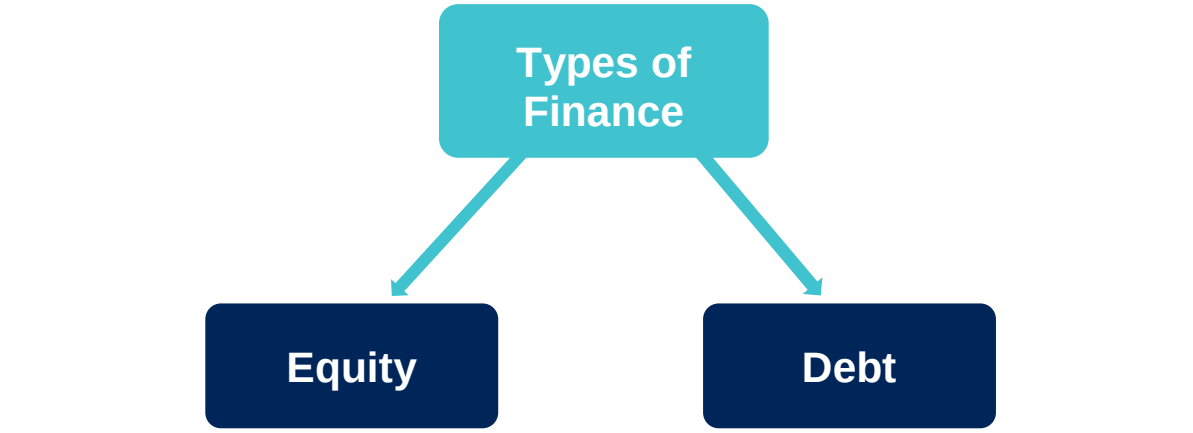
At the end of this session you should be able to:

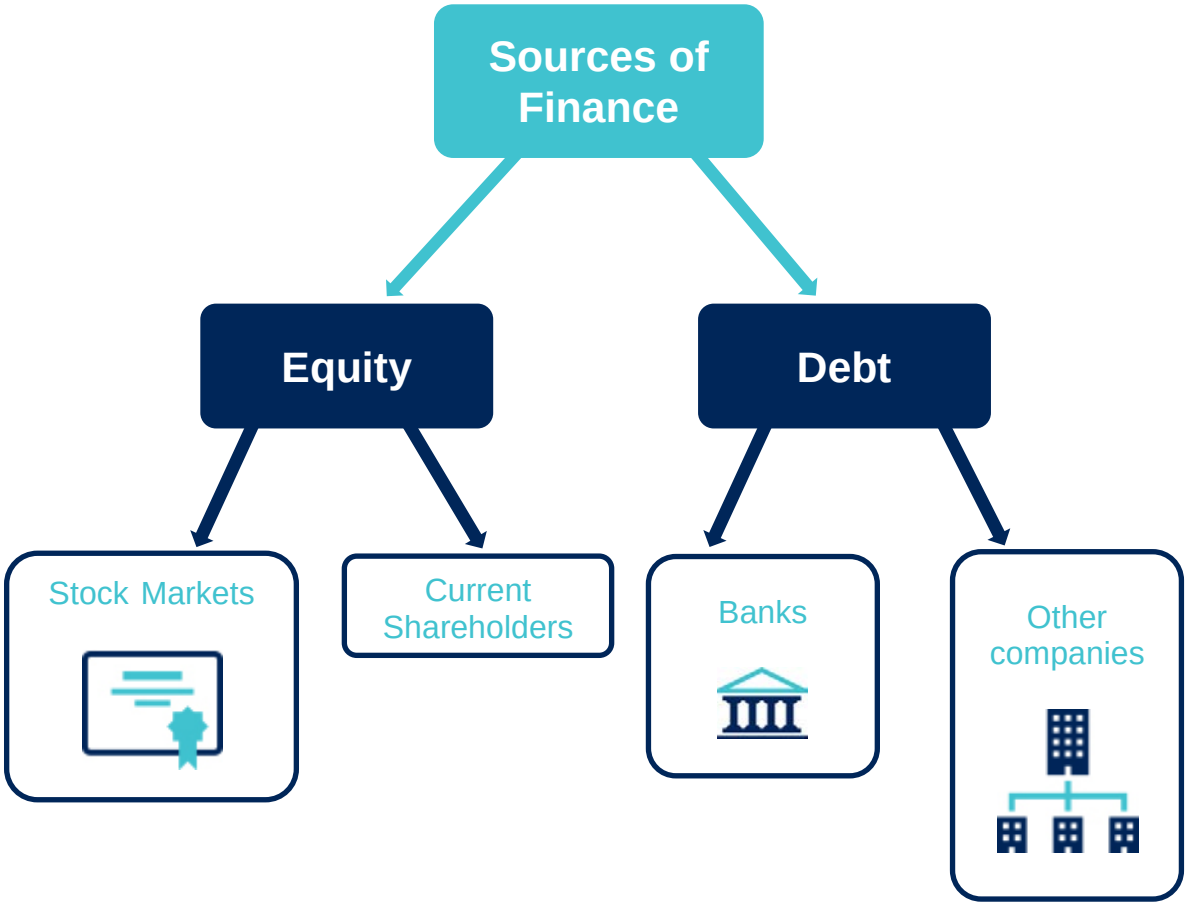
- discuss the characteristics of different types of long-term debt and equity finance
- discuss the markets for and methods of raising long-term finance

and answer questions relating to these areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 1 of your Study Text.

Overview


Types of Finance
Equity
Debt


Sources of Finance
Equity
Debt
Stock Markets
Current Shareholders
Banks
Other companies

1 Types of long-term finance

To raise finance an entity has a number of options:

- to issue shares (equity finance)
- to take out a loan (debt finance)
- to use other sources of finance e.g. government grants, retained earnings/cash reserves, venture capital.

Notes

2 Equity finance

2.1 Equity finance

Companies can raise cash by selling their shares to investors.

Two main types of share exist.

- Ordinary Shares – carry voting rights, discretionary dividends
- Preference Shares – no voting rights, guaranteed dividends

2.2 Sources of equity finance

Share finance will be issued using either:

- capital markets – used for listed entities only. The company will issue new shares.
- current shareholders – private companies can only issue shares in this fashion. They do not have access to capital markets to trade shares.

Notes

2.3 Issuing shares to current shareholders – Rights Issues

A common method of issuing shares is via a rights issue.

This is an issue of new shares **AT A DISCOUNTED PRICE** to current shareholders based on their current shareholding.

JS made a 1 for 4 rights issue at a price of $2.10. The current market price of a JS share is $2.50.

A 1 for 4 rights issue means that, for every 4 shares a shareholder currently owns, they get the chance to buy one new share at a cheap price ($2.10).

Definitions

Cum right price (CRP) – price of the shares immediately before the rights issue

Theoretical ex rights price (TERP) – price of the shares immediately after the rights issue

The exam may ask you to calculate the TERP after a rights issue has occurred

Illustrations and further practice

Now try illustration 1 or TYU 1 from Chapter 1 in the Study Text

Notes

3 Debt Finance

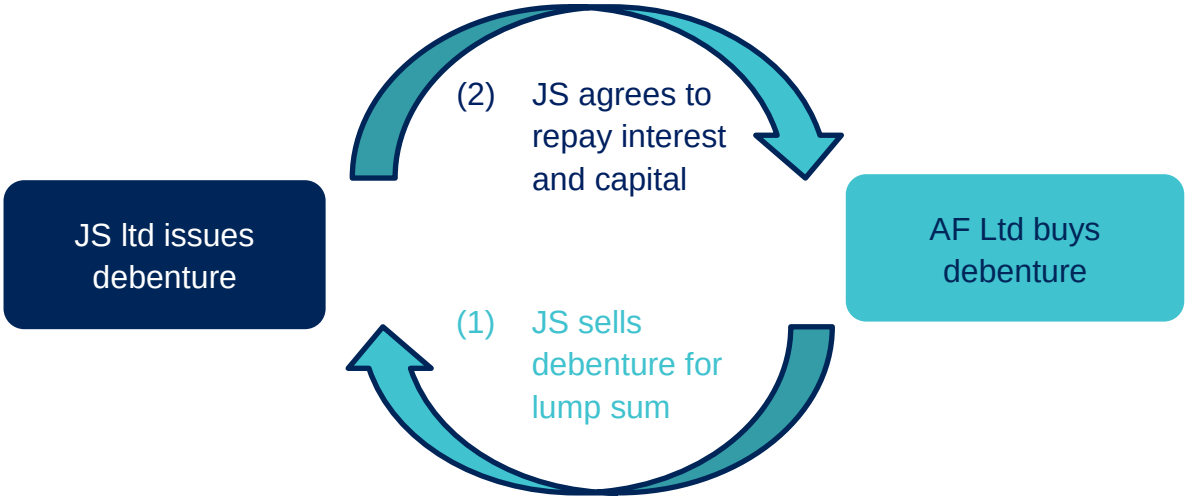
3.1 Types of debt finance

Loans

Debt finance obtained from banks and other financial institutions are often referred to as loans

Debentures/loan stock/ bonds

Debt finance obtained from other companies or organisations (e.g. governments) can often be described as debentures. The entity raising finance is said to have **issued** a debenture



Debt finance requires the repayment of interest and capital at designated timings. Debt carries a default risk which is not present with equity finance.

Notes

3.2 Debt finance definitions

JS issues 5% $100 debentures at a market value of $96. The debenture is redeemable after 5 years at a premium of 10%.

Term	Definition	Equivalent from example
Par value	Headline value of a debenture	$100
Coupon rate	Minimum interest repayment per annum based on **par** values	5% × $100 = $5 interest repayment each year (in cash)
Market value	Cash received from issuing loan	$96
Redemption date	Date of repayment of capital element of loan	5 years
Premium	Extra amount repayable at redemption date based on par values	$10 10% premium on par value of $100 = repayment of $110 (premium of $10)

Notes

4 Debt vs equity finance

Advantages

Disadvantages

Debt	Equity
High default risk – interest and capital	No default risk for ordinary shares.
Minimum servicing of finance per year required – interest	Dividends are discretionary
Cheap form of finance	Can be expensive in periods of strong performance
Can be easily accessible	Uptake depends on market conditions and shareholder appetite. Share issues can fail to raise the desired amounts.

Notes

5 Debt financing for investors

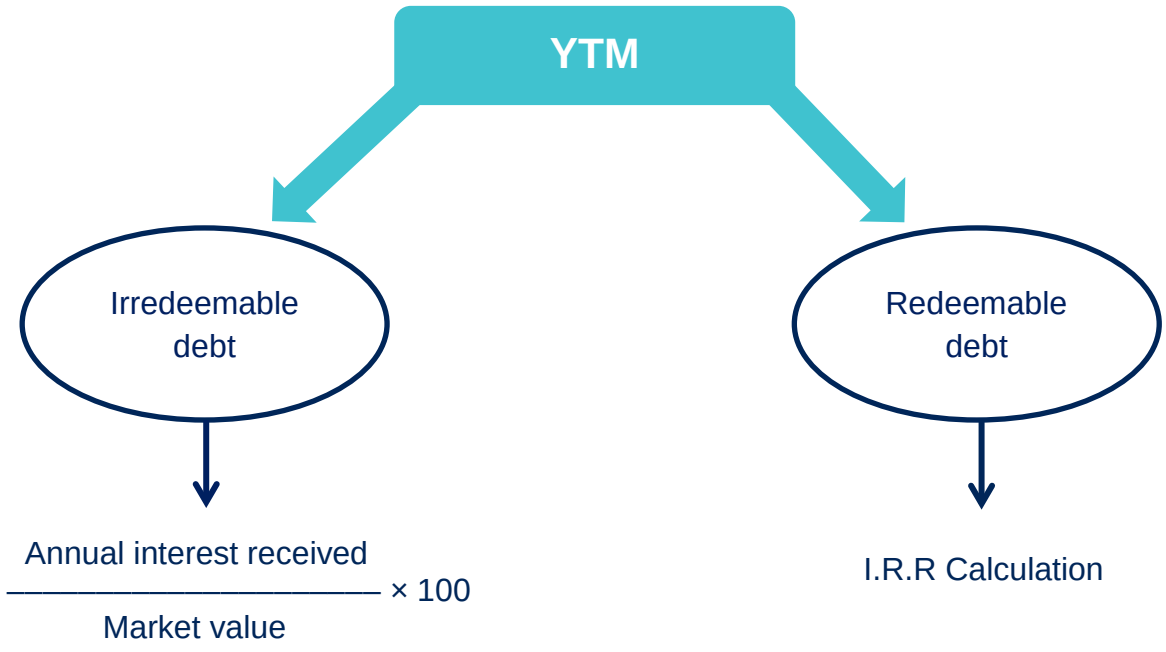
5.1 Debt investors

Debt Investors will provide finance to entities by acquiring debentures/ loan stock/ loan notes/bonds.

Why will they want to part with their hard earned cash to invest?

They will want to make a return on their investment (Profit on the money they invested!).

Debt investors will assess the YIELD ON MATURITY (YTM) on an investment to compare it to other investments and determine whether to invest in the debenture.



Notes

Illustrations and further practice

From Chapter 1, now try TYU 2 for irredeemable debt YTM and TYU 3 for redeemable debt YTM.

Notes

Notes

OT Questions

You should now be able to answer TYU 1–4 from the Study Text and questions 1–13 from the Exam Practice Kit.

For further reading, visit Chapter 1 of the Study Text.

Chapter 2

Cost of capital

Outcome

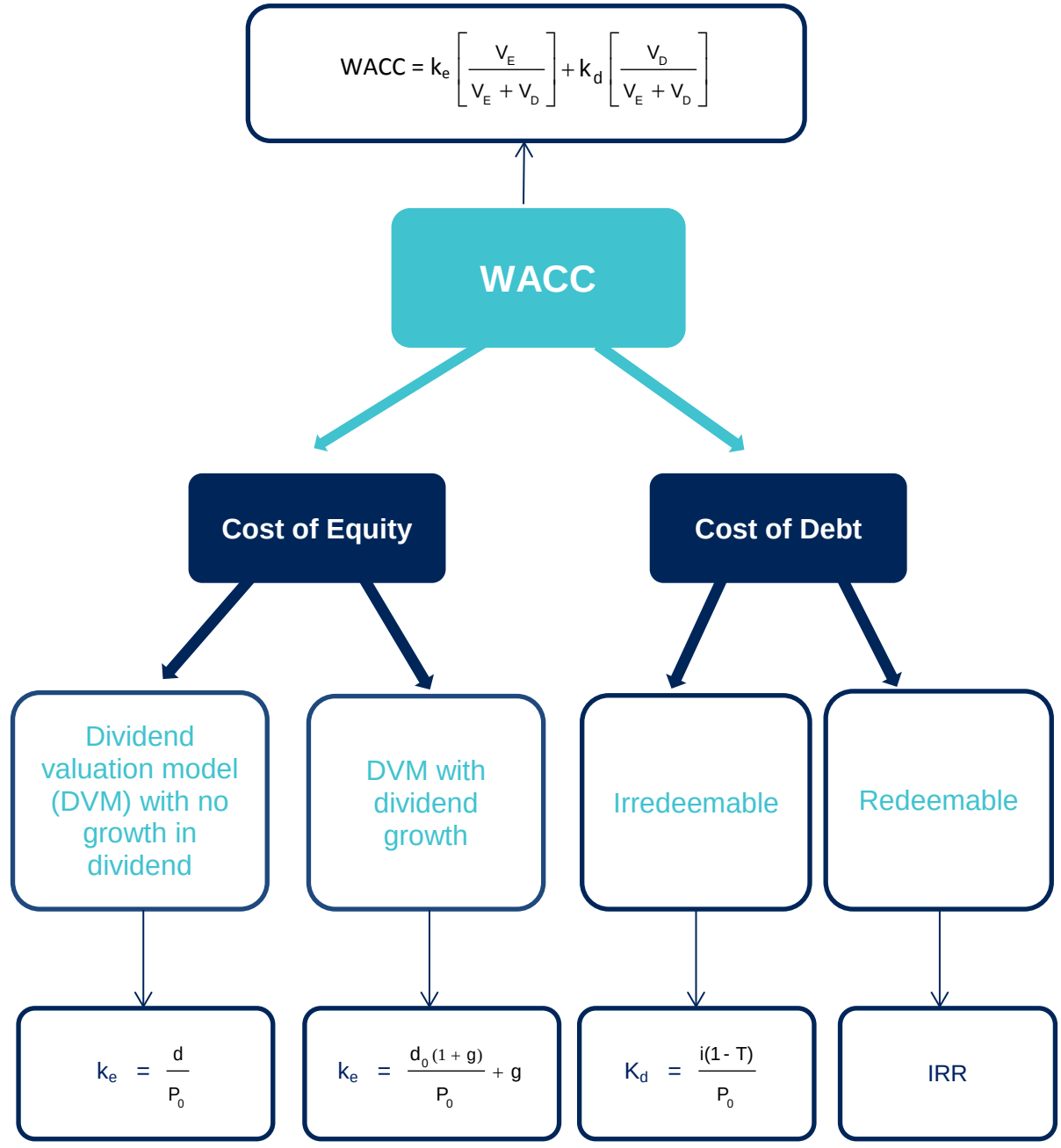
At the end of this session you should be able to:

- calculate the cost of equity for an incorporated entity using the dividend valuation model with and without growth in dividends
- calculate the post-tax cost of debt for an incorporated entity including post-tax cost of bank borrowings, post-tax cost of bond and post-tax cost of convertible bonds up to and including conversion
- calculate the weighted average cost of capital (WACC) for an incorporated entity and understand its use and limitations
- calculate the yield to maturity on bonds

and answer questions relating to these areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 2 of your Study Text.

Overview


$WACC = k_e \left[\frac{V_E}{V_E + V_D}\right] + k_d \left[\frac{V_D}{V_E + V_D}\right]$
WACC
Cost of Equity
Cost of Debt
Dividend valuation model (DVM) with no growth in dividend
DVM with dividend growth
Irredeemable
Redeemable
$k_e = \frac{d}{P_0}$
$k_e = \frac{d_0(1+g)}{P_0} + g$
$K_d = \frac{i(1-T)}{P_0}$
IRR

1 Weighted Average Cost of Capital (WACC)

1.1 Definition of WACC

The weighted average cost of capital (WACC) is used as a discount rate when performing investment appraisals.

The WACC will be used when calculating a project's NPV to determine if a project is feasible.

The WACC is calculated as:

Cost of equity ($k_{e)}$ × proportion of total finance made up by equity	X
+	
Cost of debt ($k_{d)}$ × proportion of total finance made up by debt	X
	_____
	WACC
	_____

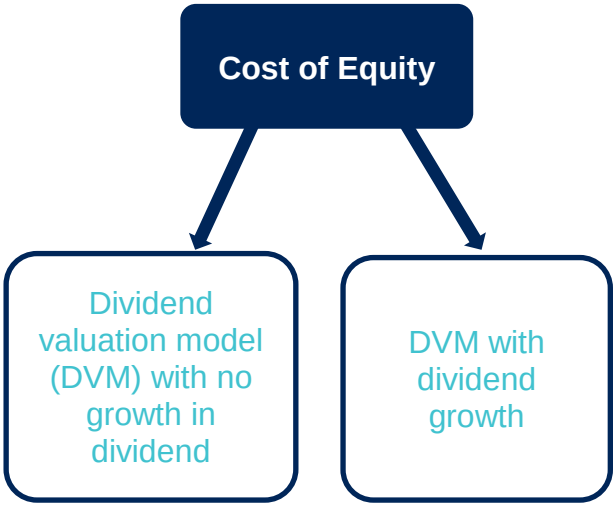
Each type of equity and debt finance will be included to work out the overall WACC for the entity.

To calculate WACC, a calculation of the cost of equity and the cost of debt must be performed.

Notes

2 Cost of equity

2.1 Summary of cost of equity options



Notes

2.2 Dividend valuation model (DVM) – expected constant dividends (no growth)

$$k_e = \frac{d}{P_o}$$

k_e = cost of equity

d = constant dividend

P_o = ex div market price of a share (ex div = AFTER dividend paid)

In exam questions prices could be quoted ex div or cum div. Read the question properly!

Illustrations and further practice

Now try TYU 1 as an illustration of cost of equity with constant dividend, from Chapter 2.

Notes

2.3 DVM with constant growth

$$k_e = \frac{d_o(1+g)}{P_o} + g$$

k_e = cost of equity

d_o = current dividend

P_o = ex div market price of a share (ex div = **AFTER** dividend paid)

g = constant rate of growth in dividends

Illustrations and further practice

Now try TYU 2 for illustration of cost of equity with constant dividend growth, from Chapter 2.

Notes

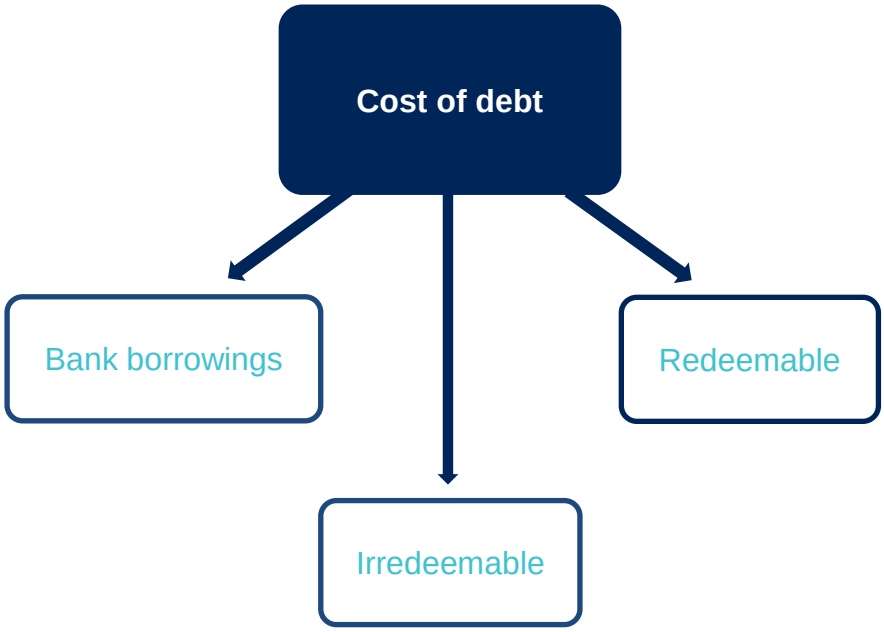
3 Cost of debt

3.1 Summary of cost of debt

If an entity takes out debt finance, they will need to pay interest associated with the debt. This is the main cost of the loan.

The interest incurred is deductible for tax purposes (the company can claim reductions in their tax bill).

Cost of debt calculations will always use the **POST** tax costs of the borrowings.



Notes

3.2 Cost of debt – bank borrowings

$$k_d = r(1-T)$$

k_d = cost of debt

r = annual % interest rate

T = corporate tax rate

Notes

3.3 Cost of debt – irredeemable and undated bonds

$$k_d = \frac{i(1+T)}{P_o}$$

k_d = cost of debt

i = interest paid each year (using coupon rate)

T = marginal tax rate

This formula can also be used for:

- redeemable bonds traded at par
- long dated debt

Illustrations and further practice

Now try TYU 3 for cost of debt on long dated bonds from Chapter 2

Notes

3.4 Cost of redeemable debt

To work out the cost of redeemable debt, an **IRR** calculation is required

Redeemable debt will create a number of cash flows for the entity.

They are:

- the initial receipt of cash (at market value)
- payments of interest (at the coupon rate) on pre-determined dates
- repayment of capital (possibly including a premium) on redemption

To work out IRR

- work out cash flows from borrowing,
- estimate IRR (gut feeling should cost be 5% or 10% or 20%?),
- calculate 2 NPVs either side of estimated IRR (e.g. if estimated IRR = 7.5% could use 5% or 10%). Hopefully one NPV = –ve and one NPV = + ve,
- calculate IRR using formula.

Interest cash flows need to be calculated **NET** of tax for the NPV calculations i(1–T).

Illustrations and further practice

Now try TYU 4 for cost of debt on redeemable bonds, from Chapter 2.

Notes

3.5 Comparison of cost of debt and yield to maturity

The cost of debt and the yield to maturity are very similar calculations. It is important to understand the main differences so mistakes are not made.

	Cost of debt ($k_{d)}$	**Yield to maturity (YTM)**
Who is it relevant to?	Entities applying for finance	Providers of debt finance (investors)
Interest	Net of tax = i(1–T) Interest creates a tax deduction which is incorporated into k_d	Gross of tax
Irredeemable	$\frac{i(1-T)}{P_o}$	$\frac{i}{P_o}$
Redeemable	IRR Interest cash flows net of tax	IRR Interest cash flows gross of tax

Notes

4 WACC calculation

Now we know how to determine the cost of capital, we can attempt the WACC calculation in its entirety.

STEP (1) – For each different type of finance (redeemable debt, irredeemable debt, equity) work out its proportion as a % of total finance using **Market** values,

STEP (2) – Determine the cost of each type of finance (as seen in section 2 & 3),

STEP (3) – (Results of step 1 × results of step 2) for each type of debt,

STEP (4) – Sum the totals of each result for step 3 = WACC.

Illustrations and further practice

Now try TYU 5 & 6 for WACC calculations from Chapter 2.

Notes

5 Using WACC

WACC should only be used when performing an investment appraisal if:

- the capital structure is constant,
- new investment carries same business risk profile of entity,
- new investment is marginal to the entity.

Notes

OT Questions

You should now be able to answer TYU 1–7 from Chapter 2 of the Study Text and questions 14–30 from the Exam Practice Kit.

For further reading, visit Chapter 2 of the Study Text.

Chapter 3

Financial instruments

Outcome

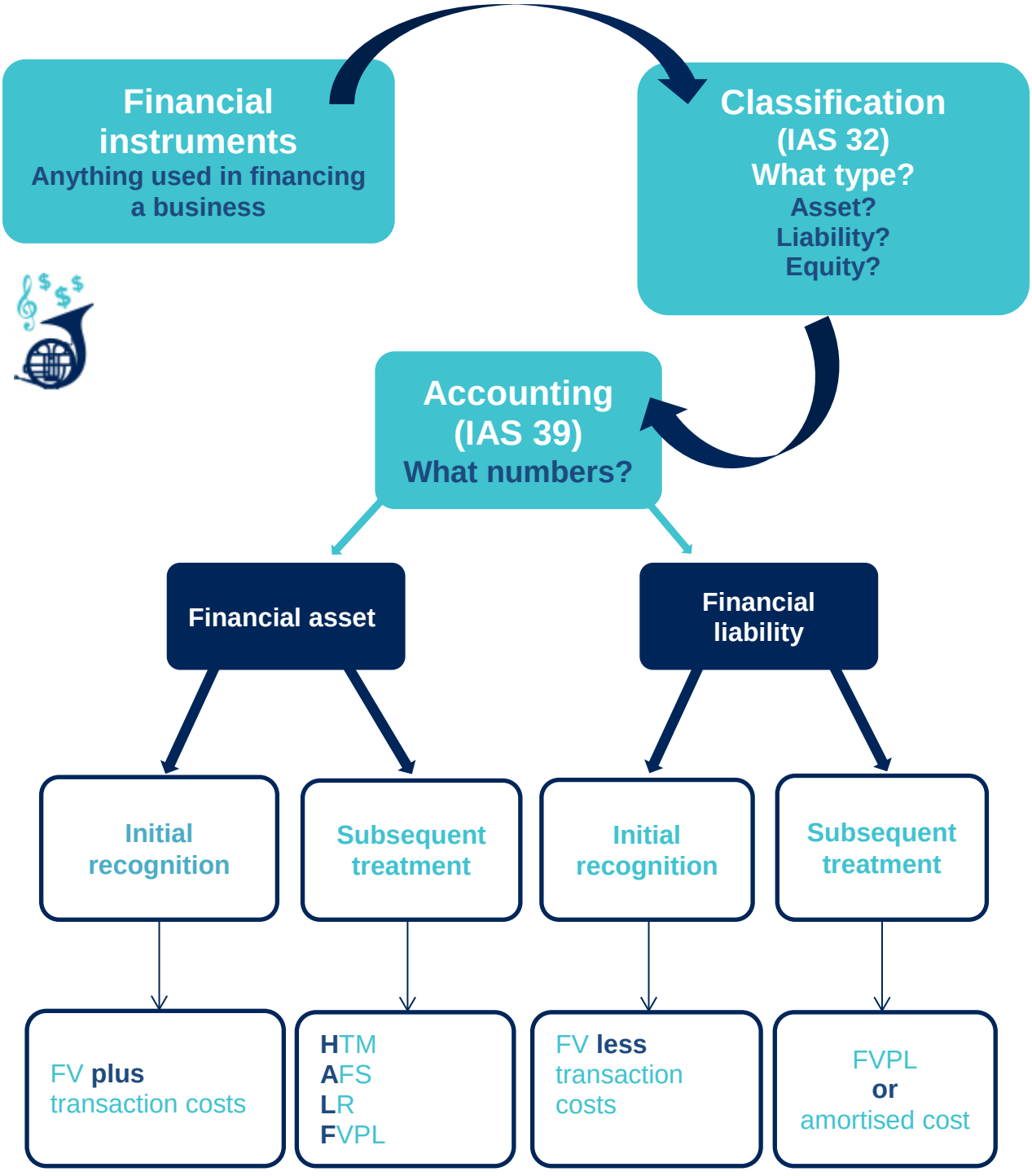
At the end of this session you should be able to:

- discuss the provisions of relevant international accounting standards in respect of the recognition and measurement of financial instruments, in accordance with IAS 32 and IAS 39 (excluding hedge accounting)
- produce the accounting entries, in accordance with relevant international accounting standards,

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 3 of your Study Text.

Overview


Financial instruments
Anything used in financing a business
Classification (IAS 32)
What type?
Asset?
Liability?
Equity?
Accounting (IAS 39)
What numbers?
Financial asset
Financial liability
Initial recognition
Subsequent treatment
Initial recognition
Subsequent treatment
FV plus transaction costs
HTM
AFS
LR
FVPL
FV less transaction costs
FVPL
or
amortised cost

1 What are financial instruments?

1.1 Definitions of financial instruments

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

Still not sure what a financial instrument actually is?

Think of them as anything that is used in financing a business. e.g. loans, shares

Anything that is used in **PROVIDING** finance = **FINANCIAL ASSET**

Anything that is used in **OBTAINING** finance = **FINANCIAL LIABILITY OR EQUITY**

Notes

1.2 Examples of financial instruments

Financial assets (PROVIDE finance)

- cash
- an equity instrument of another entity
- a contractual right to receive cash from another entity
- a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable.

Financial liabilities (OBTAIN finance)

- A contractual obligation to deliver cash to another entity.
- A contractual right to exchange financial instruments with another entity under conditions that are potentially unfavourable.

Equity instrument (OBTAIN finance)

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Notes

1.3 Financial asset or financial liability?

In an exam scenario, it is important that you can spot the difference between the types of instrument. The wording of the scenario is crucial in order to accurately determine the type of instrument involved.

Action	Examples	Providing or obtaining finance?	Instrument
BUYS bonds/debentures	➢ Company buys a 5% debenture for £1m	Providing	**Asset**
BUYS shares	➢ Company buys 1m $1 shares at $1.5	Providing	**Asset**
ISSUES bond/debenture	➢ Company issues a 5% debenture for £1m	Obtaining	**Liability**
ISSUES shares	➢ Company issues 1m $1 shares at $1.5	Obtaining	**Equity**

Notes

2 Classification of financial instruments

2.1 Classification of financial instruments (IAS 32)

IAS 32 considers how companies should classify the various methods of OBTAINING finance**.**

Can classify as either a:

- financial liability, or an
- equity instrument.

Notes

How do you think we should classify the following specific methods of financing an entity?

Instrument	Classification
Ordinary shares	Equity
Loans	Liability
Debentures/loan stock/loan notes/bonds	Liability
Preference shares	Depends! If obligation to deliver cash exists = liability e.g redeemable preference shares or include cumulative preference dividends If no obligation exists = equity e.g irredeemable preference shares with dividends that are not cumulative.
Convertible loans (loans that can be turned into shares in the future)	Both! Hybrid instruments contain both liability components and equity components.

Notes

2.2 Convertible loan initial recognition

Step 2 – PV of cash flows	X	
Step 3 – Equity	X	β
Step 1 – Cash from loan	X	

Journal to record convertible loan

Dr Cash	**(from step 1)**
Cr Liability	**(from step 2)**
Cr Equity	**(from step 3)**

The accounting treatment above illustrates the **INITIAL** recognition of the convertible loan only.

The liability would be subsequently treated at **amortised cost** (see section 3.3).

Notes

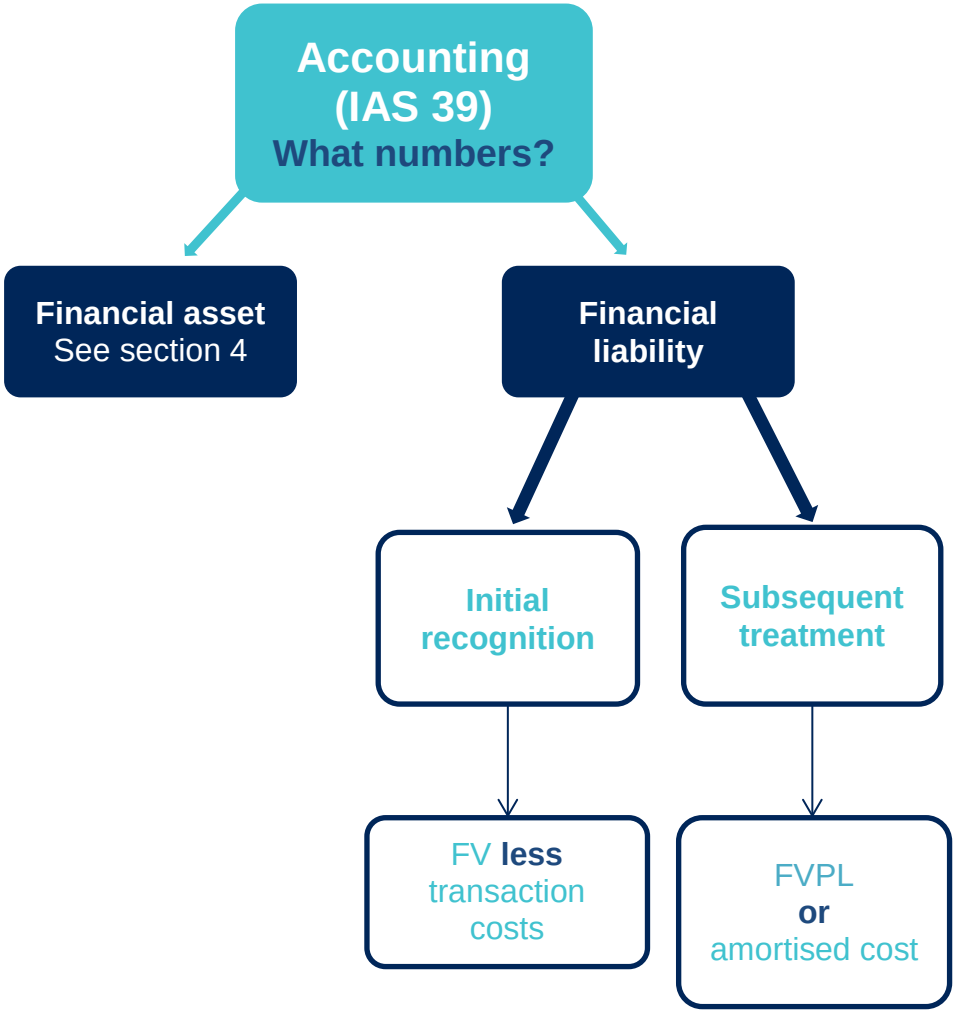
Illustrations and further practice

Now try TYU 7 part (a) to illustrate the initial recognition of a convertible loan from Chapter 3

Notes

3 IAS 39 – Financial liabilities

3.1 Summary of financial liabilities under IAS 39



3.2 Initial recognition of financial liabilities

Per IAS 39, financial liabilities are initially recorded at FAIR VALUE **LESS** transaction costs.

N.B. If FVPL, transaction costs are taken to P/L as an expense.

Par value of liability	x
Less discount	(x)
Cash received	x
Less Transaction costs	(x)
Amount initially recorded	x

Dr Cash

Cr Financial Liability

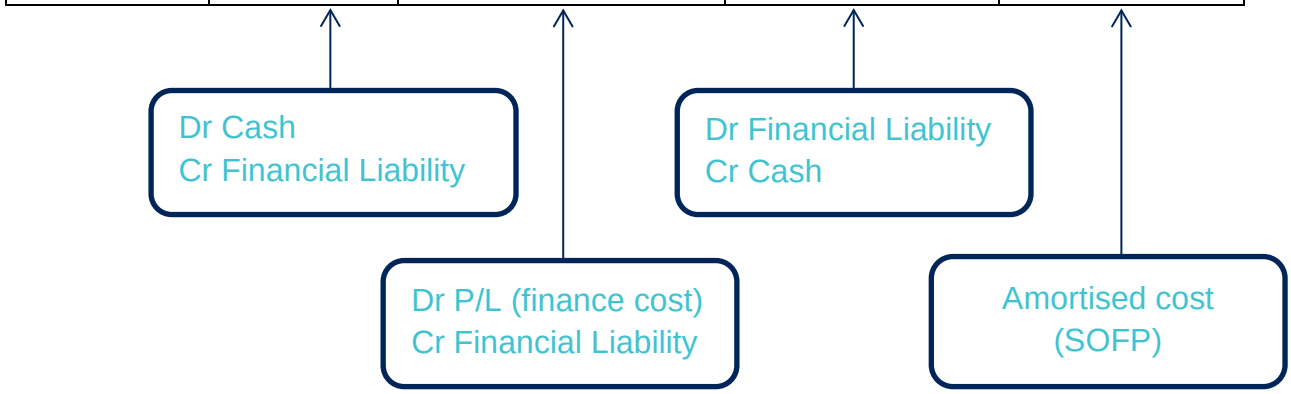
Notes

3.3 Subsequent treatment of financial liabilities

Financial liabilities are typically shown at amortised cost.

Amortised cost accounting

	Opening balance	Interest (at effective IR %)	Repayment (at coupon rate)	Closing balance
Year 1	X	X	(X)	X
Year 2	X	X	(X)	X



Liabilities that are held for trading can be designated as FVPL financial liabilities. See section 4.3 for a definition of FVPL.

Loss making derivatives (shown as financial liabilities) are also FVPL.

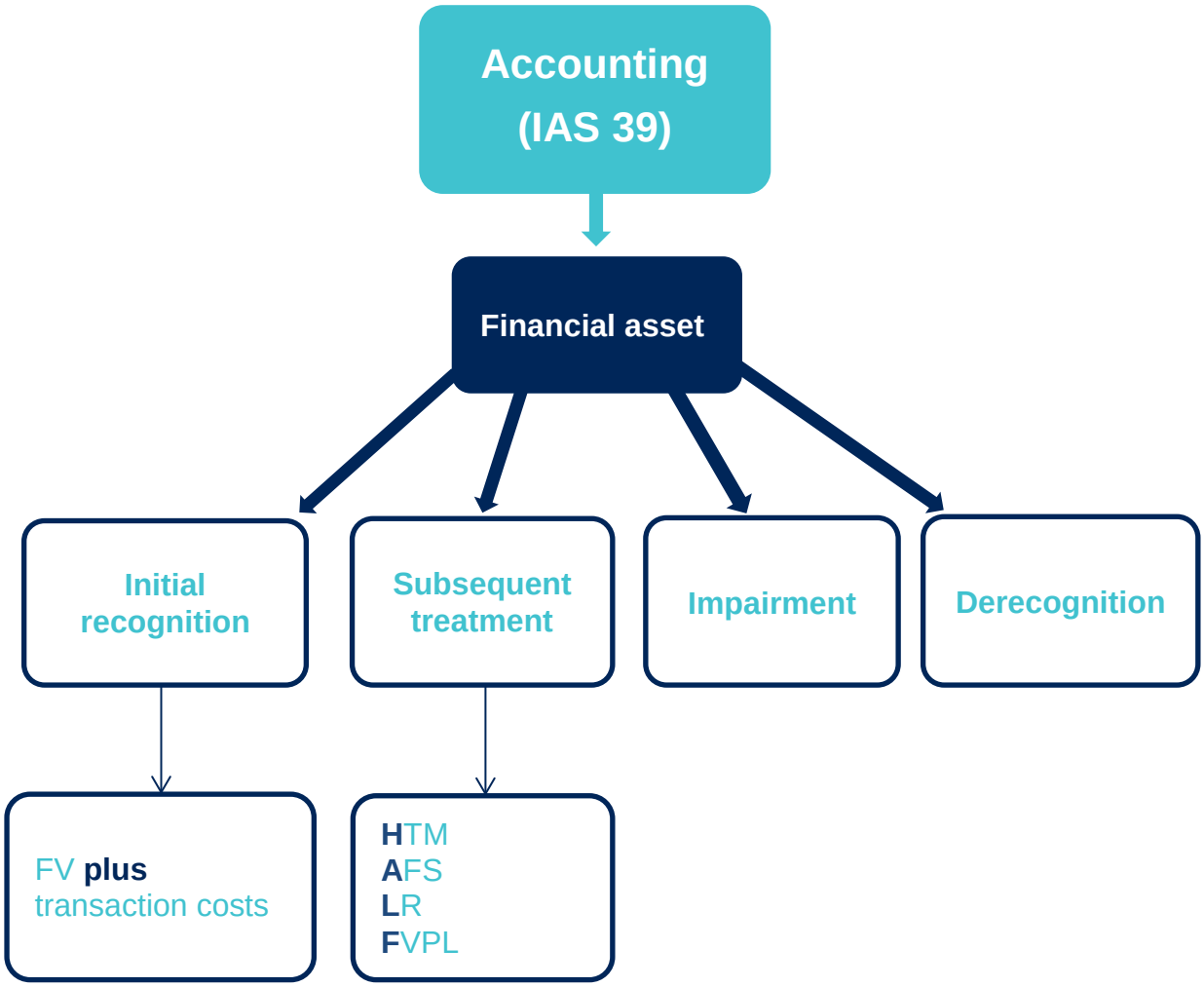
Illustrations and further practice

From Chapter 3, now try TYU 3 for an illustration of the accounting of a financial liability

Notes

4 IAS 39 – Financial assets

4.1 Summary of financial assets under IAS 39



Notes

4.2 Initial recognition of financial assets

Financial assets are initially recorded at their FAIR VALUE (normally cost) **PLUS** transaction costs.

N.B. If the asset is classified as FVPL, the transaction costs are taken to P/L as an expense.

Journal entry

Dr Financial Asset

Cr Cash

Notes

4.3 Subsequent treatment of financial assets

Financial assets will be categorised into 4 separate classifications, with differing accounting treatments.

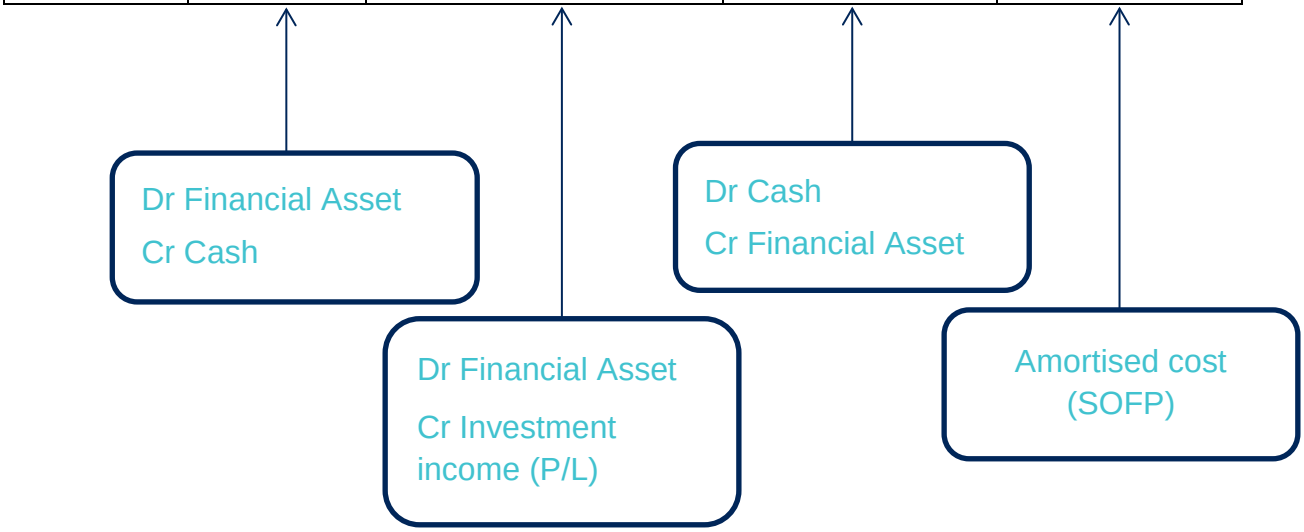
Candidates must be able to differentiate between the types of FA.

Financial asset classification	Definition	Subsequent treatment
Fair value through profit or loss (FVPL)	▪ Held for trading (short term), or ▪ Any derivative.	▪ Revalue to fair value, ▪ Gains/losses to P/L.
Held to maturity (HTM)	▪ Fixed and determinable repayments, ▪ Intention to hold until maturity date, ▪ Quoted.	▪ Amortised cost
Loans and receivables (LR)	▪ Fixed and determinable repayments, ▪ Not quoted.	▪ Amortised Cost
Available for sale (AFS)	▪ Any financial asset that does not meet the definitions of other categories.	▪ Revalue to fair value ▪ Gains/losses in reserves/OCI

Notes

Amortised cost accounting – financial assets

	Opening balance	Interest (at effective rate %)	Receipt (at coupon rate)	Closing balance
Year 1	X	X	(X)	X
Year 2	X	X	(X)	X



Notes

Illustrations and further practice

Now try TYU 12 for an illustration of the accounting of a financial asset held at amortised cost from Chapter 3.

Then try TYU 13 for an illustration of the accounting of FVPL and AFS financial assets from Chapter 3.

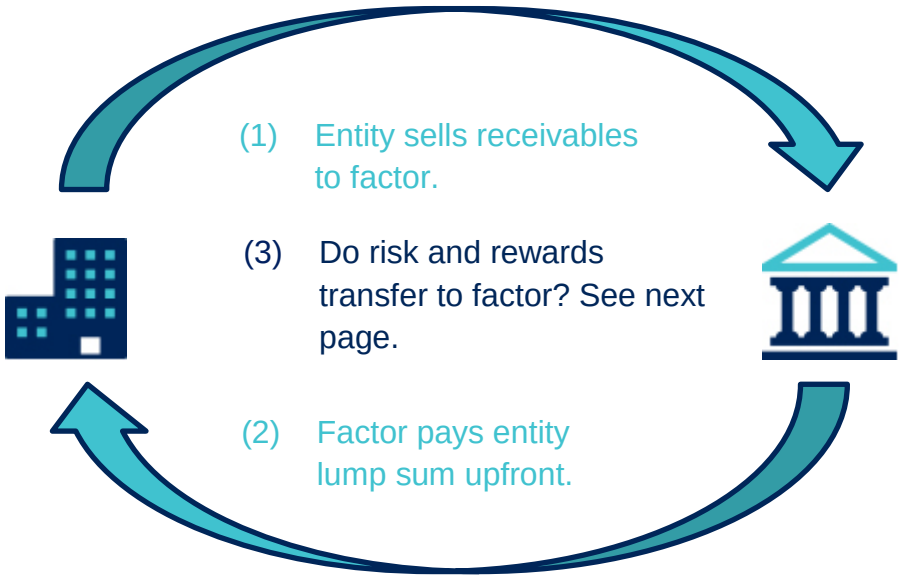
Notes

4.4 Derecognition of financial assets

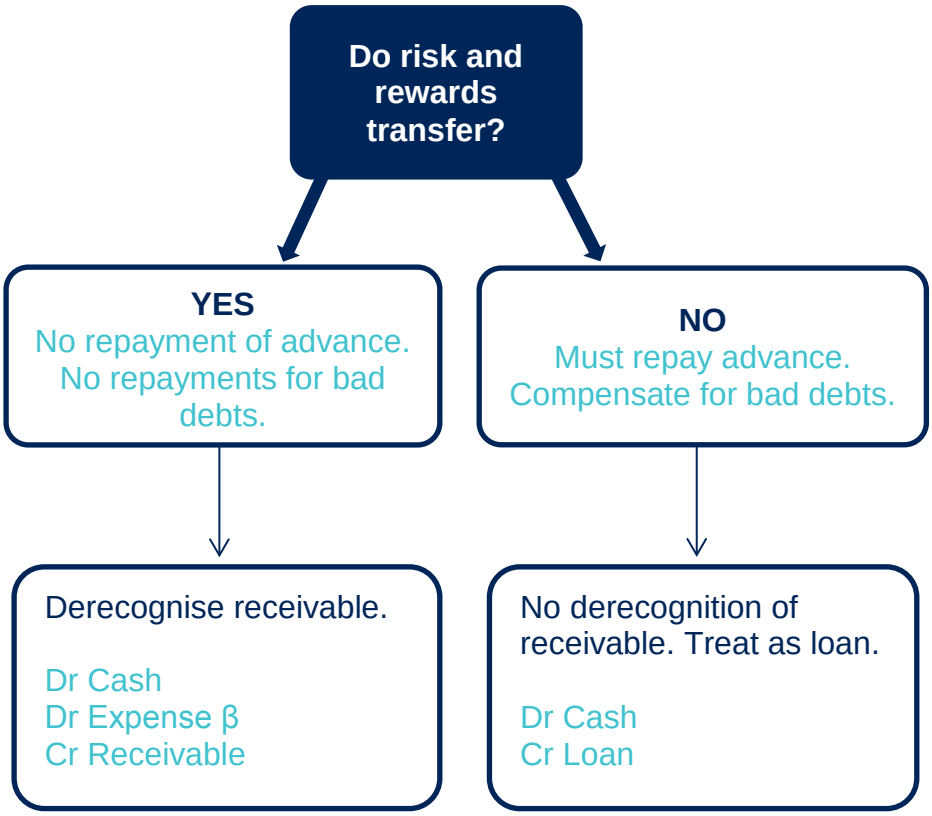
Only derecognise a financial asset if:

- the contractual rights to the cash flows expire
- the **RISKS** and **REWARDS** are transferred.

Examinable scenario – factoring



Notes


Do risk and rewards transfer?
YES
No repayment of advance.
No repayments for bad debts.
NO
Must repay advance.
Compensate for bad debts.
Derecognise receivable.
Dr Cash
Dr Expense β
Cr Receivable
No derecognition of receivable. Treat as loan.
Dr Cash
Cr Loan

Notes

5 Derivatives

5.1 Definition

A derivative is a financial instrument that derives its value from changes in the value of underlying items (typically from volatile markets) e.g. shares, commodities, exchange rates and interest rates.

5.2 Characteristics

- Its value changes in response to changes in an underlying item.
- It requires little or no initial investment.
- It is settled at a future date.

They also must be speculative in nature (the entity does not intend to take delivery of or trade the underlying item).

Notes

5.3 Common examples of derivatives

Forwards – contract to buy or sell at a date in the future at a specific price determined now (based on today's prices).

Future – same as forward but an active market exists (forwards are bespoke; futures all have the same characteristics).

Options – Option to buy or sell in the future at a price set now. Less risky as do not need to go through with the option if it is loss making.

5.4 Accounting for derivatives

Derivative are classified as FVPL.

- Revalue to FV.
- G/L to P/L.

If derivative makes a gain – show as a financial asset.

If derivative makes a loss – show as a financial liability.

Notes

Illustrations and further practice

Now try TYU 18 for an illustration of the accounting of a derivative from Chapter 3

Notes

Notes

OT Questions

You should now be able to answer TYU 1–21 from Chapter 3 of the Study Text and questions 31–48 from the Exam Practice Kit.

For further reading, visit Chapter 3 of the Study Text.

Chapter 4

Share based payments

Outcome

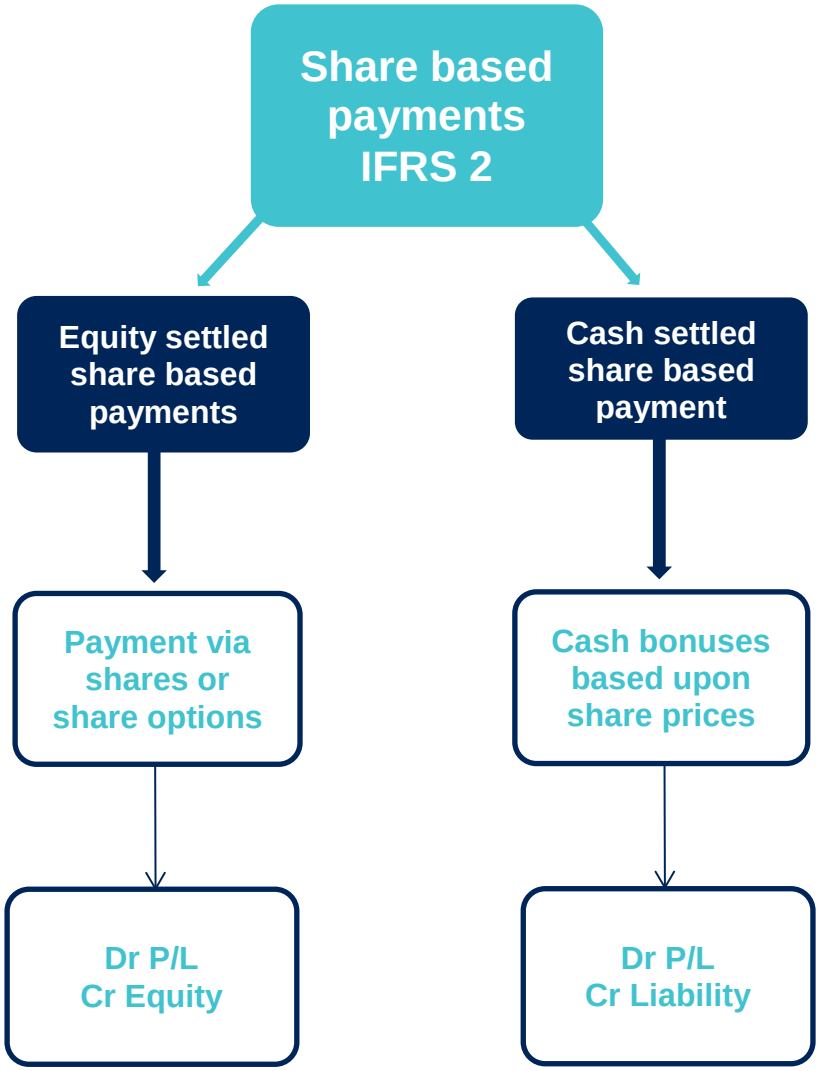
At the end of this session you should be able to:

- understand and account for equity settled share based payments
- understand and account for cash settled share based payments (SAR's)

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 4 of your Study Text.

Overview


Share based payments IFRS 2
Equity settled share based payments
Cash settled share based payment
Payment via shares or share options
Cash bonuses based upon share prices
Dr P/L
Cr Equity
Dr P/L
Cr Liability

1 Equity settled share based payments

1.1 Definitions

An equity settled share based payment arises when an entity pays staff for their services or pays other parties (typically for goods purchased) by issuing shares or share options.

The following terms are important.

Grant date – date that the share based payment comes into existence (is granted).

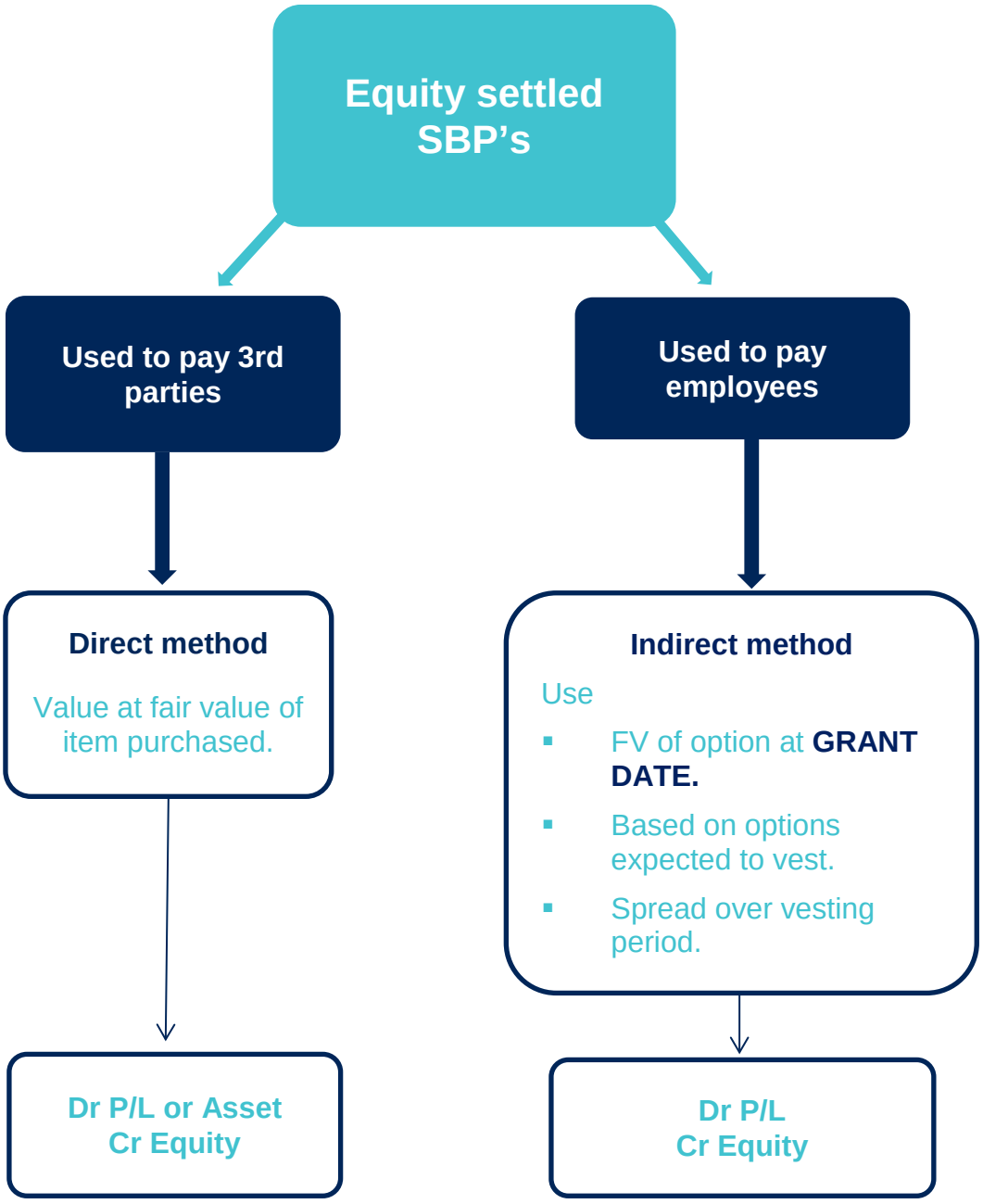
Vesting date – date that all conditions associated with SBP are met so options CAN be turned into shares.

Exercise date – date the options ARE turned into shares.

Vesting period – period from grant date to vesting date.

Notes

1.2 Accounting for equity settled share based payments



Notes

Illustrations and further practice

Now work through TYU 1 to illustrate the accounting of equity settled share based payments from Chapter 4.

Notes

2 Cash settled share based payments

2.1 What are cash settled share based payments?

Bonuses paid in cash to employees based upon share prices.

e.g. if the share price on an entity is above $5 at a certain date, the entity pays the excess above $5 to its staff as a cash payment.

Cash settled SBP's are also known as share appreciation rights (SAR's).

Notes

2.2 Cash settled share based payment recognition

Use:

- FV of SAR at **YEAR END.**
- Based on SAR's expected to vest.
- Spread over vesting period.

Dr P/L

Cr Liability

Notes

Illustrations and further practice

Now try TYU 3 to illustrate the accounting of equity settled share based payments from Chapter 4

Notes

Notes

OT Questions

You should now be able to answer TYU 1–6 from Chapter 4 of the Study Text and questions 49–53 from the Exam Practice Kit.

For further reading, visit Chapter 4 of the Study Text.

Chapter 5

Earnings per share

Outcome

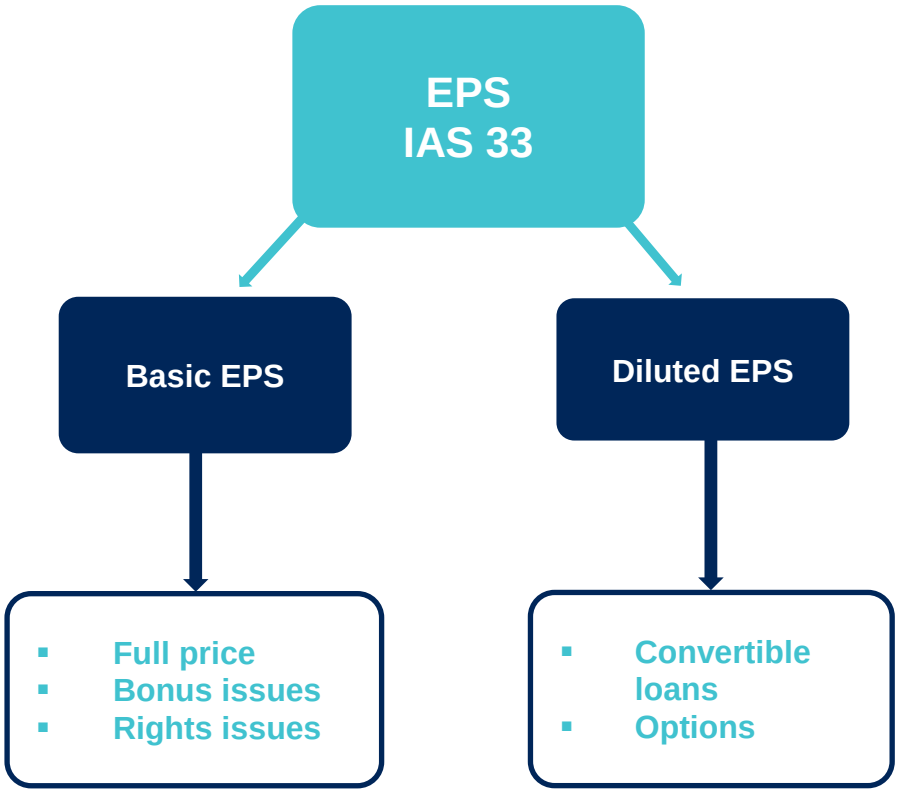
At the end of this session you should be able to:

- produce the disclosures for earnings per share
- calculate basic and diluted earnings per share

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 5 of your Study Text.

Overview


EPS
IAS 33
Basic EPS
Diluted EPS
Full price
Bonus issues
Rights issues
Convertible loans
Options

1 Earnings per share

1.1 Objective of earnings per share (EPS)

- EPS is an analysis tool used to assess a company's performance.
- It is used by potential users of the financial statements in its own right and is part of the P/E ratio.
- PLC's must disclose basic and diluted EPS.

Notes

2 Basic EPS

1.2 Calculation of basic EPS

$$\frac{\text{Earnings (profits attributable to ordinary shareholders)}}{\text{Weighted average number of ordinary shares}}$$

Earnings = PAT – NCI share of profits – irredeemable preference share dividends

Why are redeemable preference share dividends not removed from earnings?

They should be treated as finance costs so are already incorporated within PAT.

Notes

Weighted average number of ordinary shares (WAV)

For EPS, the year-end number of shares in existence does not suffice for the basic EPS calculation. This is because specific types of shares issues may have occurred during the year.

To accurately calculate WAV, the impact of the following types of share issues must be considered:

- full price issues
- bonus issues
- rights issues

Notes

2 Basic EPS: Full price share issues

2.1 Weighted average number of shares: full price share issues

Cash is generated from share issues. These share issues contribute to earnings potential.

The number of shares is time apportioned.

Actual number of shares in issue	n/12	
number of shares before share issue	months before share issue/12	X
number of shares after share issue	months after share issue/12	X
		WAV

Illustrations and further practice

Now work through TYU 1 or TYU 2 to illustrate the impact of full price share issues on basic EPS from Chapter 5.

Notes

3 Basic EPS: Bonus issues

3.1 Weighted average number of shares: Bonus issues

A bonus issue is an issue of shares to existing shareholders based on their existing shareholding for **FREE.**

A 1 for 4 bonus issue leads to one new free share for every four shares currently held.

EPS calculations treat these share issues as if they have always been in existence.

Any share issues **BEFORE** the bonus issue must be scaled up by the **BONUS FRACTION.**

$$\text{Bonus fraction} = \frac{\text{Shares after the bonus issue}}{\text{Share before the bonus issue}}$$

Notes

WAV calculation with a bonus issue

Actual number of shares in issue	n/12	Bonus Fraction	
number of shares before share issue	months before share issue/12	BF	X
number of shares after bonus issue	months after share issue/12		X
			WAV

Notes

3.2 Bonus issues and comparatives

Bonus issues are treated as if they have always existed.

Therefore, the impact of the bonus issue on the comparative (last years) EPS calculation must be considered.

IAS 33 is treating the bonus issue as if it had also occurred in the previous year.

> Adjusted comparative EPS = Last years' EPS × inverse of the bonus fraction

Illustrations and further practice

Now work through TYU 4 to illustrate the impact of bonus issues on basic EPS and TYU 5 to illustrate the impact on comparatives from Chapter 5.

Notes

4 Basic EPS: Rights issues

4.1 Weighted average number of shares: rights issues

A rights issue is an issue of shares to existing shareholders based on their existing shareholding at a discounted price

Rights issues are considered, for EPS purposes, as:

- **part full price issue**
- **part bonus issue.**

Bonus issues are treated as if they have always existed, so are scaled up by the bonus fraction.

The same treatment is applied to rights issues. They have a free element so it will be necessary to scale up any shareholdings before the rights issue by a bonus fraction.

Notes

Bonus fraction for a rights issue

$$\frac{\text{Cum rights price}}{\text{Theoretical ex rights price}} = \frac{\text{CRP}}{\text{TERP}}$$

Notes

WAV calculation with a rights issue

Actual number of shares in issue	n/12	Bonus Fraction	
number of shares before rights issue	months before share issue/12	BF	X
number of shares after rights issue	months after share issue/12		X
			WAV

Just like a bonus issue, the impact of the rights issue on the comparative EPS calculation must be considered.

Adjusted comparative EPS = Last years' EPS × inverse of the bonus fraction

Notes

Illustrations and further practice

Now work through TYU 7 & 8 to illustrate the impact of rights issues on basic EPS and TYU 9 to illustrate the impact on comparatives, from Chapter 5.

Notes

5 Diluted EPS

5.1 What is diluted EPS and why is it needed?

At the year-end, transactions may exists that could create future shares issues. e.g.

- convertible loans
- options.

Diluted EPS provides investors with further information about the impact of these potential shares on EPS. It provides a worst case scenario EPS calculation.

Diluted EPS (DEPS) is calculated as:

$$\frac{\text{Earnings + notional extra earnings}}{\text{WAV number of ordinary share + notional extra shares}}$$

Notes

5.2 Convertible loans and DEPS

What is a convertible loan? (See Chapter 3 section 2 for further info)

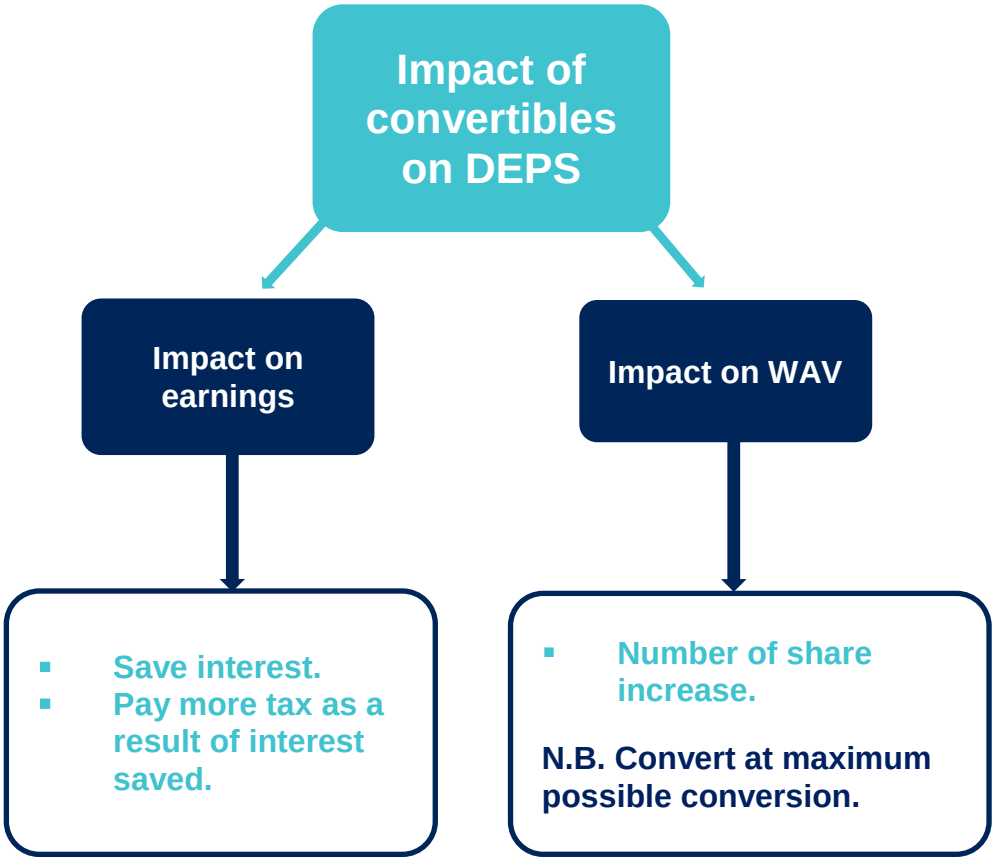
A convertible loan is a loan that can be turned into shares.

A convertible could create future shares. The potential future shares could impact EPS.

DEPS must show the impacts on EPS of the loan being converted into shares.

Notes

What impact will converting a loan into shares have on EPS?



Notes

Illustrations and further practice

Now work through TYU 11 to illustrate the impact of convertible loans on diluted EPS, from Chapter 5.

Notes

5.3 Share options and DEPS

What are share options?

A share option gives the holder an option to buy shares at a set price in the future.

e.g. option to buy shares at $2.

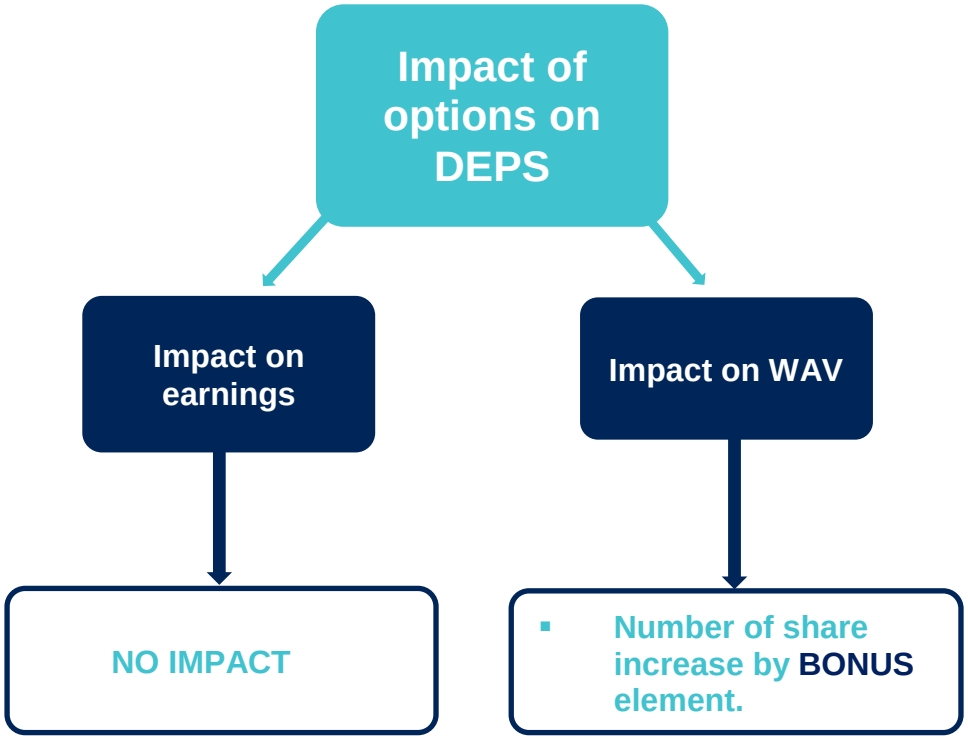
The option will only be exercised if the holder will make a gain. The holder will buy at a cheap price. e.g. share price is actually $3; option to buy at $2.

DEPS treats options as potential discounted shares. Options are considered as being:

- part full price share issue
- part free/bonus issue.

The free/bonus issue element is treated as if it already exists within the DEPS calculation.

Notes


Impact of options on DEPS
Impact on earnings
Impact on WAV
NO IMPACT
Number of share increase by BONUS element.

Notes

To work out the free shares

Step 2. Number of full price shares purchased with cash from options	x	
Step 3. Bonus shares	x	β
Step 1. Number of options in existence	x	

DEPS calculation with option

$$\frac{\text{Earnings}}{\text{WAV number of ordinary share + Bonus shares from step 3}}$$

Notes

Illustrations and further practice

Now work through TYU 12 to illustrate the impact of options on diluted EPS, from Chapter 5.

Notes

OT Questions

You should now be able to answer TYU 1–15 from Chapter 5 of the Study Text and questions 54–63 from the Exam Practice Kit.

For further reading, visit Chapter 5 of the Study Text.

Chapter 6

Leases

Outcome

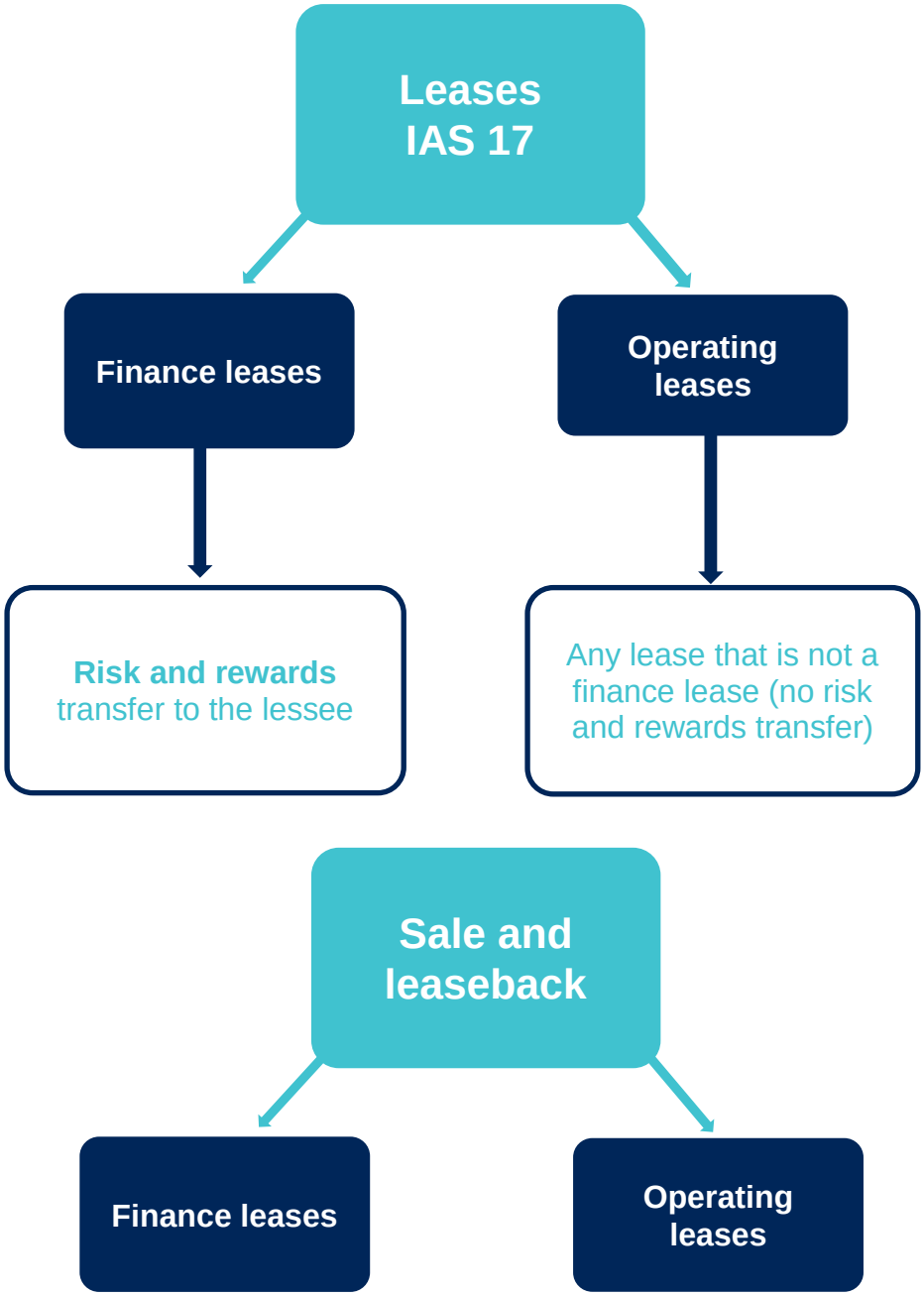
At the end of this session you should be able to:

- differentiate between finance and operating leases
- prepare the accounting entries for finance leases and operating leases
- prepare the accounting entries for sale and leaseback arrangements

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 6 of your Study Text.

Overview


Leases
IAS 17
Finance leases
Operating leases
Risk and rewards
transfer to the lessee
Any lease that is not a finance lease (no risk and rewards transfer)
Sale and leaseback
Finance leases
Operating leases

1 Finance Leases

1.1 Definition of a finance lease

A finance lease is any lease where the risks and rewards transfer to the lessee

1.2 Characteristics of a finance lease

- Legal title is transferred to the lessee at the end of the lease.
- The lessee has the option to purchase the asset for a price substantially below FV.
- The lease term is the majority of the economic lifetime.
- The present value of the minimum lease payments amounts to substantially all of the FV of the asset.
- The asset is highly specialised so that only the lessee can use the asset without major modification.
- The lessee bears losses from cancelling the lease.

Notes

1.2 Accounting for finance leases

4 steps

(1) Capitalise the asset

Dr Asset

Cr Finance Liability

Capitalise at the lower of:

- PV of minimum lease payments
- FV of the asset

(2) Depreciate the asset

Dr Depreciation expense

Cr Asset

Depreciate over the lower of:

- Lease term
- Useful economic life of the asset

(3) Record interest expense

Dr Finance cost

Cr Finance lease liability

Interest will be allocated using:

- Actuarial method (%)
- Sum of digits

(4) Record lease payment and show current and noncurrent liability split

Dr Finance lease liability

Cr Cash

Notes

Financial lease liability workings

Lease payments in arrears

	Opening balance	Interest	Lease payment	Closing balance
Year 1	X	X	(X)	**A**
Year 2	X	X	(X)	**B**

Current liability = A–B

Non-current liability = B

Lease payments in advance

	Opening balance	Lease payments	Sub–total	Interest	Closing balance
Year 1	X	(X)	X	X	**A**
Year 2	X	(X)	**B**		

Current liability = A–B

Non-current liability = B

Notes

Illustrations and further practice

Now work through TYU 4 (a) for illustration of finance lease accounting with payments in arrears and advance, from Chapter 6.

Notes

2 Operating leases

2.1 Definition of an operating lease

An operating lease is any lease that is not a finance lease.

No risk and reward transfer to the lessee.

2.2 Accounting for an operating lease

- No capitalisation of the asset.
- Lease rentals are charged to the P/L on a systematic basis over the lease term (typically straight line).
- Difference between amount in P/L and the cash payment is recognised as a prepayment or accrual.

Dr Rental expense

Cr Cash

Cr/Dr Accrual/Prepayment

Notes

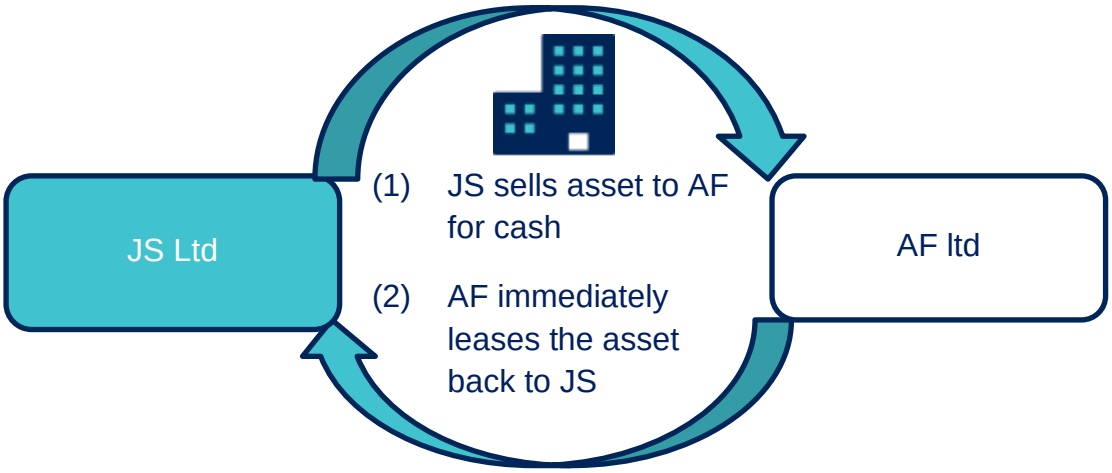
Illustrations and further practice

Now work through TYU 1 for illustration of operating lease accounting, from Chapter 6

Notes

3 Sales and leaseback

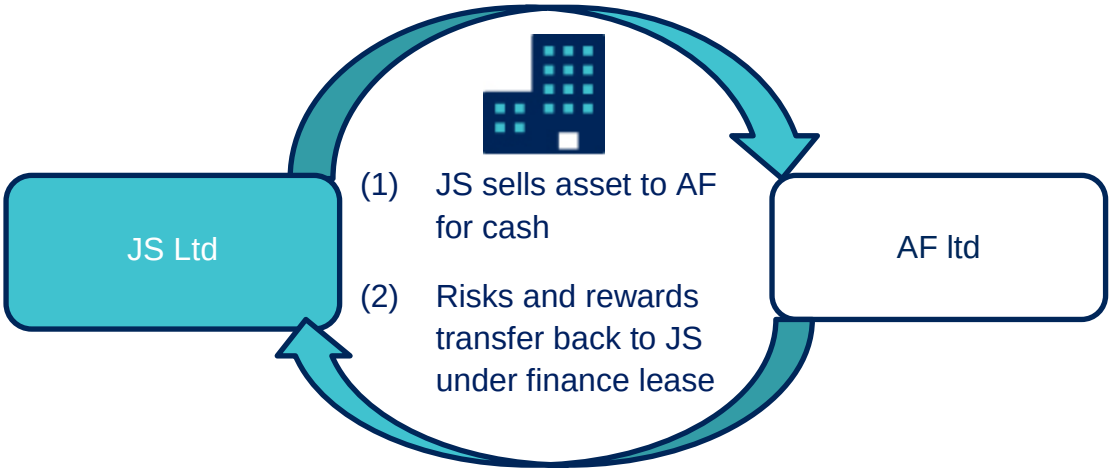
3.1 What is a sales and leaseback arrangement?



The accounting treatment for sales and leaseback depends on the type of lease involved.

Notes

3.2 Sale and finance leaseback



In substance, no real sale happens, this is a LOAN arrangement. The risks and rewards of the asset do not leave the seller.

Notes

The accounting consists of 2 main steps.

(1) The asset is derecognised and any gain or loss on disposal is deferred over the lease term

➢ To derecognise the asset:

Dr Cash

Cr PPE

Cr Deferred Income

➢ To release deferred income over lease term

Dr Deferred Income

Cr P/L

(2) Record as a finance lease (using 4 steps as per section 1.2)

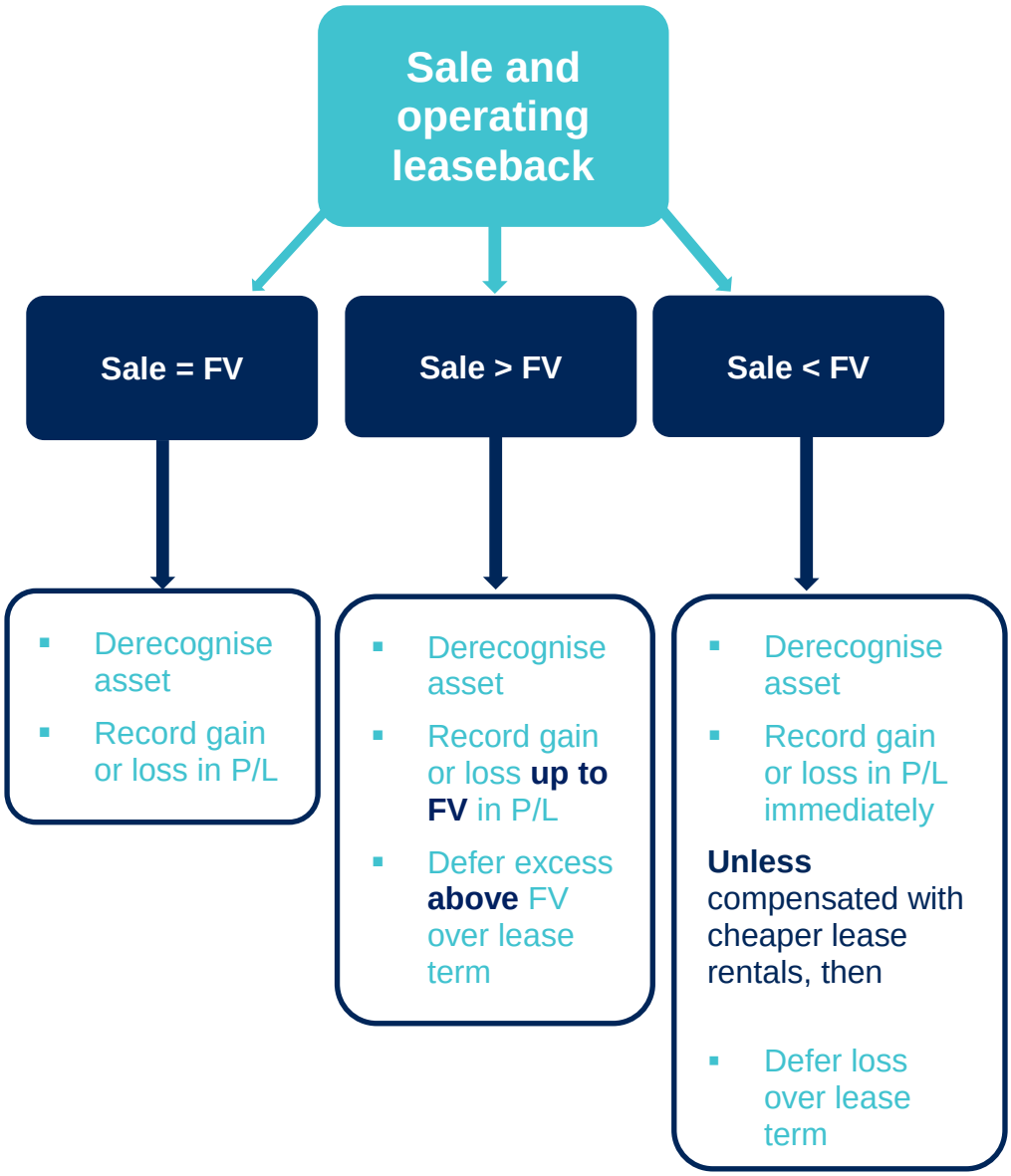
Illustrations and further practice

Now work through TYU 11 (5) to illustrate the accounting of a sale and finance leaseback, from Chapter 6.

Notes

3.3 Sale and operating leaseback

The treatment of an operating leaseback depends on the selling price agreed.



Notes

Illustrations and further practice

Now attempt TYU 9 to illustrate the accounting of a sale and operating leaseback from Chapter 6.

Notes

OT Questions

You should now be able to answer TYU 1–11 from Chapter 6 of the Study Text and questions 64–68 from the Exam Practice Kit.

For further reading, visit Chapter 6 of the Study Text.

Chapter 7

Revenue

Outcome

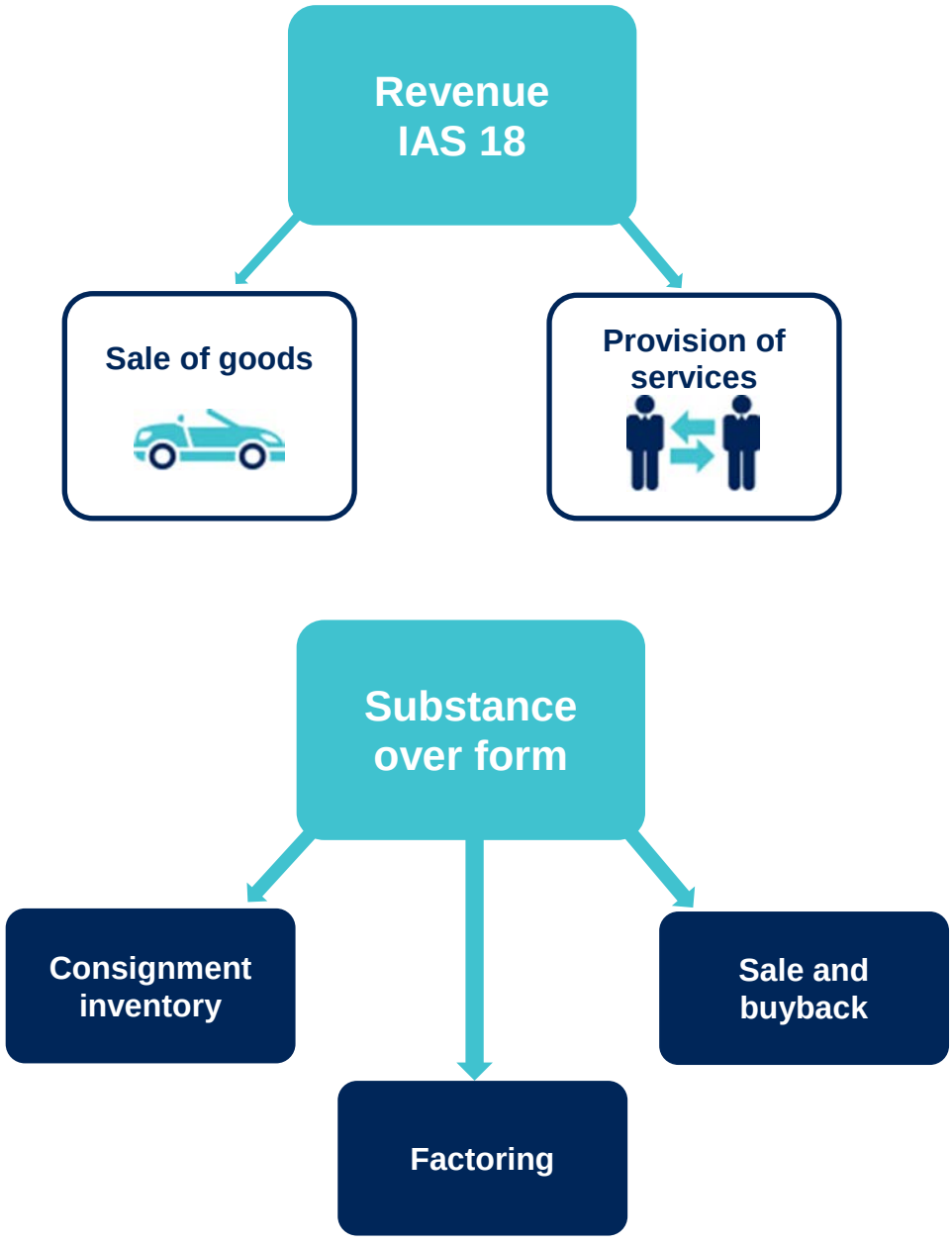
At the end of this session you should be able to:

- understand the principles of accounting for revenue from sales of both goods and services
- discuss the principles of substance over form and apply them to sale and buyback, consignment stock and factoring arrangements

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 7 of your Study Text.

Overview


Revenue
IAS 18
Sale of goods
Provision of services
Substance over form
Consignment inventory
Factoring
Sale and buyback

1 Revenue

1.1 The objective of IAS 18

When should a company recognise revenue?

- On despatch?
- On delivery?
- On signing of a contract?

- On installation?
- On completion?
- On receipt of payment?

The answer is dependent on the terms and conditions of the sale and the type of product on offer.

IAS 18 sets out rules for recognition of revenue dependent on whether the company sales good or provides a service.

Notes

1.2 Revenue recognition on the sale of goods

Revenue should be recognised when all of the following criteria have been met:

- the significant **RISKS AND REWARDS** of ownership have transferred to the buyer
- the seller does not retain continuing managerial involvement or control over the good
- revenue can be measured reliably
- probable economic benefit will flow to the entity
- costs can be measured reliably.

1.3 Revenue recognition on the provision of services

Revenue should be recognised when all of the following criteria have been met:

- revenue can be measured reliably
- probable economic benefit will flow to the entity
- the **STAGE OF COMPLETION** can be measured reliably
- costs can be measured reliably.

Consider the following companies. When do you think they would recognise revenue?

Tesco? Tins of beans – at point of sale

Vodafone? Phone – on despatch to customer/POS, line rental – as service provided

Kaplan? As courses progress

Notes

Illustrations and further practice

Now work through TYU 1 and set any from TYU 2–4 from Chapter 7

Notes

2 Substance

2.1 What is substance over form?

The IASB framework outlines that accountant should apply the commercial substance over the legal form.

This means that accountants are more interested in the business (commercial) reality rather than what the law decrees.

What examples have we seen so far where substance over form is applied in the accounts?

Tutor notes guidance – discussion points

- Finance Leases.
- Factoring.
- Redeemable preference dividends.

Notes

2.2 Substance and revenue

Examples exist where legally it appears that a sale has occurred but, with consideration of the substance of the arrangement, a different transaction is accounted for.

Examples relevant for F2 include:

- sale or return arrangements (consignment inventory)
- factoring (see Chapter 3, section 4.4)
- sale or buyback arrangements.

Consideration of whether RISKS and REWARDS have transferred will determine the appropriate accounting treatments.

Notes 

2.3 Sale or return (consignment inventory)

A sale is made where the customer can return the goods to the supplier if the customer cannot sell the product.

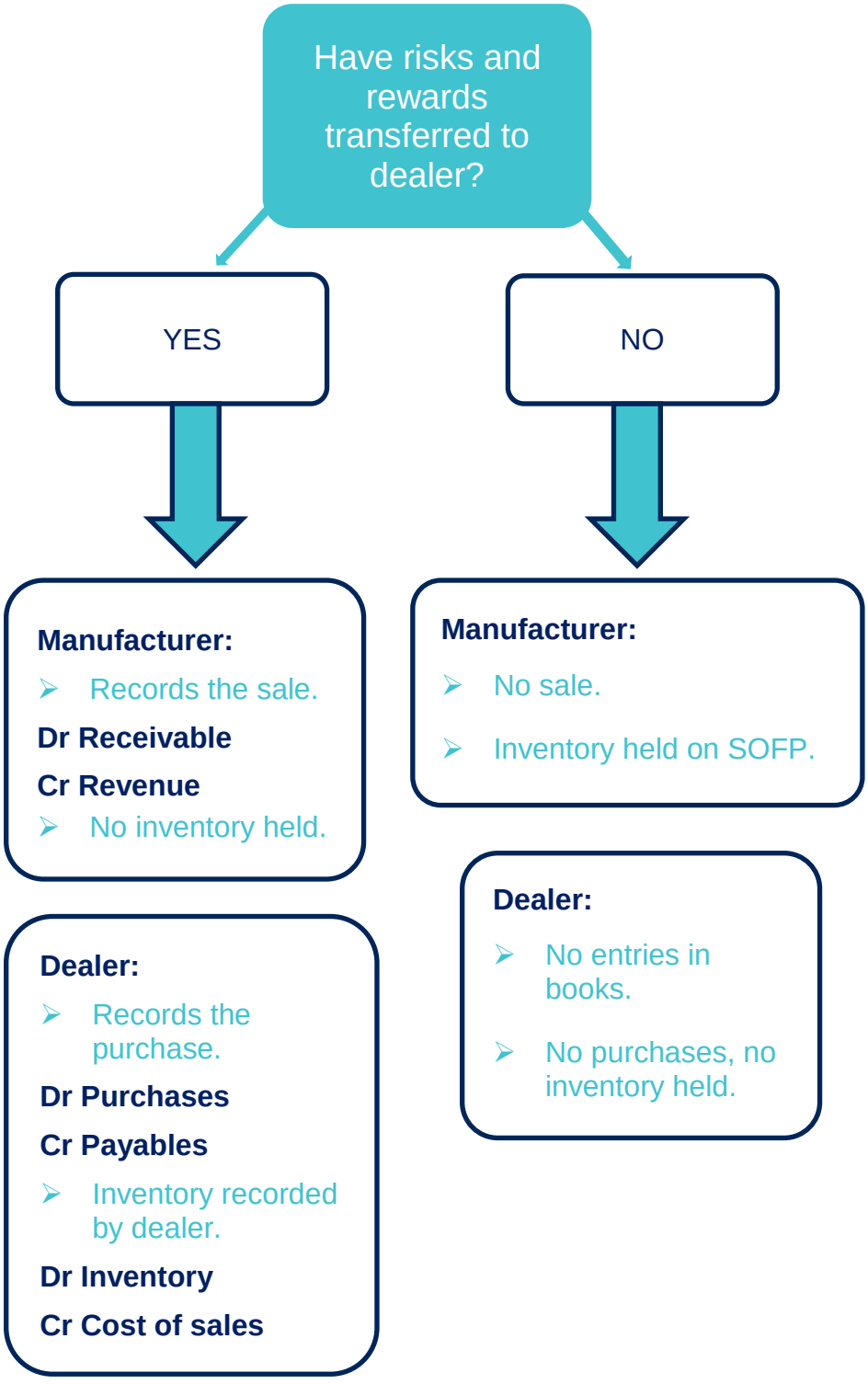
Have the risks and rewards transferred from manufacturer to dealer?

Must consider whether:

- dealer can return with no penalties
- price paid by dealer determined at time of delivery
- dealer can use car with no penalties
- insurance costs borne by dealer.

Notes

Accounting for consignment inventory

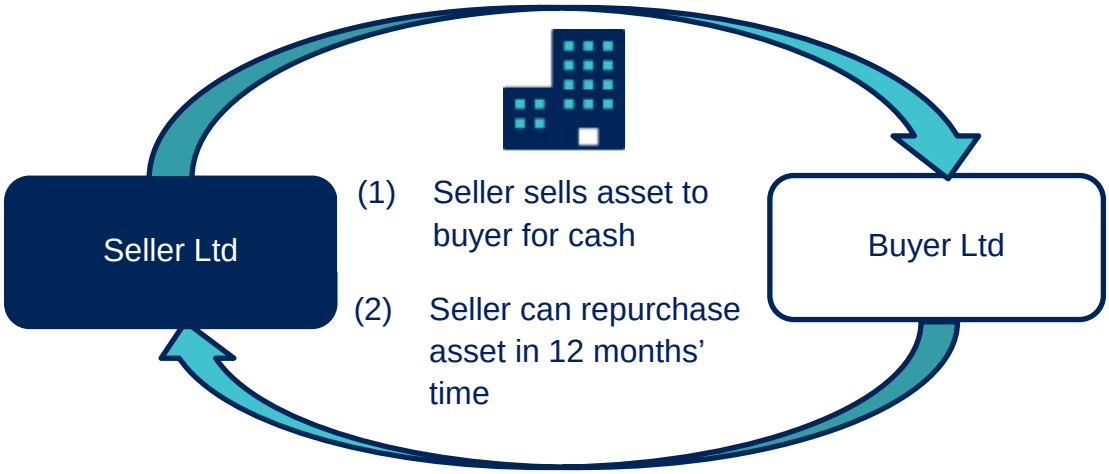


Illustrations and further practice

Now set TYU 5 as a consignment inventory example, from Chapter 7.

Notes

2.4 Sale and buyback

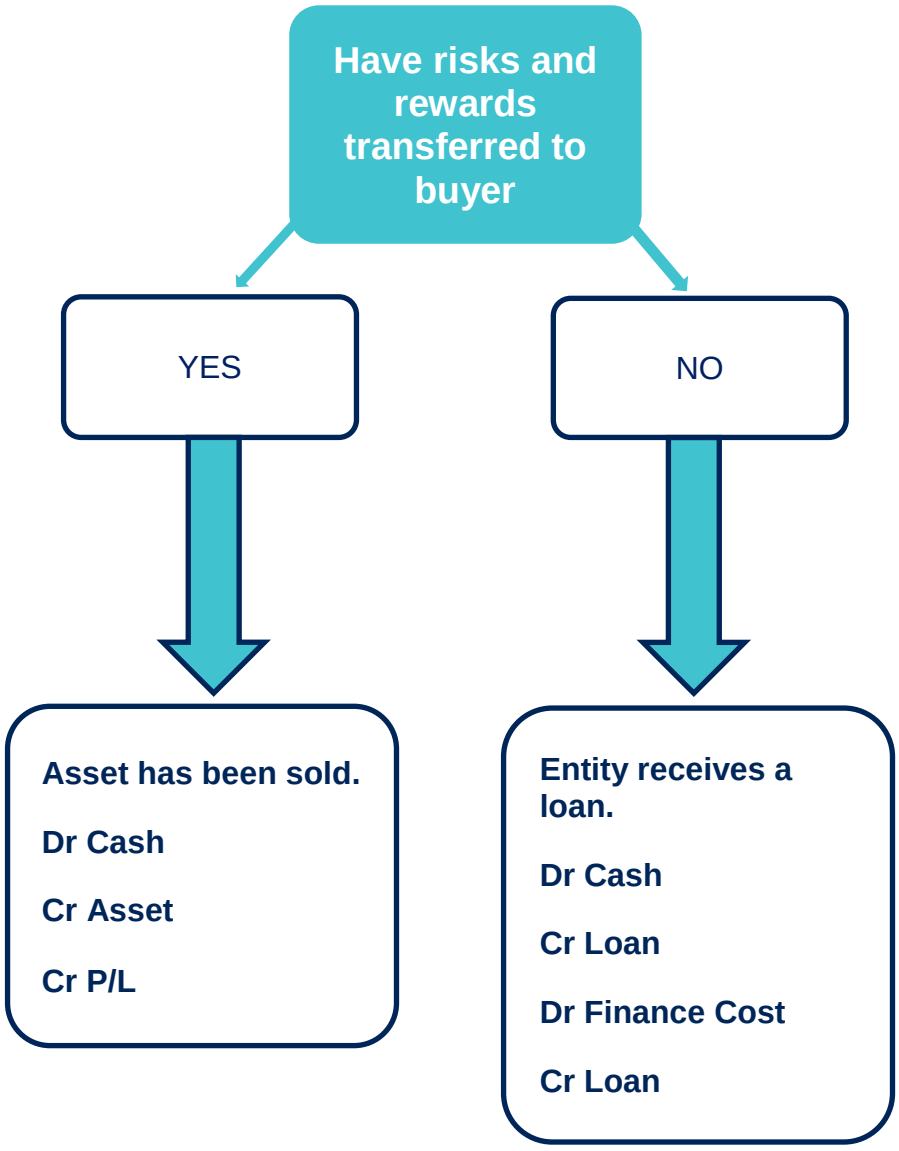


Have the risks and rewards transferred from manufacturer to dealer?

Must consider whether:

- initial sale is made at fair value or not
- seller is obliged to buyback the asset as per the terms of the arrangement
- any option to repurchase is likely to be exercised.

Notes


Have risks and rewards transferred to buyer
YES
NO
Asset has been sold.
Dr Cash
Cr Asset
Cr P/L
Entity receives a loan.
Dr Cash
Cr Loan
Dr Finance Cost
Cr Loan

Notes

Illustrations and further practice

Now set TYU 6 as a sale and buyback example from Chapter 7.

Notes

OT Questions

You should now be able to answer TYU 1–7 from Chapter 7 of the Study Text and questions 69–74 from the Exam Practice Kit.

For further reading, visit Chapter 7 of the Study Text.

Chapter 8

Provisions, contingent liabilities and contingent assets

Outcome

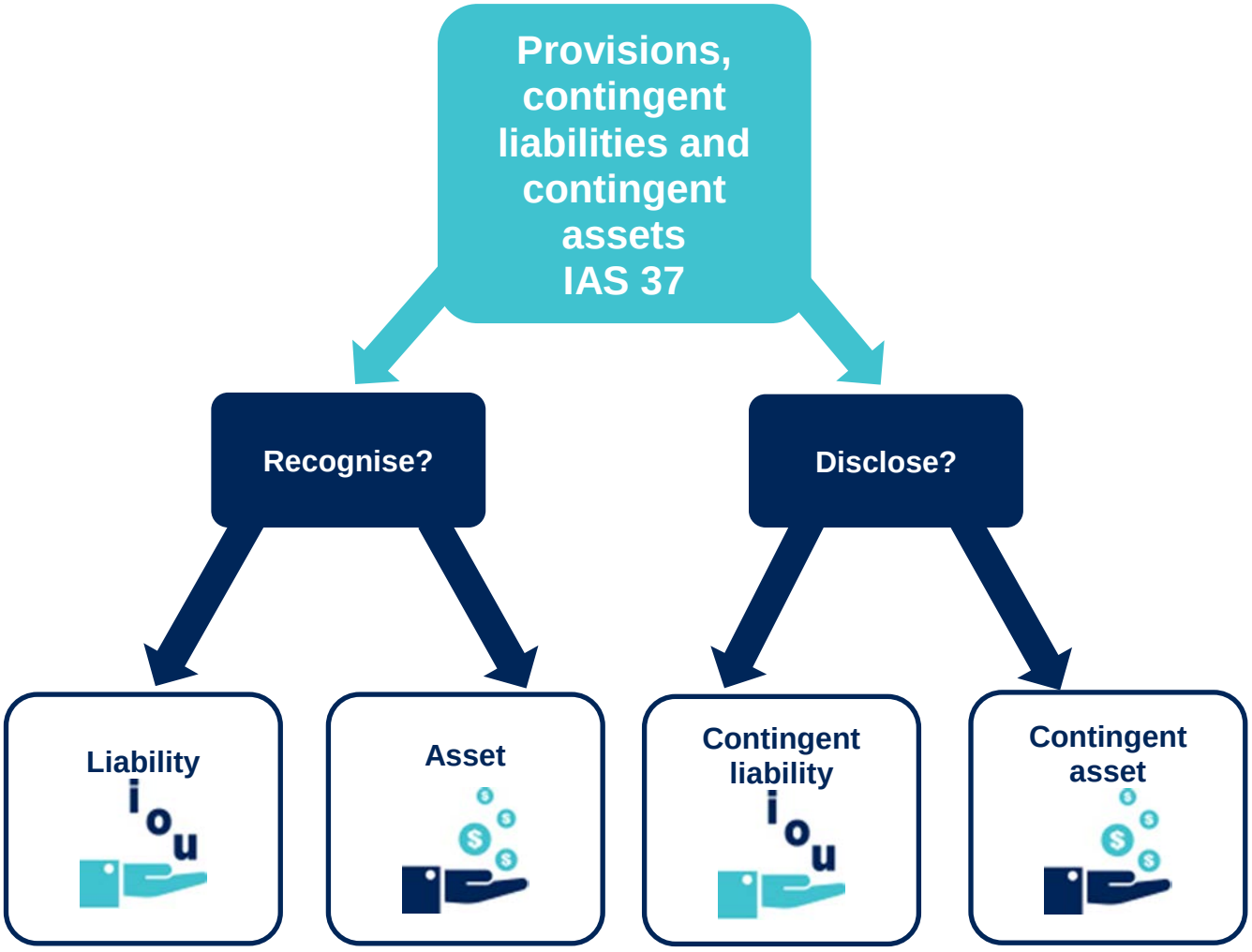
At the end of this chapter you will be able to:

- discuss the recognition and measurement of provisions and the need for and disclosure of contingent assets and liabilities, in accordance with IAS 37

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 8 of your Study Text.

Overview


Provisions, contingent liabilities and contingent assets IAS 37
Recognise?
Disclose?
Liability
Asset
Contingent liability
Contingent asset

1 Objective of IAS 37

1.1 The need for IAS 37

At any year end, situations may exist that could cause future liabilities to be paid or assets to be received.

There is **UNCERTAINTY** regarding the amounts that will be paid or received.

For example:

Uncertain liabilities:

- **damages from an unresolved court case against an entity**
- **customers' warranty claims.**

Uncertain assets:

- **claims against an insurance policy**
- **compensation from court cases when the entity is the claimant.**

IAS 37 outlines the rules for accounting for these uncertain assets or liabilities.

Notes

2 Recognition

2.1 Recognition of uncertain liabilities

A provision is required to recognise an uncertain liability.

To recognise a provision:

- an present obligation (legal or constructive) as a result of a past event exists
- a **PROBABLE** outflow of economic benefit will occur
- a reliable estimate can be made of the amount of the obligation.

If all above conditions are met, post the following journal:

Dr P/L

Cr Provision

N.B. Only the movement in the provision is posted in any accounting period.

Notes

Illustrations and further practice

Now work through TYU 1 from Chapter 8

Notes

2.2 Specific applications regarding uncertain liabilities

(1) Future operating losses

- No obligation to incur future operating losses.
- No provision allowed.

(2) Onerous Contracts (loss making contracts)

- Obligation exists with probable outflow of resources.
- Record provision recognised at the lower of:
  - cost of fulfilling contract
  - cost of compensation for failing to fulfil contract.

(3) Restructuring

- A provision can only be made if:
  - a detailed formal plan regarding the restructuring exists
  - a valid expectation in those affected has been created.

(4) Decommissioning costs

- If an obligation exists to restore land that is being built upon by an entity, a provision can be made for the future costs of restoration.
- The costs are capitalised as part of the cost of the asset.

Dr PPE/Asset

Cr Provision

Notes

Illustrations and further practice

Now work through TYU 4 from Chapter 8

Notes

2.3 Recognition of uncertain assets

Uncertain assets occur when the possibility exists of a future inflow of economic benefit e.g. insurance claims.

An uncertain asset should only be recognised if it is **VIRTUALLY CERTAIN** to be received.

Uncertain liabilities are recognised earlier than uncertain assets.

IAS 37 leads to the accounts being prepared prudently.

Notes

3 Disclosure – contingent liabilities and assets

3.1 Accounting for contingent liabilities and assets

Contingent liabilities and contingent assets are NOT recognised in the financial statements

No double entry is posted.

They are:

- **DISCLOSED** in the notes to the financial statements.

What is a contingent liability?

A contingent liability is an uncertain liability with:

- a **POSSIBLE** chance of outflows of economic benefit.

What is a contingent asset?

A contingent asset is an uncertain asset with:

- a **PROBABLE** chance of inflows of economic benefit.

Notes

4 Summary of IAS 37

Probability	Liability	Asset
Virtually certain	Recognise	Recognise
Probable	Recognise	Disclose
Possible	Disclose	No disclosure
Remote	No disclosure	No disclosure

Notes

Notes

OT Questions

You should now be able to answer TYU 1–6 from Chapter 8 of the Study Text and questions 75–77 from the Exam Practice Kit.

For further reading, visit Chapter 8 of the Study Text.

Chapter 9

Deferred tax

Outcome

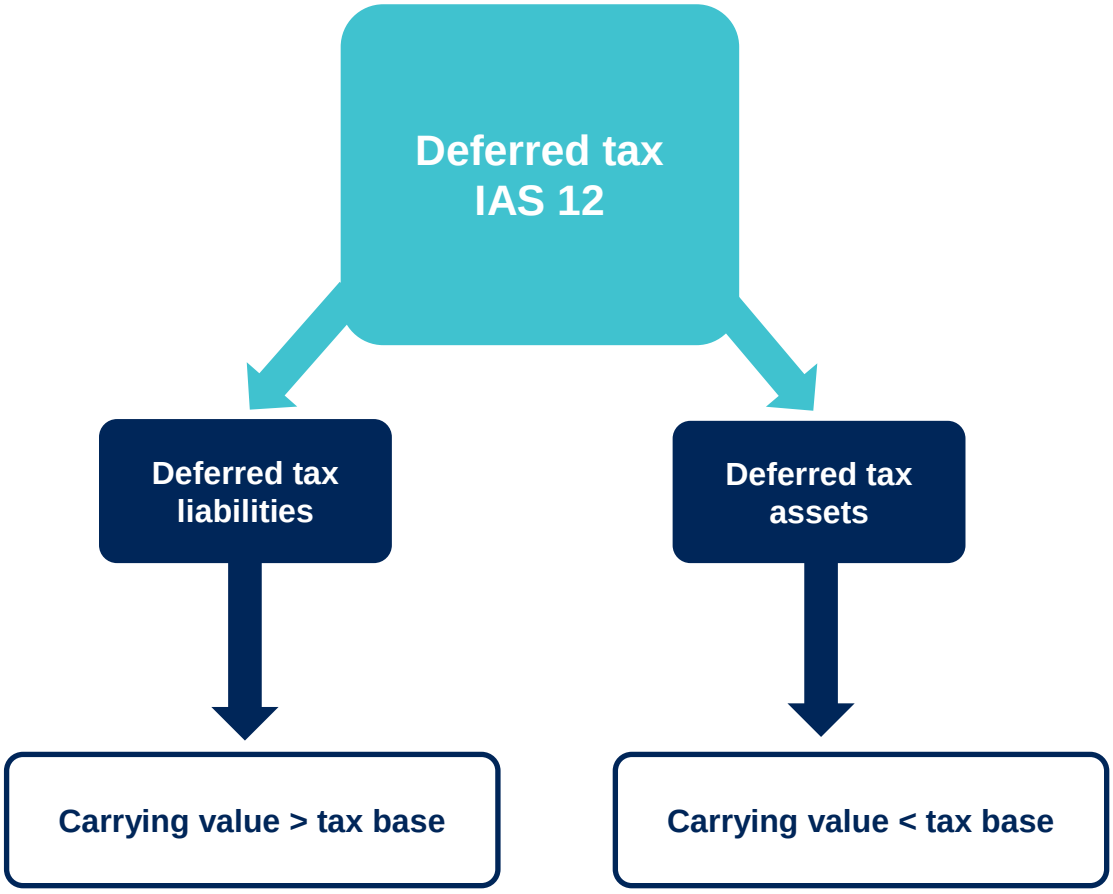
At the end of this session you should be able to:

- discuss the need for deferred tax in the financial statements and understand the cause of deferred tax (temporary differences)
- produce the accounting entries in relation to deferred tax

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 9 of your Study Text.

Overview


Deferred tax
IAS 12
Deferred tax liabilities
Deferred tax assets
Carrying value > tax base
Carrying value < tax base

1 Introduction to deferred tax

1.1 What is deferred tax?

Deferred tax is the estimated **FUTURE** tax consequences of transactions recognised in the **CURRENT** financial statements.

It is an application of the **ACCRUALS** concept and attempts to eliminate the mismatch between **ACCOUNTING PROFITS** and **TAXABLE PROFITS.**

1.2 What causes deferred tax?

Temporary differences between:

- the **CARRYING VALUE (CV)** of an asset or liability, and
- its **TAX BASE.**

e.g. Differences between the carrying value of PPE and the tax written down value of PPE caused by accelerated capital allowances.

Notes

2 Accounting for deferred tax

2.1 Three steps to account for deferred tax

STEP (1) Calculate temporary difference.

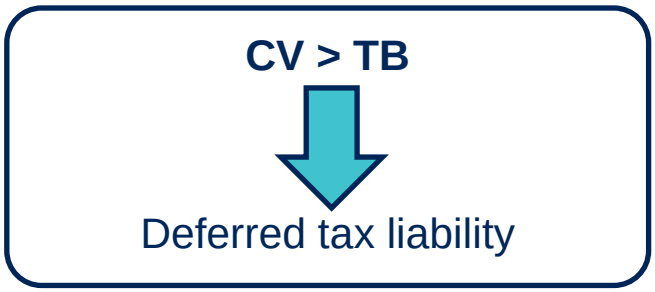
STEP (2) Calculate deferred tax liability or asset as per the year end.

STEP (3) Post the movement in deferred tax balance.

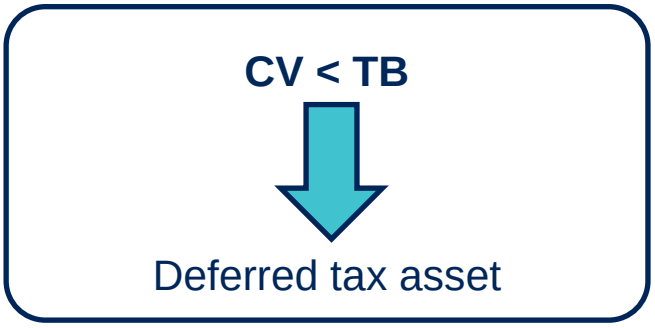
Notes

Step (1) Calculate temporary difference

If the temporary difference causes:



If the temporary difference causes:



Illustrations and further practice

Now work through TYU 2 to illustrate calculating a temporary difference and the DT impact caused from Chapter 9.

Notes

Step (2) Calculate deferred tax balances as at year end

Temporary difference (step 1)	x
× Tax rate	
Year-end deferred tax liability/asset	x

Notes

Step (3) Post the movement in the deferred tax balance

Only the movement in the provision is posted in any accounting period.

Look out for brought forward deferred tax balances.

Assuming increases in deferred tax, the journals required are:

Dr P/L	**Dr Deferred tax asset**
Cr Deferred tax liability	**Cr P/L**

The deferred tax entry should match the treatment of the transaction causing deferred tax

E.g. Capital allowances to P/L, revaluations to OCI

Notes

Illustrations and further practice

Now work through TYU 1 (a) to illustrate the accounting of deferred tax from Chapter 9.

Notes

3 Specific applications of deferred tax

3.1 Specific applications regarding deferred tax

(1) Unutilised Trading Losses

- Losses are not taxable in current periods.
- Unutilised losses can be used to obtain future tax relief in periods when profits are made (losses offset the future profits and reduce tax bill).
- Create a **DEFERRED TAX ASSET.**

Deferred tax assets can only be recognised up to the extent that is it probable that future taxable profits will be available to offset the losses.

Illustrations and further practice

Now work through TYU 3 to illustrate the impact on deferred tax from unutilised losses, from Chapter 9.

Notes

(2) Deferred tax from transactions recorded in OCI

- The deferred tax entry should match the treatment of the transaction causing deferred tax.
- Any transactions that are recorded in OCI that cause deferred tax will see the deferred tax movement recorded in OCI. e.g. Revaluations of PPE, AFS financial assets.

Assuming increases in deferred tax, the journals required are:

Dr OCI	**Dr Deferred tax asset**
Cr Deferred tax liability	**Cr OCI**

Illustrations and further practice

Now work through TYU 4 to illustrate the impact on deferred tax of revalued PPE from Chapter 9.

Notes

(3) Deferred tax on share options

- Per IFRS 2, share options reduce profits each year from the grant date to the vesting date.
- For tax purposes, no relief is given until the options are exercised (based on the intrinsic value of the option).
- Creates a **DEFERRED TAX ASSET.**

Illustrations and further practice

Now work through illustration 1 from Chapter 9 or set for homework if short on time.

Notes

OT Questions

You should now be able to answer TYU 1–5 from Chapter 9 of the Study Text and questions 82–86 from the Exam Practice Kit.

For further reading, visit Chapter 9 of the Study Text.

Chapter 10

Construction contracts

Outcome

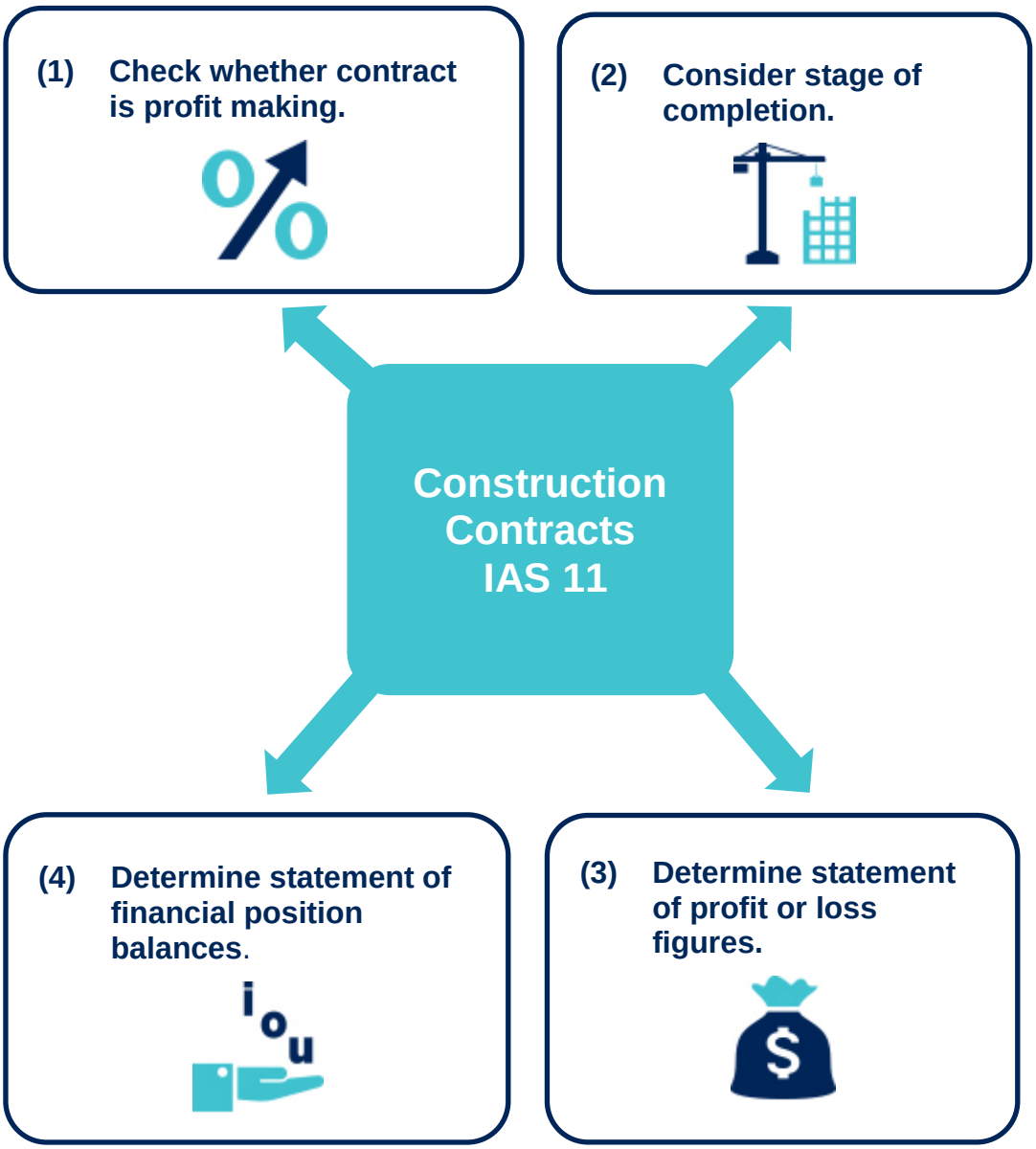
At the end of this chapter you will be able to:

- prepare the accounting entries for construction contracts in accordance with IAS 11

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in chapter 10 of your Study Text.

Overview

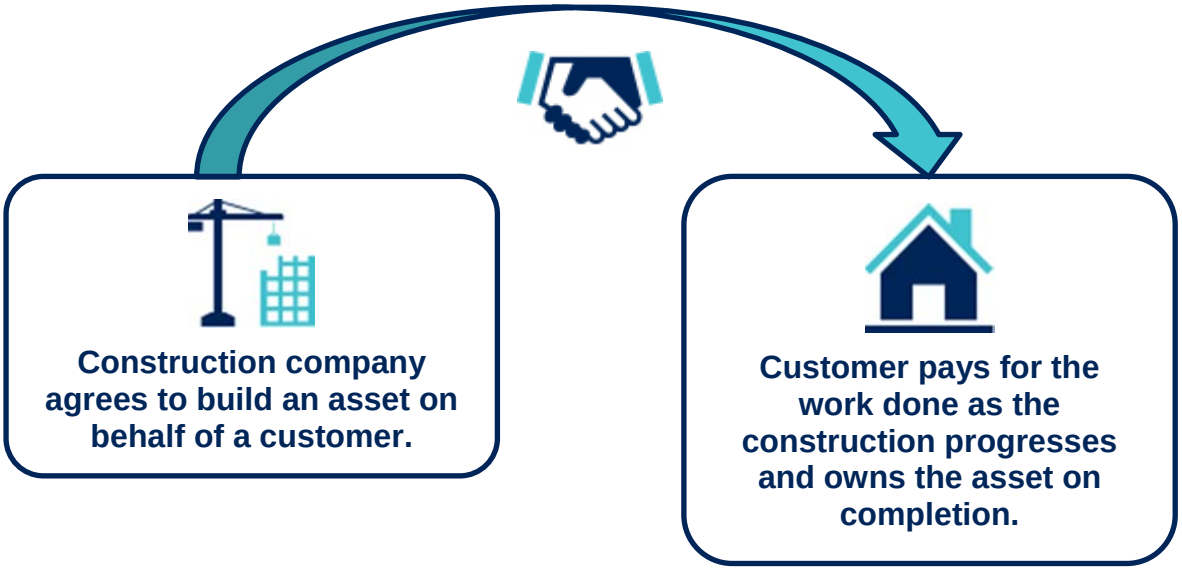

(1) Check whether contract is profit making.
(2) Consider stage of completion.
Construction Contracts IAS 11
(4) Determine statement of financial position balances.
IOU
(3) Determine statement of profit or loss figures.
$

1 Introduction to construction contracts

1.1 Introduction to construction contracts

A construction contract is a specifically negotiated contract for the construction of a substantial asset.

e.g. stadiums, buildings, bridges, tunnels, ships.



IAS 11 looks at the accounting for construction contracts from the construction company's (seller's) perspective.

Notes

2 Accounting for construction contracts

2.1 Four steps for the accounting of construction contracts

STEP (1) Determine if overall contract is **PROFITABLE** (looking out for loss making contracts).

STEP (2) Determine the **STAGE OF COMPLETION** of the contract.

STEP (3) Calculate figures for the current period **STATEMENT OF PROFIT OR LOSS**.

STEP (4) Calculate figures as at the reporting date for the **STATEMENT OF FINANCIAL POSITION.**

Notes

Step (1) Determine if the overall contract is profitable

To calculate whether a contract is profitable, consider:

Contract price	x
Less	
Costs incurred to date	(x)
Expected costs to complete	(x)
Overall contract profit/loss	**x/(x)**

Watch out for **LOSS** making contracts. The loss will need to be recognised immediately. See step (3).

For contracts were progress is uncertain, revenue = recoverable costs. Therefore, no profit can be recognised.

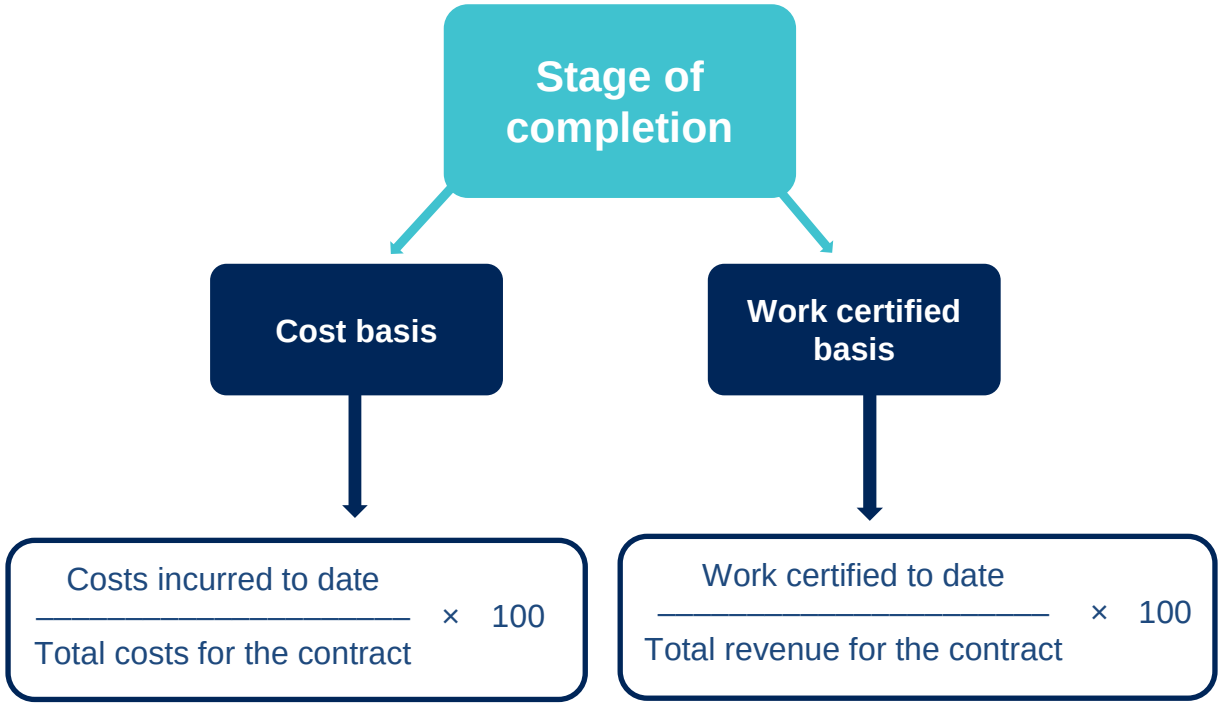
Notes

Step (2) Determine the stage of completion of the contract

Two methods exist to determine stage of completion:

- cost basis
- work certified basis.

The exam question will inform you of which method is relevant for your scenario.



Notes

Step (3) Calculate the figures for the current period statement of profit or loss

Profitable contracts

Revenue	x	[Completion % (step 2) × contract price] – previously recognised revenue.
Cost of sales	(x)	[Completion % (step 2) × total costs] – previously recognised costs.
Gross profit	**x**	

Loss making contracts

Revenue	x	[Completion % (step 2) × contract price] – previously recognised revenue.
Cost of sales	(x)	β
Gross profit	**X**	**Total loss from step (1) recognised immediately.**

Notes

Step (4) Calculate year-end figures for the STATEMENT OF FINANCIAL POSITION

The statement of financial position will show GROSS AMOUNTS OWED FROM/TO CUSTOMERS

Costs incurred to date	x
Recognised profits to date	x
Recognised losses to date	(x)
Amounts billed to customers	(x)
Gross amounts owed from/to customers	x/(x)

Amounts owed from customers = asset.

Amounts owed to customers = liability.

Illustrations and further practice

Now work through TYU 3 to illustrate the accounting of construction contracts from Chapter 10.

Notes

Notes

OT Questions

You should now be able to answer TYU 1–5 from Chapter 10 of the Study Text and questions 78–81 from the Exam Practice Kit.

For further reading, visit Chapter 10 of the Study Text.

Chapter 11

Related parties

Outcome

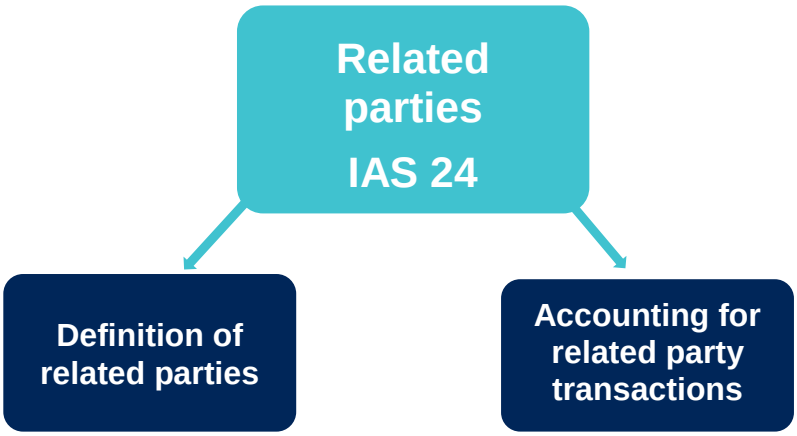
At the end of this session you should be able to:

- discuss the need for and nature of disclosure of transactions between related parties, in accordance with IAS 24

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 11 of your Study Text.

Overview


Related parties
IAS 24
Definition of related parties
Accounting for related party transactions

1 Related parties of an entity

1.1 Related party definition

A related party is a person or entity that is related to the entity preparing its financial statements.

They can be considered as an entity or person that could exert an undue influence over the entity.

1.2 Who are deemed related parties to an entity?

- Key management personnel (KMP).
- Close family members of KMP.
- Entities that are members of the same group (Parent, subsidiaries, associates and joint ventures).

1.3 Who are NOT deemed related parties to an entity?

The following are specifically excluded per IAS 24:

- two entities simply due to having a common director/ member of KMP
- two joint venturers
- providers of finance
- key customers and suppliers.

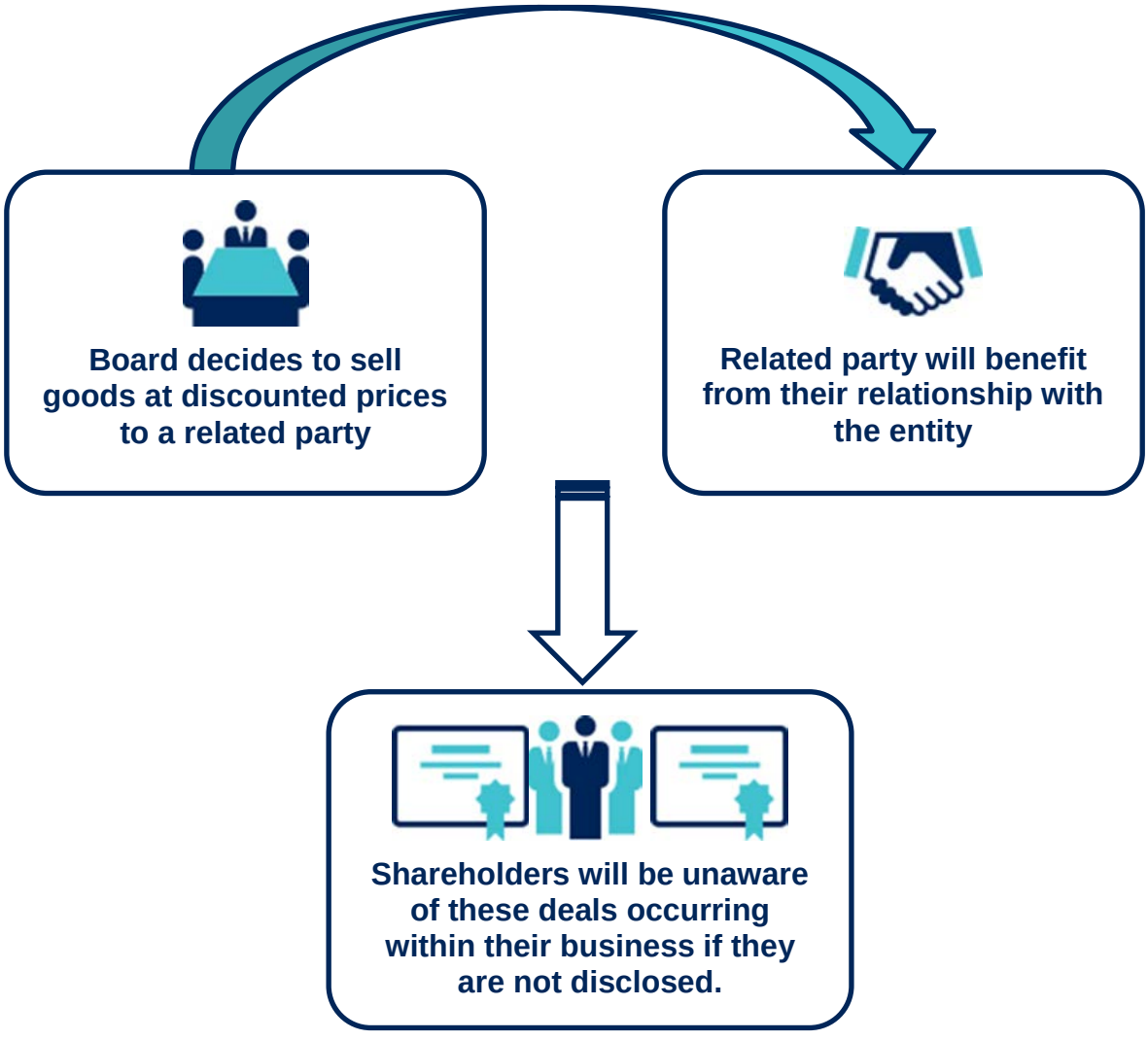
Notes

2 Related party transactions

2.1 Accounting for related party transactions

All transactions to or from related parties **MUST** be **DISCLOSED** in the financial statements.

2.2 The need for related party transaction disclosures



Notes

OT Questions

You should now be able to answer TYU 1–2 from Chapter 11 of the Study Text and questions 87–88 from the Exam Practice Kit.

For further reading, visit Chapter 11 of the Study Text.

Chapter 12

Basic group accounts (F1 revision)

Outcome

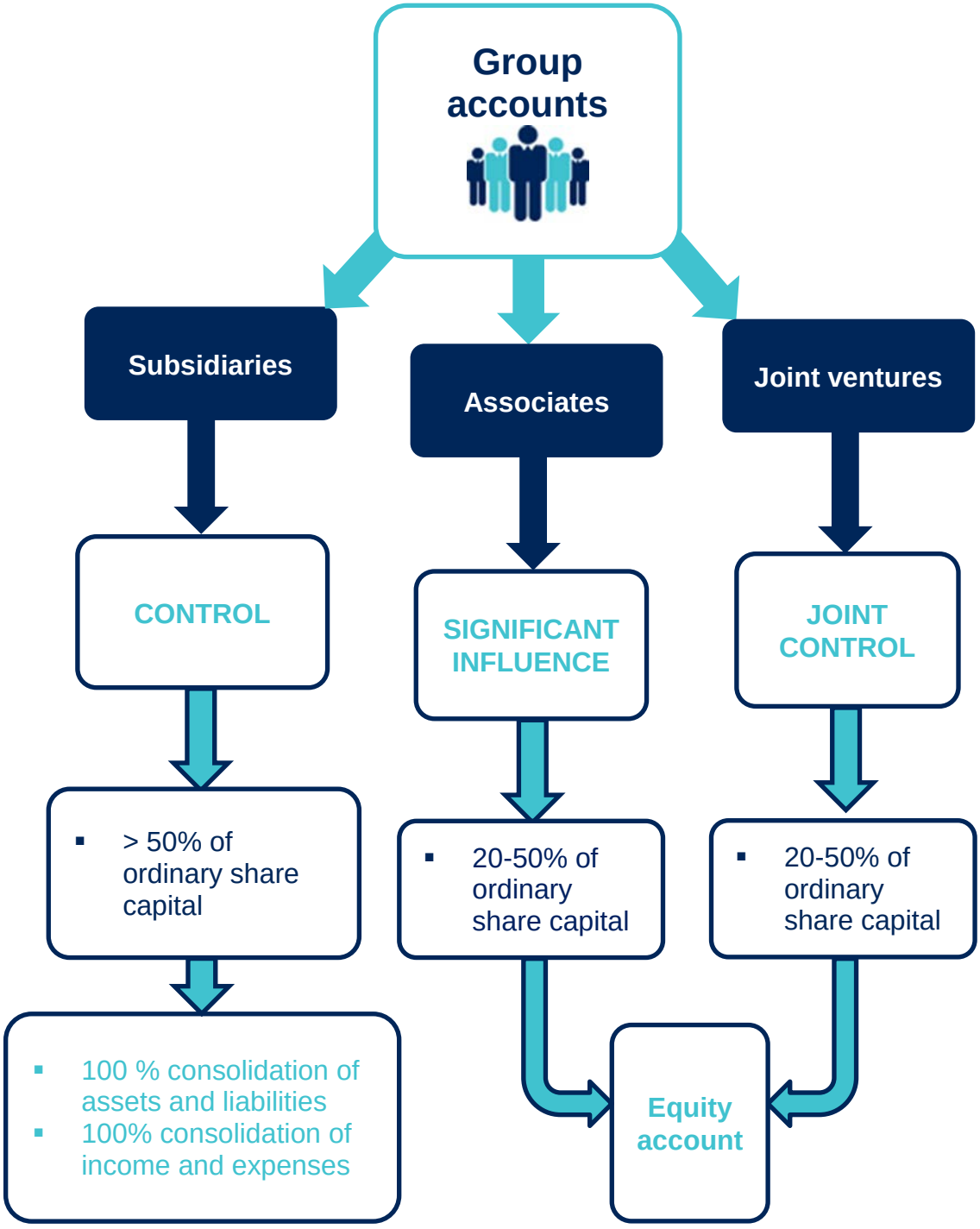
At the end of this session you should be able to:

- produce consolidated statements of profit or loss and other comprehensive income
- produce consolidated statements of financial position

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 12 of your Study Text.

Overview


Group accounts
Subsidiaries
Associates
Joint ventures
CONTROL
SIGNIFICANT INFLUENCE
JOINT CONTROL
▪ > 50% of ordinary share capital
▪ 20-50% of ordinary share capital
▪ 20-50% of ordinary share capital
▪ 100 % consolidation of assets and liabilities
▪ 100% consolidation of income and expenses
Equity account

1 Introduction to group accounts

1.1 What is a group?

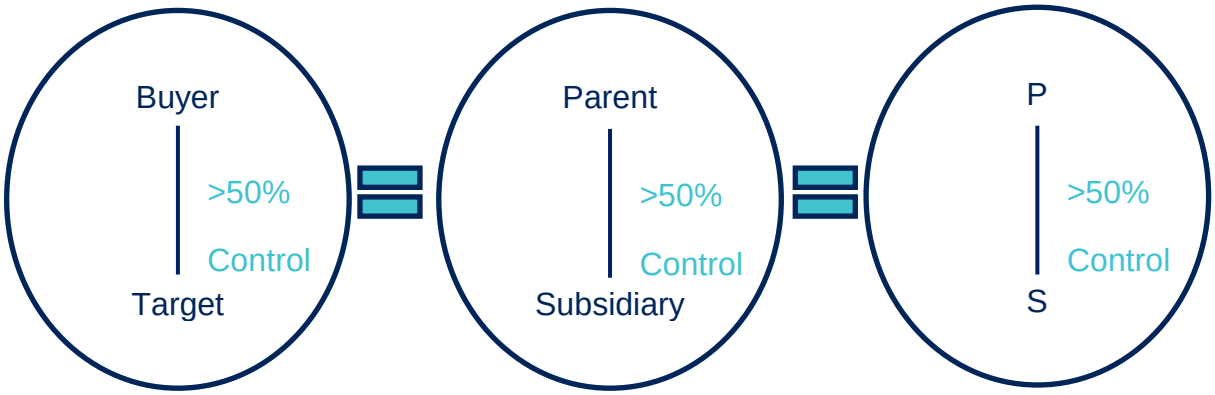
A group exists where one company **CONTROLS** another company.

1.2 What is control?

Control is defined by IFRS 10 Consolidated financial statements. Per IFRS 10, control is achieved when the investor has:

- **power** over the investee (achieved when owning > 50% of voting rights)
- exposure, or rights, to variable returns from its involvement in investee
- the ability to use its power to affect the amount of variable returns.

Notes



Subsidiaries will be consolidated using ACQUISITION accounting.

Notes

2 Consolidated statement of financial position

2.1 Basic consolidated statement of financial position pro forma

Consolidated statement of financial position as at …… 20XY

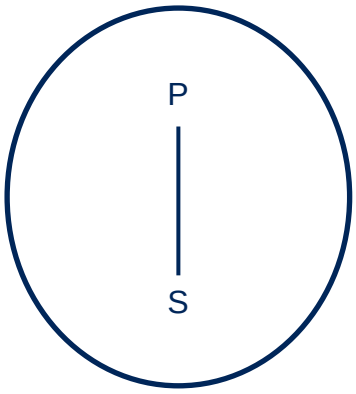
Goodwill	x (W3)	Represents **CONTROL** in S. Adding 100% of assets of Sub nets off against P's investment in S.
Assets (100% of P & S)	x	
Total assets	**x**	
Share capital and share premium (100% of P's only)	x	Represents **OWNERSHIP**
Reserves (100% of P and P's % of post-acquisition movements)	x (W5)	
NCI (NCI share of S's net assets at reporting date)	x (W4)	
Total equity	x	
Liabilities (100% of P & S)	x	Represents **CONTROL**
Total equity and liabilities	x	

Notes

2.2 Consolidated statement of financial position standard workings

There are 5 standard consolidation workings for a CSOFP.

(W1) Group Structure



P's %

NCI %

Date of acquisition

Notes

(W2) Net assets of subsidiary

	Acquisition	Reporting date
Share capital	x	x
Share premium	x	x
Retained earnings	x	x
Other reserves	x	x
FV adjustments	x	x
PUP adjustment		x
	x	x
	W3	

Difference = post acquisition movement in reserves.

Notes

(W3) Goodwill

Cost of investment	x	
NCI at acquisition	x	Check whether FV method or proportionate method
less		
FV of Subs net assets at acquisition	(x)	
GW at acquisition	x	
Impairment	(x)	W5 if proportionate. W4 and W5 if FV method.
GW at reporting date	x	CSOFP

Negative goodwill is credited to P/L as a discount on purchase.

Notes

(W4) Non-controlling interest (NCI)

NCI at acquisition (as per W3)	x	FV or proportionate?
NCI % x S post acquisition reserves	x	
NCI % impairment (FV method only)	(x)	
NCI at year end	x	CSOFP

Notes

(W5) Consolidated reserves

	Retained earnings	Other reserves
100% P's reserves	x	x
P's % of post-acquisition profits (W2)	x	x
Impairment	(x)	
Reserves at year end	x	x

Notes

2.3 Methods of calculating NCI within goodwill

Two methods of calculating goodwill are allowed:

- the proportionate method (P's GW only)
- the fair value method (100% of GW – P's and NCI's GW).

The calculations are given below.

	Proportionate method		Fair value method
Cost of investment	x		x
NCI at acquisition			
NCI % × S's NA's at acquisition	x	**FV of NCI at acquisition**	x
less			
Subs NA's at acquisition	(x)		(x)
GW at acquisition	x		x

N.B. Only the NCI at acquisition line has changed between the methods. The NCI at acquisition within the goodwill calculation will always be used in the NCI working (W4).

Impairment of goodwill

- Using proportionate method – relates to P only so take all to group retained earnings (W5).
- Using FV method – relates to both the P and the NCI.

Split using % to NCI working (W4) and group retained earnings (W5).

Notes

Illustrations and further practice

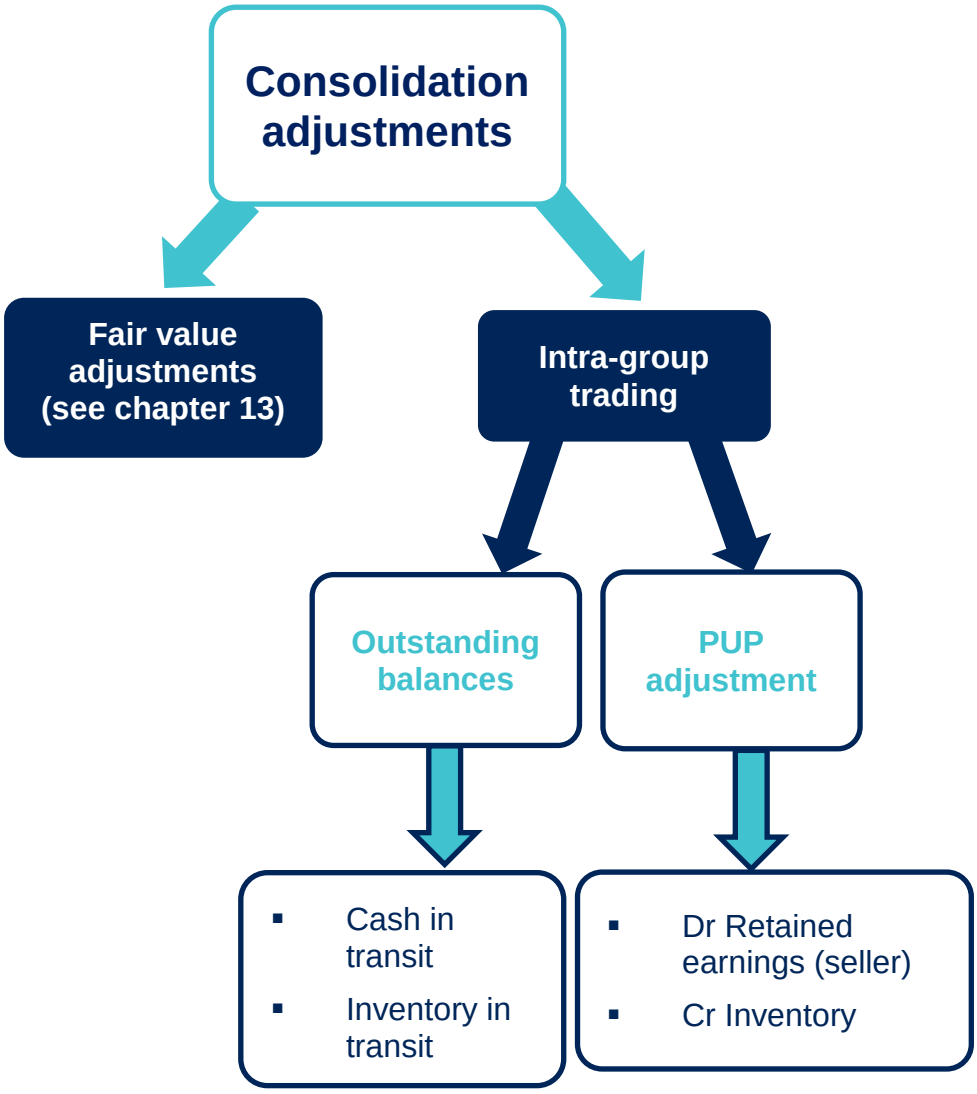
Now work through TYU 1 to illustrate the 2 methods of calculating goodwill from Chapter 12.

Then work through TYU 3 to show the technique of preparing a CSOFP from Chapter 12.

Notes

3 Consolidation adjustments and the CSOFP

3.1 Consolidation adjustments and the CSOFP



Notes

3.2 Intergroup transactions

The consolidated accounts remove the impact of intra-group transactions.

The impacts of sales within the group should be eliminated.

When the Parent sells to the Sub or vice versa:

- outstanding balances will arise
- profits could be made.

Notes

3.3 Outstanding balances

If an intra-group sale occurs on credit, amounts may still be outstanding at the year end.

If the outstanding balances **AGREE**:

Cancel out immediately

Dr Payables

Cr Receivables

If the balances do **NOT AGREE** due to **CASH IN TRANSIT**

1. Treat cash as received at year end

Dr Cash

Cr Receivables

2. Cancel out intra-group balances

Dr Payables

Cr Receivables

If the balances do **NOT AGREE** due to **INVENTORY IN TRANSIT**

1. Treat Inventory as received at year end

Dr Inventory

Cr Payables

2. Cancel out intra-group balances

Dr Payables

Cr Receivables

Illustrations and further practice

Now work through illustration 2 as an example of dealing with intra-group outstanding balances from Chapter 12.

3.4 PUP Adjustments and the CSOFP

A **PUP** is a provision for unrealised profits.

It will be required when:

- an intragroup sale occurs at a profit
- the goods are still held in the group.

ALWAYS adjust the SELLERS retained earnings in the CSOFP

If P sells to S:

Dr Retained Earnings of P (W5)

Cr Inventory (CSOFP)

If S sells to P:

Dr Retained Earnings of S (W2)

Cr Inventory (CSOFP)

Illustrations and further practice

Now work through illustration 3 as an example a PUP adjustment on the CSOFP from Chapter 12.

Notes

4 Consolidated statement of profit or loss and other comprehensive income

4.1 Consolidated statement of profit or loss and OCI pro forma

Consolidated statement of P/L and other comprehensive income for period ended …… 20XY

Revenue (100% of P & S)	x
Cost of sale (100% of P & S)	x
Gross Profit	**x**
Distribution costs (100% of P & S)	(x)
Admin expenses (100% of P & S)	(x)
Operating profit	**x**
Finance Costs (100% of P & S)	(x)
Profit before tax	**x**
Tax (100% of P & S)	(x)
Group profit after tax	**x**
Other Comprehensive income	x
Total comprehensive income	TCI
Amounts attributable to ordinary shareholders	x β
NCI share of profit (NCI % of S's total comp income)	x
	TCI

Adding 100% of income and expenses of Sub represents **CONTROL** in S.

Split of group profits between shareholders represents **OWNERSHIP** in S

5 Consolidation adjustments and the CSOPL

5.1 Common consolidation issues for CSOPL

- Mid-year acquisitions

If a subsidiary is acquired part way through the year, the group will add 100% of income and expenses since the acquisition date.

- FV adjustment depreciation (see Chapter 13)

Any extra depreciation charged as a result of a FV adjustment on S's assets will be charged to the group p/l.

The NCI% will be allocated to the NCI balance.

- Intra-group sales

Any impact of intragroup sales will be removed from group revenue and COS.

The group cannot show revenue from sales to itself!

- PUP adjustments

If an intra-group sale occurs at a profit and the goods remain in the group:

  - always add the PUP to the **SELLERS** cost of sales.

- Impairment

Using proportionate – all allocated to P. No impact to NCI.

Using FV method – split between P and NCI. Must include NCI% within NCI balance.

Notes

Illustrations and further practice

Now work through TYU 5 as a CSOPL example from Chapter 12.

Notes

6 Associates

6.1 Definition of an associate

An associate is an entity over which the parent has SIGNIFICANT INFLUENCE.

Typically achieved via a shareholding of between 20-50%.

6.2 Accounting for an associate

Use **EQUITY** accounting.

No addition of assets and liabilities or income and expenses (no control is held).

Notes

CSOFP

"One liner" – Investment in associate (in NCA's).

Cost of investment	x	
P's % of A's movement in NA's	x	
less		
Impairment	(x)	
PUP (if A has inventory)	(x)	
Investment in associate	x	CSOFP

Notes

CSOPL

"One liner" – Share of associates profit (above group profit before tax).

P's % of A's total profit after tax	x	
less		
Impairment	(x)	
PUP (if A is seller)	(x)	
Investment in associate	x	CSOFP

Illustrations and further practice

Now work through TYU 8 as an group with associate example from Chapter 12.

For homework, set expandable text on PUP adjustments with associates and example 7 from Chapter 12

Notes

Notes

OT Questions

You should now be able to answer TYU 1–8 from Chapter 12 of the Study Text and questions 89–106 from the Exam Practice Kit.

For further reading, visit Chapter 12 of the Study Text.

Chapter 13

Basic group accounts – goodwill and joint arrangements

Outcome

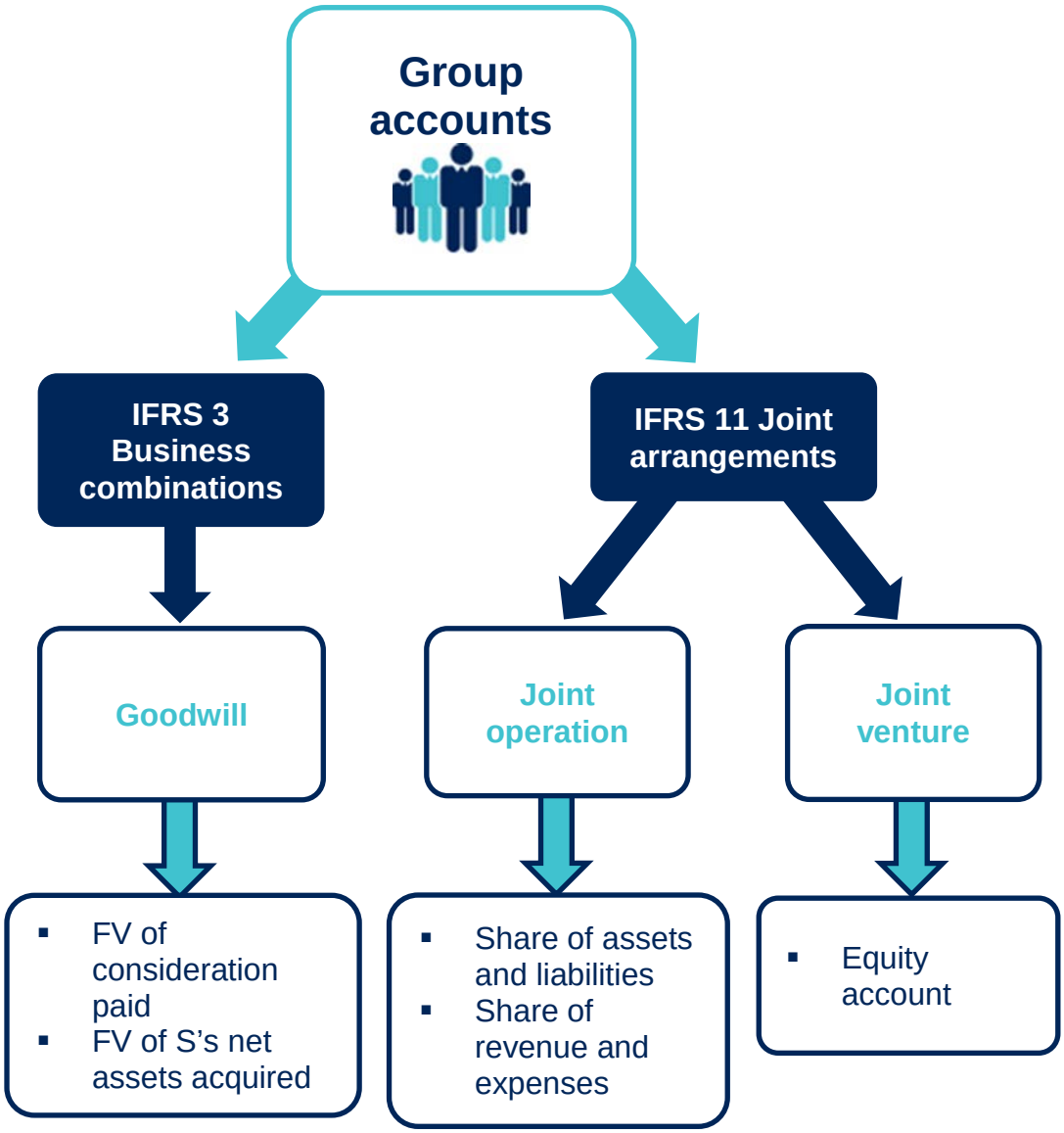
At the end of this session you should be able to:

- prepare accurate GW calculations considering the impact of fair value adjustments on the consolidated accounts
- account for joint arrangements within the group accounts

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 13 of your Study Text.

Overview


Group accounts
IFRS 3 Business combinations
IFRS 11 Joint arrangements
Goodwill
Joint operation
Joint venture
FV of consideration paid
FV of S's net assets acquired
Share of assets and liabilities
Share of revenue and expenses
Equity account

1 IFRS 3 Business Combinations

1.1 IFRS Business combination and goodwill

The calculation of goodwill is set out in IFRS 3 Business Combinations.

Goodwill is the excess of the amount paid to acquire a subsidiary above the value of the subsidiary's net assets.

Per IFRS 3, goodwill is calculated as:

FAIR VALUE of consideration paid (cost)	x	
NCI at acquisition	x	FV method or proportionate method?
less		
FAIR VALUE of S's net assets at acquisition	(x)	
GW at acquisition	x	

IFRS 3 outlines how to determine the FV of consideration paid and the FV of S's net assets at acquisition.

Each component is separately considered in the following sections.

Notes

1.2 Fair value of consideration paid

Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an **ORDERLY TRANSACTION** between market participants”.

Different methods of paying for a subsidiary may be used. IFRS 3 outlines what should be considered as the FV for each method of payment.

Method of Payment		FV (per IFRS 3)	Journal
Cash (upfront)		**Cash paid**	Dr GW Cr Cash
Deferred cash		**Present value (PV)**	Dr GW Cr Liability
Shares (upfront)		**Market value (MV) at acquisition**	Dr GW Cr Share capital & share premium
Deferred shares		**MV at acquisition**	Dr GW Cr Shares to be issued
Contingent consideration		**FV (given in calculation)**	Dr GW Cr Liability

Notes

Items specifically **EXCLUDED** from FV of consideration paid:

- directly attributable costs of acquisition e.g. legal and professional fees (to P/L)
- provisions for future losses in subsidiary.

Illustrations and further practice

Now work through TYU 1 to illustrate the impacts of FV of consideration on the calculation of goodwill from Chapter 13.

Notes

1.3 FV of subsidiary's net assets at acquisition

On consolidation, the subsidiaries net assets must be valued at **FAIR VALUE (FV).**

The assets in the subsidiaries individual accounts will be shown at **CARRYING VALUE (CV).**

CV does not always equal **FV**

FV adjustments will be required on consolidation.

Fair value adjustments will be commonly required for:

- property plant and equipment
- intangible assets
- contingent liabilities.

Notes

Recording fair value adjustments

- Adjust the Net Assets working of sub (W2)
  - Always at acquisition.
  - Typically at reporting date (assuming revalued asset hasn't been sold by year end).
- Adjust the value of the asset/liability (CSOFP)

Notes

Recording extra depreciation on FV adjustments

- Adjust the Net Assets working of sub (W2)
- At reporting date only.
- Reduce the value of the asset/liability with the extra depreciation (CSOFP).

Remember, LAND is NOT depreciated

Illustrations and further practice

Now work through TYU 3 to illustrate the impact of FV adjustments on the CSOFP from Chapter 13.

Notes

2 IFRS 11 Joint arrangements

2.1 Definitions

JOINT ARRANGEMENT – arrangements were 2 or more parties have JOINT CONTROL.

JOINT CONTROL – achieved when:

- Contractual arrangement exists between the parties
- Decisions require the unanimous consent of all parties.

Two types of joint arrangement exist:

(1) joint ventures

(2) joint operations.

JOINT VENTURES – the parties have the rights to the **NET ASSETS** of the arrangement.

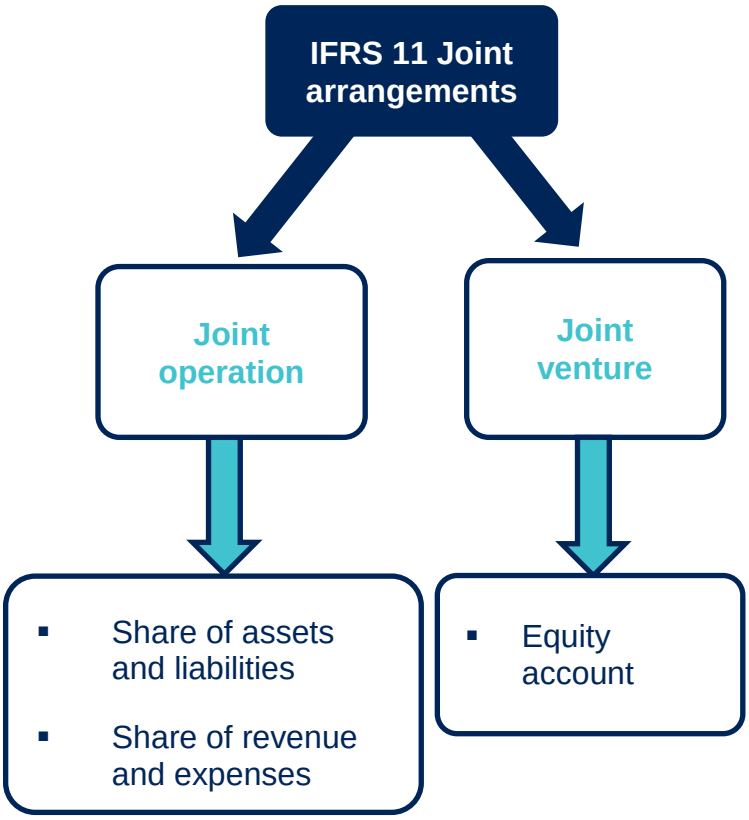
e.g. A separate entity exists that is >50% owned between the shareholders

JOINT OPERATIONS – the parties have the rights to **THE ASSETS AND THE OBLIGATIONS** of the arrangement**.**

e.g. The companies involved in the joint operation contribute their own assets and liabilities to a project. No separate entity exists.

Notes

2.2 Accounting for joint arrangements



Notes

Notes

OT Questions

You should now be able to answer TYU 1–11 from Chapter 13 of the Study Text and questions 89–106 from the Exam Practice Kit.

For further reading, visit Chapter 13 of the Study Text.

Chapter 14

Complex group structures

Outcome

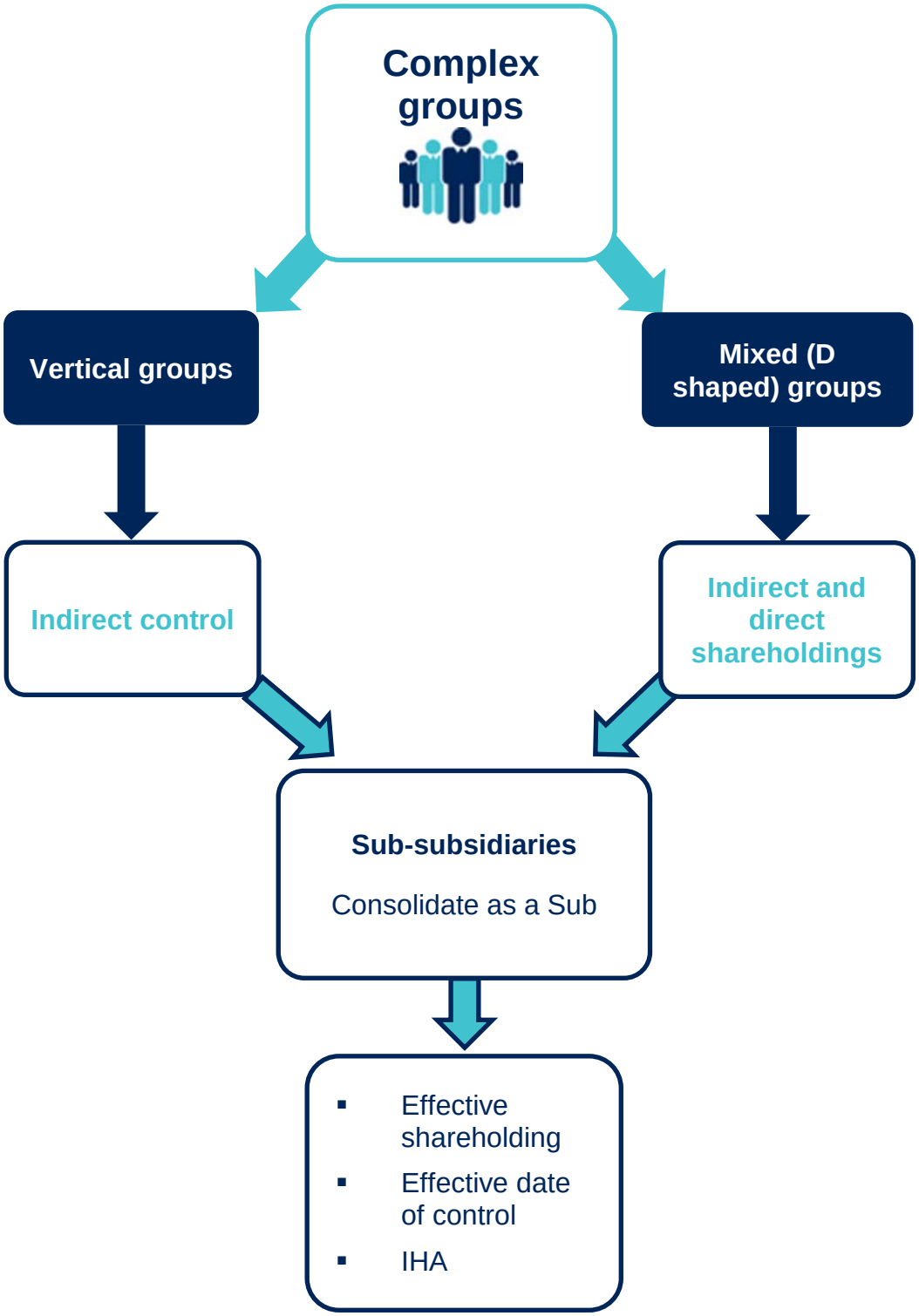
At the end of this session you should be able to:

- demonstrate the impact on the group financial statements of acquiring indirect control of a subsidiary

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 14 of your Study Text.

Overview


Complex groups
Vertical groups
Mixed (D shaped) groups
Indirect control
Indirect and direct shareholdings
Sub-subsidiaries
Consolidate as a Sub
Effective shareholding
Effective date of control
IHA

1 Complex group structures

1.1 Types of complex groups

- Vertical groups.
- Mixed (D shaped groups).

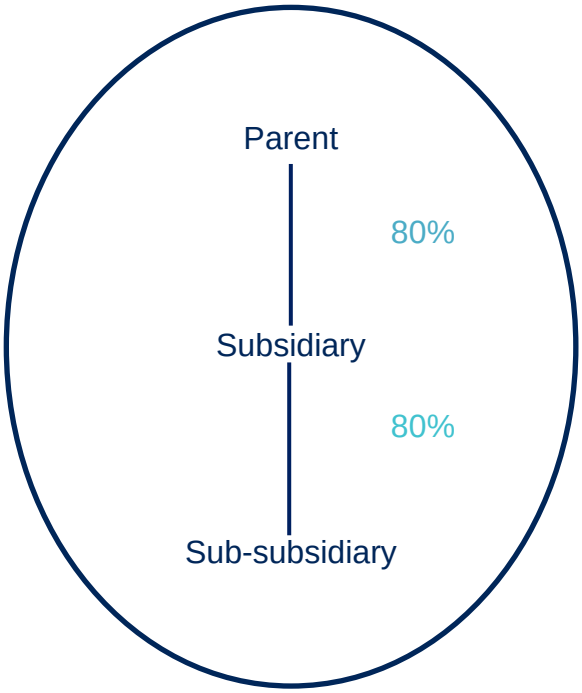
Notes

2 Vertical groups

1.2 Vertical group structures

A vertical group will consist of an **INDIRECTLY CONTROLLED** subsidiary.

Called a **SUB-subsidiary** (sub-sub).



Notes

1.3 Accounting for sub-subsidiaries in a vertical group

Parent has **CONTROL** in the sub-subsidiary.

Treat as a normal subsidiary but with 3 main complications.

(1) Effective shareholdings

(2) Date of effective control

(3) Indirect holding adjustment (IHA)

Notes

1.4 Accounting for sub-subsidiaries in a vertical group: Effective Shareholding.

Effective shareholding = (P% in S) × (S% in sub-sub)

Using group structure set out previously.

Effective shareholding = 80% × 80% = 64%.

NCI % = 36%.

Be aware that P's effective shareholding does not need to be above 50% for P to have indirect control in the sub-sub.

As long as the subsidiary has a controlling interest in the sub-sub, the parent will have indirect control, irrespective of the effective shareholding. %.

Illustrations and further practice

Now work through illustration 2 to show different examples of effective shareholding calculations including those where the effective shareholding is <50% from Chapter 14.

Notes

1.5 Accounting for sub-subsidiaries in a vertical group: effective date of control

The sub-sub should only be consolidated from the date of effective control.

The **DATE OF EFFECTIVE CONTROL** is the:

Later of:

- date P purchased S
- date S purchased sub-sub.

Illustrations and further practice

Now work through illustration 3 & 4 to illustrate how to determine the effective date of control from Chapter 14.

Notes

1.6 Accounting for sub-subsidiaries in a vertical group: indirect holding adjustment (IHA)

Who purchases the sub-sub?	Subsidiary
Who owns the subsidiary?	Parent and NCI of S

The IHA adjusts for the amount contributed in purchasing the sub-sub by the NCI of S.

- On preparation of a CSOFP including a sub-sub, goodwill and NCI will need to be calculated.
- Both of these calculations will be affected by the IHA.

Notes

Sub-sub's goodwill calculation

Cost of investment	x	
IHA	**(x)**	Take to NCI working
(**S** NCI% × cost of investment)		
NCI at acquisition	x	
less		
FV of Sub-subs net assets at acquisition	(x)	
GW at acquisition	x	

S's NCI working

NCI at acquisition	x
NCI % × S post acquisition reserves	x
IHA	**(x)**
NCI at reporting date	x

Notes

Illustrations and further practice

Now work through illustration 5 to illustrate the IHA from Chapter 14.

Now Work through TYU 2 as an example of a CSOFP with a vertical group from Chapter 14.

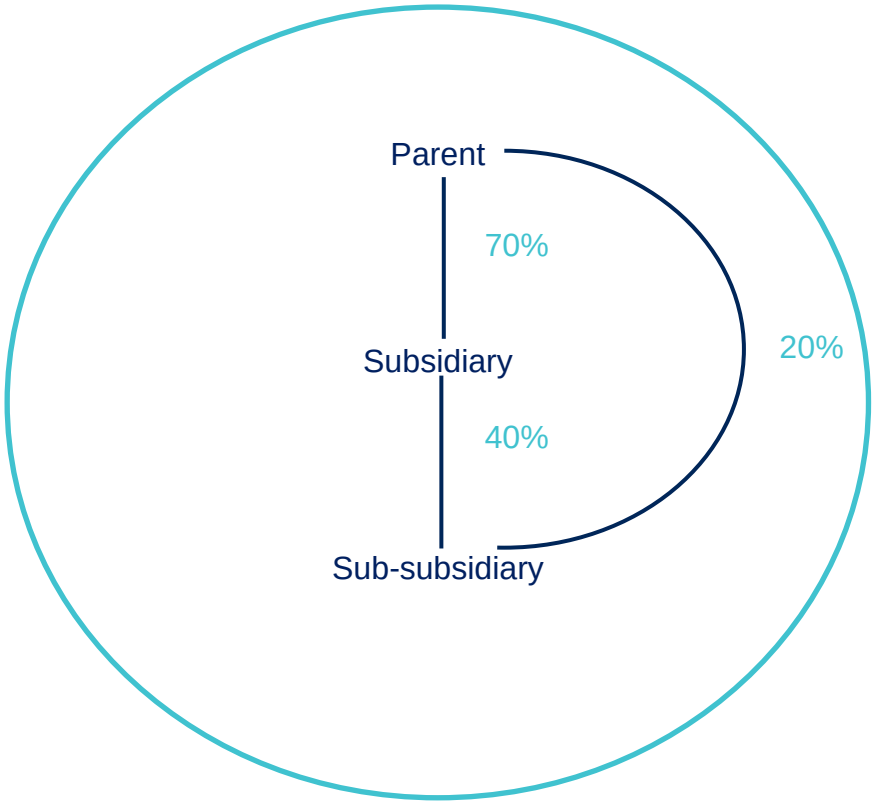
Notes

3 Mixed (D-shaped) groups

3.1 Mixed group structures

A mixed group will contain a sub-subsidiary with a combination of:

- an indirect shareholding by P
- a direct shareholding by P.



Notes

3.2 Accounting for Sub-subsidiaries in a mixed group

The treatment is very similar to a vertical group.

Parent has **CONTROL** in the sub-subsidiary.

Treat as a normal subsidiary but with 3 main complications.

(1) Effective shareholdings

(2) Date of effective control

(3) Indirect holding adjustment (IHA)

Notes

The only difference relates to calculating the effective shareholding.

Indirect shareholding (P% in S) × (S% in sub-sub)	x
+	
Direct shareholding (P% in sub-sub)	x
Effective shareholding	x

Using group structure set out previously,

Indirect shareholding 70% × 40%	28
+	
Direct shareholding	20
Effective shareholding	48%
NCI %	**52%**

Notes

OT Questions

You should now be able to answer TYU 1–11 from Chapter 14 of the Study Text and questions 107, 108, 113–114, 116,117 and 129 from the Exam Practice Kit.

For further reading, visit Chapter 14 of the Study Text.

Chapter 15

Changes in group structure

Outcome

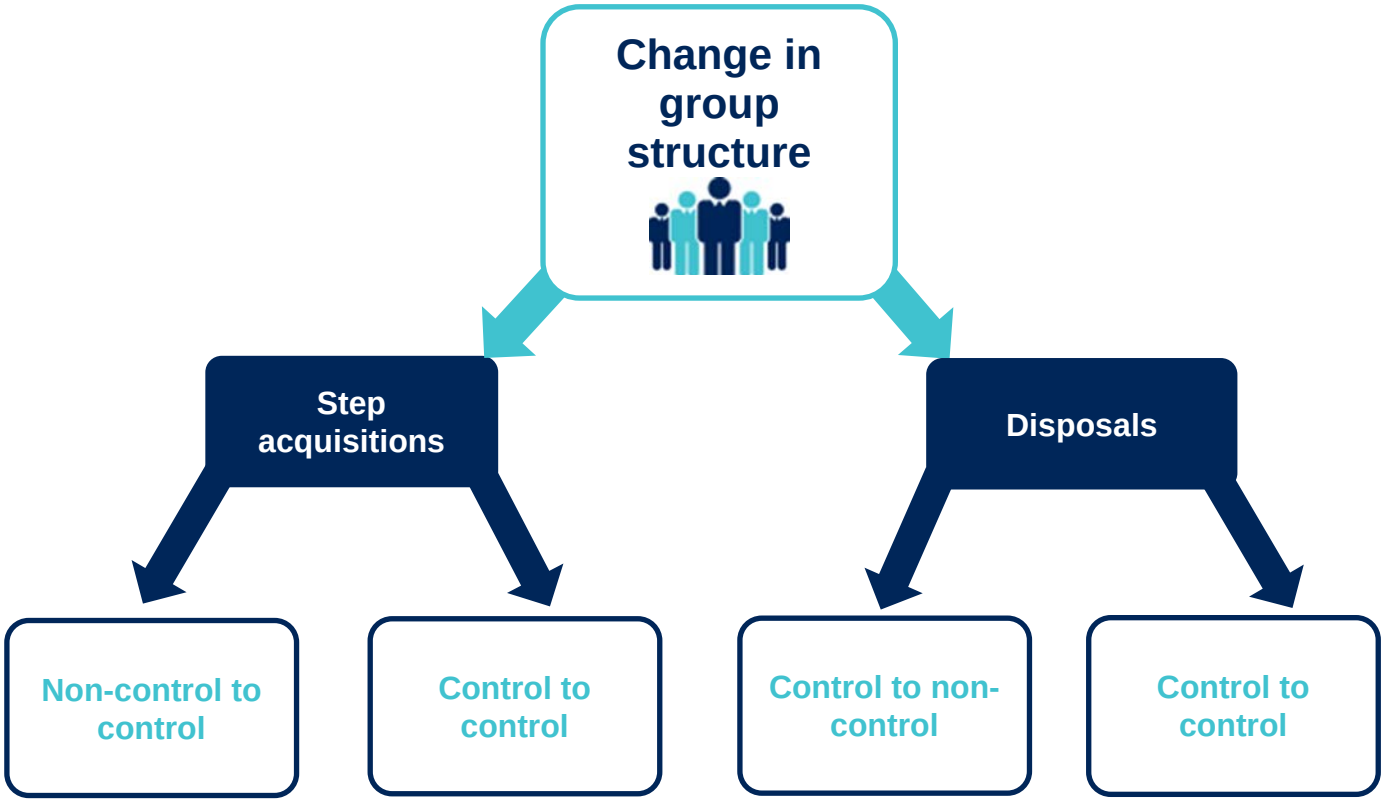
At the end of this session you should be able to:

- demonstrate the impact on the group financial statements of acquiring additional shareholdings
- demonstrate the impact on the group financial statements of disposing of all or part of a shareholding in the period

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 15 of your Study Text.

Overview


Change in group structure
Step acquisitions
Disposals
Non-control to control
Control to control
Control to non-control
Control to control

1 Step acquisitions – summary

1.1 Step acquisitions

Not every acquisition in a group occurs in one purchase. Investments can be obtaining via piecemeal purchases known as step acquisitions.

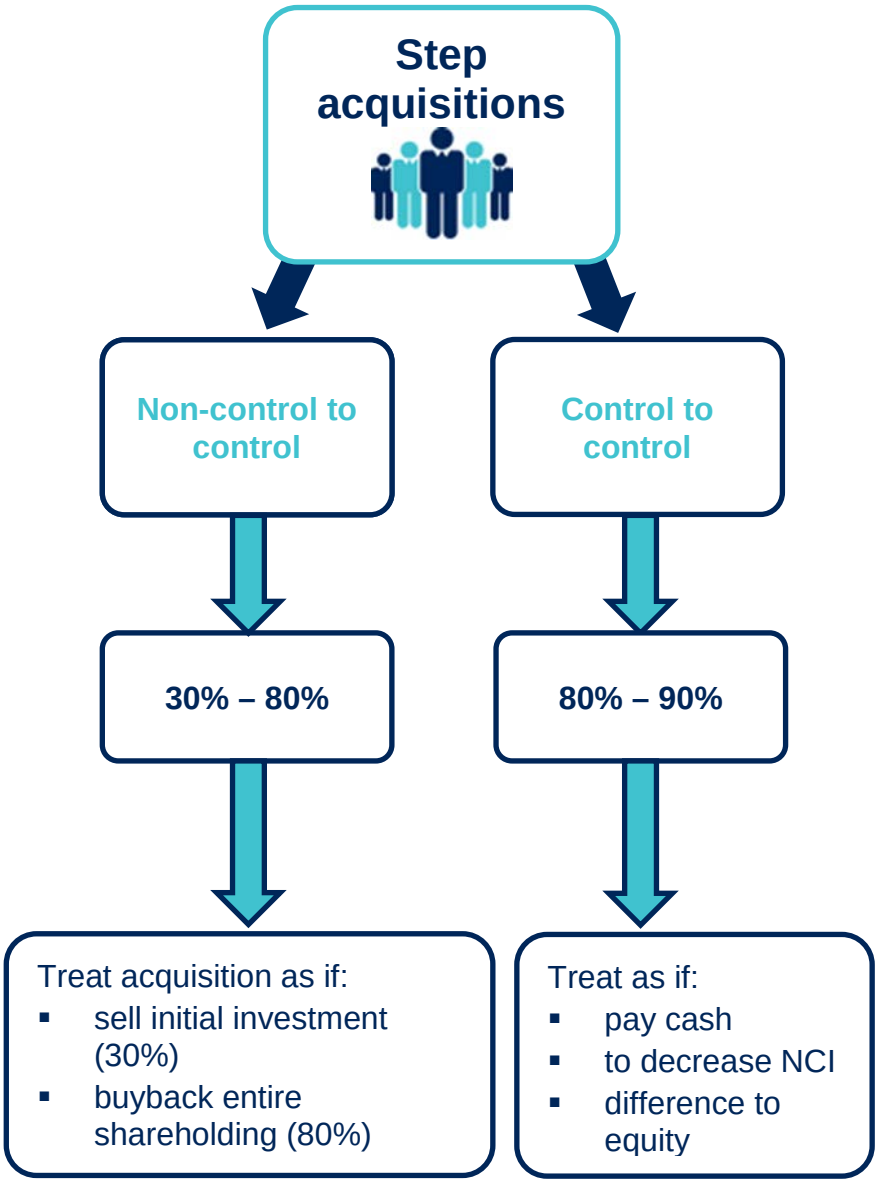
Two main types of step acquisition will impact the group financial statements:

(1) non-control to control

(2) control to control.

Notes

1.2 Step acquisitions in summary



Notes

1.3 Step acquisitions that achieve control

Consolidation of a subsidiary only occurs on the date control is achieved.

The step acquisition is treated as if the group:

- sells the initial investment (30%)
- buys the entire investment all at once (80%).

Notes

- **Sell the initial investment (30%)**

  - Revalue initial investment to FV
  - G/L's go to P/L

- **Buy the entire investment all at once (80%)**

The new FV of the initial investment is included, along with the step acquisition price, within the cost of investment in **GOODWILL.**

Cost of investment	
(FV of initial + cost of step acquisition)	x
NCI at acquisition	x
less	
FV of Subs net assets at acquisition	(x)
GW at acquisition	x
Impairment	(x)
GW at reporting date	x

Notes

Illustrations and further practice

Now work through TYU 1 to illustrate the impact of a non-control to control step acquisition on a CSOFP from Chapter 15.

Notes

1.4 Control to control step acquisitions (80% – 90%)

- Transfer between shareholders.
- Subsidiary before and after the acquisition.
- No change to goodwill.

Step acquisition is treated as if:

- Pay cash
- To decrease NCI
- Difference to equity

→

Dr NCI

Cr Cash

Dr/Cr Equity

The movement in NCI is calculated as a **PROPORTION** of the NCI balance at the step acquisition date.

Illustrations and further practice

Now work through TYU 5 to illustrate the impact of a non-control to control step acquisition on a CSOFP from Chapter 15.

Notes

2 Disposals

2.1 Disposals

A disposal occurs when the parent sells the shares of a subsidiary.

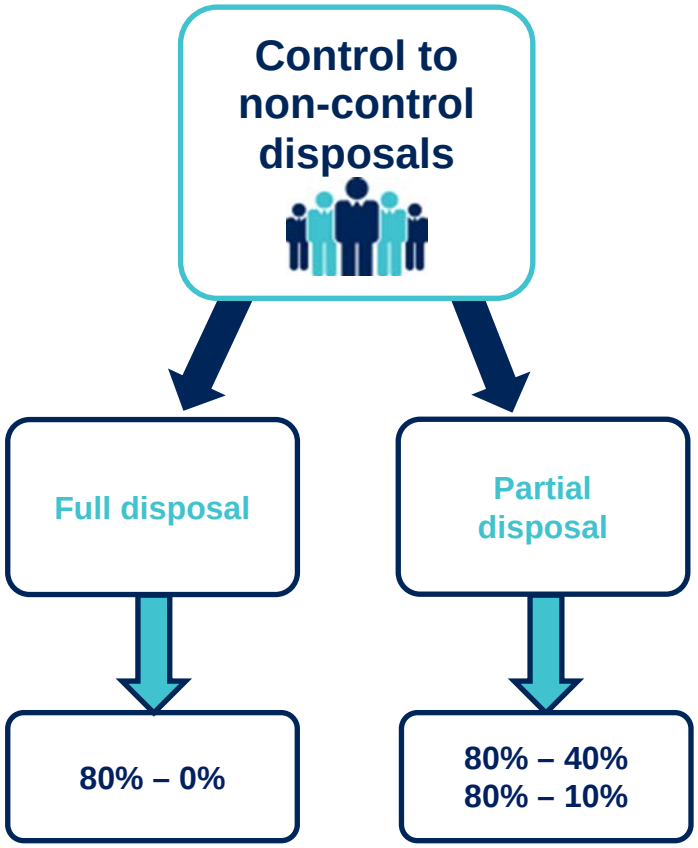
Two main types of disposal will impact the group financial statements:

(1) control to non-control (lose control)

(2) control to control (control retained).

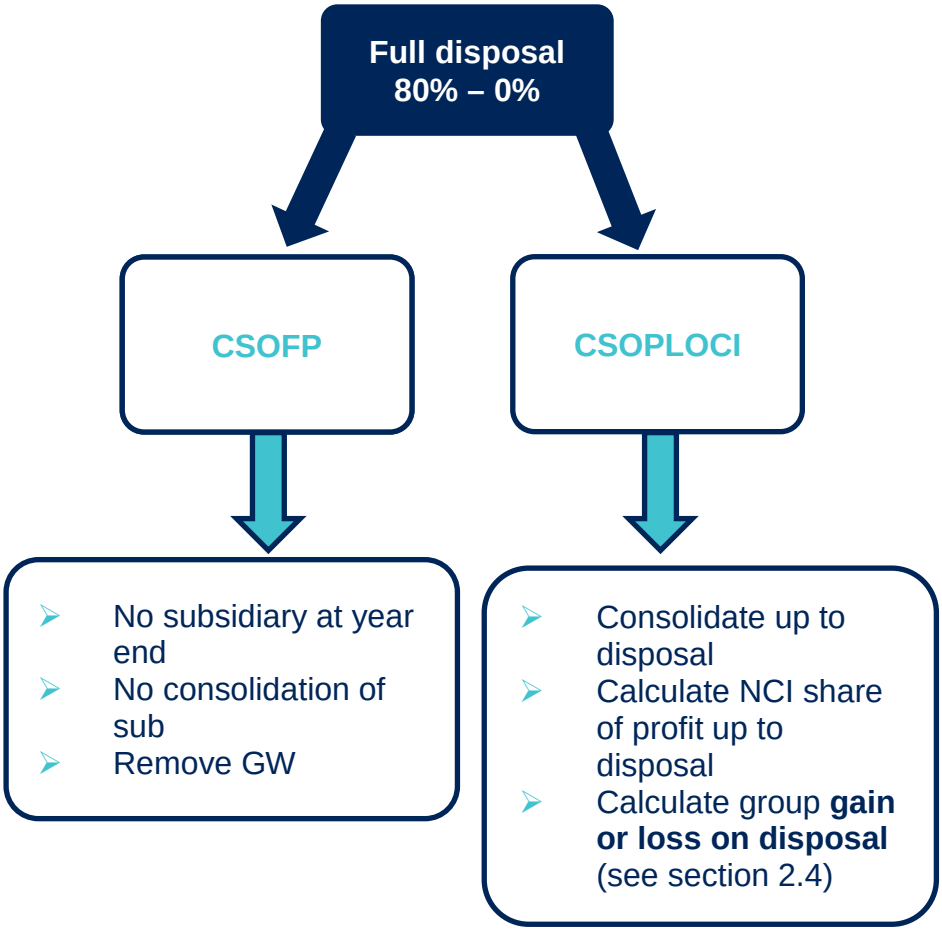
Notes

2.2 Control to non-control disposals



Notes

2.3 Full disposals in group accounts



Notes

2.4 Calculation of gain or loss on disposal

Proceeds on disposal		x
less		
Carrying value of subsidiary at disposal		
Sub's NET ASSETS at disposal	x	
Sub's GOODWILL at disposal	x	
less		
NCI at disposal	(x)	
		(x)
Groups gain or loss on disposal		**X**

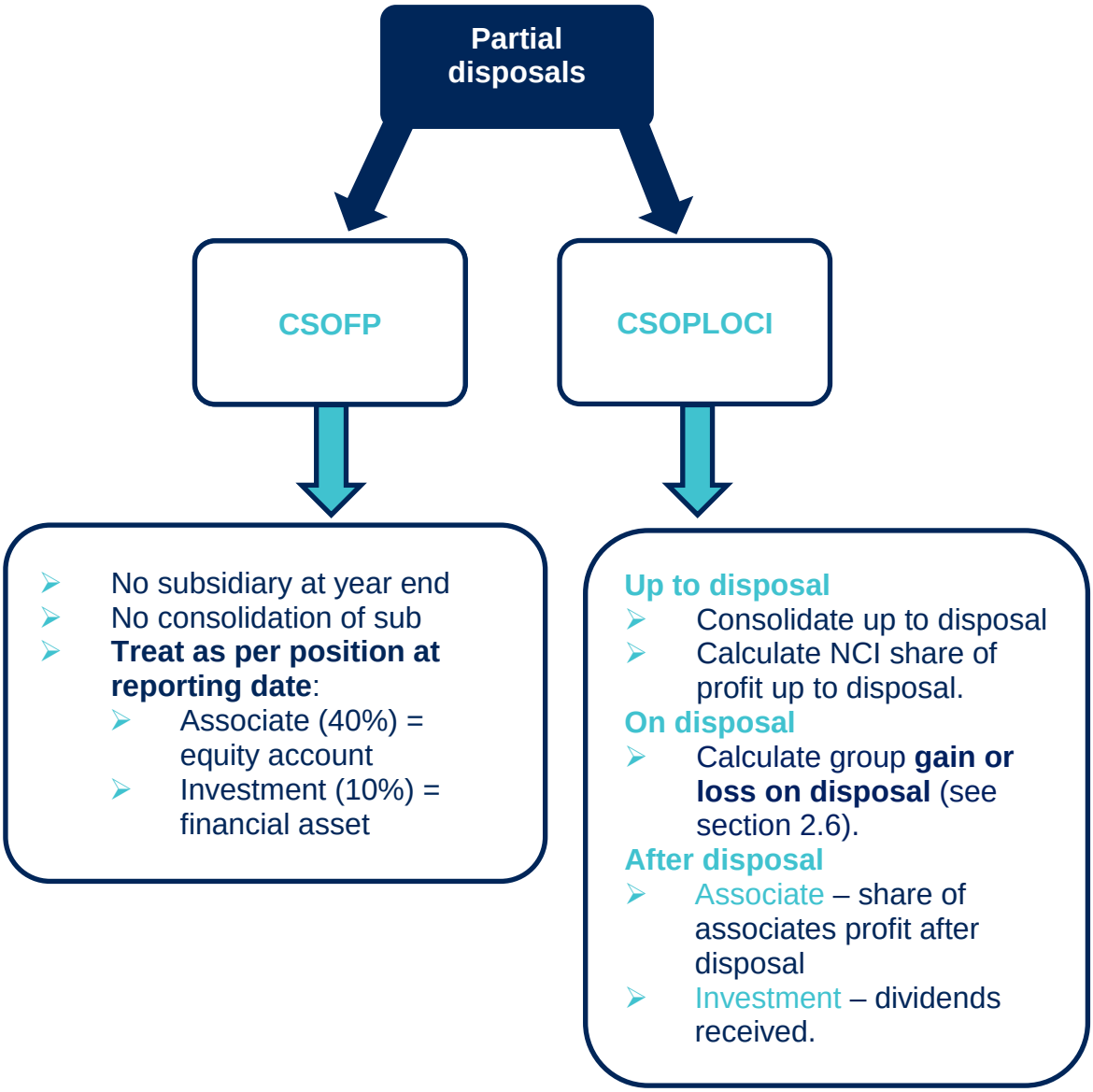
The gain or loss is shown as an exceptional item on the CSOPL.

Illustrations and further practice

Now work through TYU 8 (aii) to illustrate the calculation of the gain or loss on disposal from a full disposal from Chapter 15

Notes

2.5 Partial disposals in group accounts



Notes

2.6 Calculation of gain or loss on partial disposal

Proceeds on disposal		x
FV OF RESIDUAL INTEREST		x
less		
Carrying value of subsidiary at disposal		
Sub's NET ASSETS at disposal	x	
Sub's GOODWILL at disposal	x	
less		
NCI at disposal	(x)	
		(x)
Groups gain or loss on disposal		**X**

The gain or loss is shown as an exceptional item on the CSOPL.

Illustrations and further practice

Now work through TYU 8 b) to illustrate the calculation of the gain or loss on disposal from a partial disposal from Chapter 15.

Set TYU 9 for homework to illustrate a disposals impact on the CSOPL from Chapter 15.

Notes

1.5 Control to control disposals (90% – 80%)

- Transfer between shareholders.
- Subsidiary before and after the acquisition.
- No change to goodwill.

Disposal is treated as if:

- Received cash
- To increase NCI
- Difference to equity

Dr Cash

Cr NCI

Dr/Cr Equity

The movement in NCI is calculated as a **SHARE (%) OF THE SUB'S NET ASSETS PLUS GOODWILL** as at the disposal date.

Illustrations and further practice

Now work through TYU 10 to illustrate the impact of a control to control disposal from Chapter 15.

Notes

OT Questions

You should now be able to answer TYU 1–12 from Chapter 15 of the Study Text and questions 119, 122, 124–128,130–131 for step acquisitions and 118, 121, 123, 132 & 135 for disposals from the Exam Practice Kit.

For further reading, visit Chapter 15 of the Study Text.

Chapter 16

Consolidated statement of changes in equity (SOCIE)

Outcome

By the end of this session you should be able to:

- Prepare the consolidated statement of changes in equity (CSOCIE)
- Appreciate and reproduce the impact to the CSOCIE of changes in group structure

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 16 of your Study Text.

Overview

1 CSOCIE

1.1 Objective of the CSOCIE

The CSOCIE shows the movements in the groups **EQUITY** balances from the CSOFP.

1.2 Basic CSOCIE pro forma

	Parent shareholders	NCI
Equity b/f	x (W1)	x (W2)
Total comprehensive income	x	x
Dividends	(x)	(x)
Equity c/f	x	x

From CSOPLOCI

- Parent = P's dividend paid **only**
- NCI = NCI's % of S's dividend paid

Notes

1.3 Equity and NCI b/f (brought forward) calculations

The parent shareholders equity b/f and NCI b/f are derived from the CSOFP workings.

Parent shareholders equity b/f is derived from group reserves working at the start of the year.

NCI b/f is derived from the NCI working as at the start of the year.

(W1) Parent shareholders equity b/f

	Parent shareholders
100 % P's Equity b/f	x
P's % of S's post acq reserves **up to the b/f date**	x
Impairment b/f	(x)
Equity b/f	W1

Notes

(W2) NCI b/f

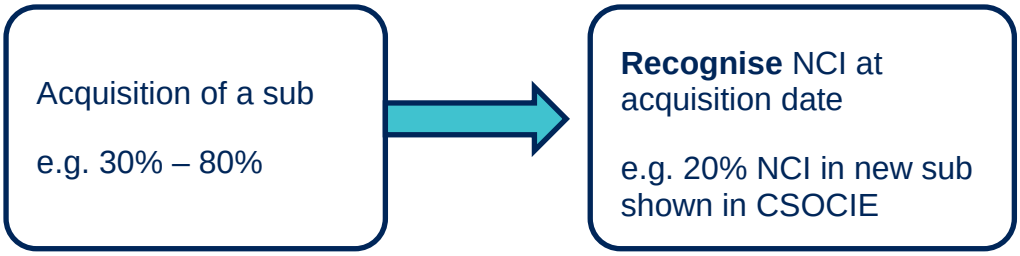
	NCI
NCI @ Acquisition	x
NCI's % of S's movement in post acq reserves **up to the b/f date**	x
NCI b/f	W2

Notes

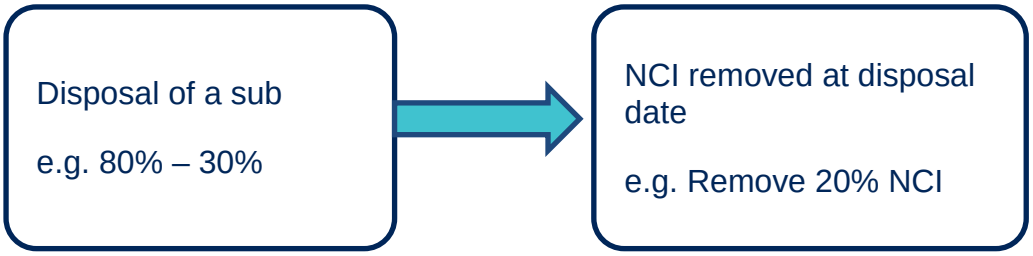
2 CSOCIE and changes in group structure

2.1 Impact of acquisitions and disposals on CSOCIE

Acquisition of a subsidiary



Disposal of a subsidiary



Notes

2.2 Impacts of transfer between owners (control to control) on CSOCIE

Control to control acquisitions (80% – 90%)

- Pay cash
- To reduce NCI
- Difference to equity

→ **Decreases** NCI at acquisition date.

Equity movement affects P's column.

Control to control disposals (90% – 80%)

- Received cash
- To increase NCI
- Difference to equity

→ **Increases** NCI at disposal date.

Equity movement affects P's column.

Notes

2.3 Revised CSOCIE pro forma

	Parent shareholders	NCI
Equity b/f	x	x
	(W1)	(W2)
Total comprehensive income	x	x
Dividends	(x)	(x)
Acquisition of sub	–	x
Disposal of sub	–	(x)
Control to control – acq	(x)/x	(x)
Control to control – disp	(x)/x	x
Equity c/f	x	x

Notes

Illustrations and further practice

Now work through TYU 7 (part 3) to illustrate the impact on CSOCIE of a control to control acquisition from Chapter 16.

Notes

OT Questions

You should now be able to answer TYU 1–7 from Chapter 16 of the Study Text and question 120 from the Exam Practice Kit.

For further reading, visit Chapter 16 of the Study Text.

Chapter 17

Consolidated statement of cash flows

Outcome

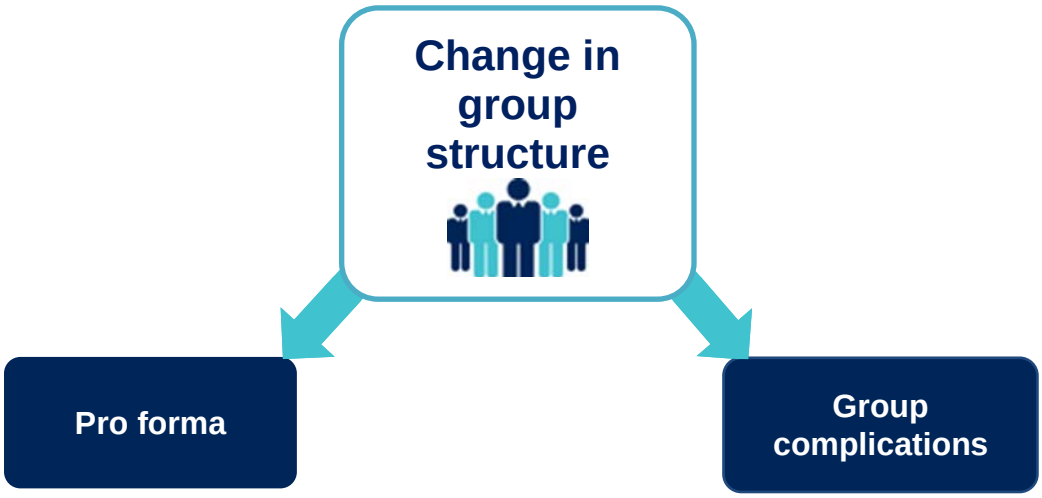
By the end of this session you should be able to:

- understand the objective of a consolidated cash flow
- prepare the consolidated statement of cash flow (CSCF)

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 17 of your Study Text.

Overview



1 CSOCF – Basics (F1 Revision)

1.1 Objective of the CSOCF

The CSOCF shows all the cash and cash equivalent outflows and inflows for a period.

The consolidated cash flow statement groups the cash flows under 3 main headings:

- cash flow from operating activities
- cash flow from investing activities
- cash flow from financing activities.

Notes

1.2 CSOCF pro forma

Consolidated statement of cash flow for the year ended…… 20XY		
Cash flows from operating activities		
Cash generated from operations	**x** REC (see 1.3)	
Tax paid	(x)	
Interest paid	(x)	
Net cash from/used in operating activities	x/(x)	x/(x)
Cash flows from investing activities		
Proceeds from sales of PPE	x	
Purchases of PPE	(x)	
Interest received	x	
Dividend received	x	
Acquisition/sale of subsidiary	(x)/x	
Net cash from/used in investing activities	x/(x)	x/(x)
Cash flows from financing activities		
Loans	(x)/x	
Share issue	x	
Dividends paid – P	(x)	
Dividends paid – NCI	(x)	
Net cash from/used in financing activities	x/(x)	x/(x)
Increase/decrease in cash and cash equivalents		**x**
Opening cash and cash equivalents		**x**
Closing cash and cash equivalents		**x**

Notes

1.3 Cash generated from operations

Cash flows from operating activities include a line for “cash generated from operations”.

Cash generated from operations includes all day to day operating cash flows.

Numerous cash flows contribute to this figure. e.g. cash from sales, purchases, wage payments, receipts from receivables.

A reconciliation between profit before tax and cash generated from operations is often used to calculate “cash generated from operations”.

Notes

Indirect method

(1) Start with PBT	x
(2) Strip out non-operating impacts from PBT	
Finance cost	x
Investment income	(x)
(3) Strip out non-cash impacts from PBT	
Gain or loss on disposal of PPE	(x)/x
Depreciation	x
Impairment	x
(4) Deal with working capital movements	
Increase/decrease in inventory	(x)/x
Increase/decrease in trade receivables	(x)/x
Increase/decrease in trade payables	x/(x)
Cash generated from operations	x/(x)

Notes

2 CSCF – complications

2.1 Consolidated statement of cash flow complications

Groups will incur or receive cash flows that single companies will not.

The impact of those cash flows must be considered within the CSCF.

The main group complications are:

- dividends paid to NCI's
- dividends received from associates
- impact of mid-year acquisitions or disposals of subsidiaries.

Notes

2.2 Dividends paid to NCI

Non-Controlling interest

β Dividend paid	**x**	Balance brought forward	x
		NCI share of profit/OCI	x
Balance carried forward	x		

Dividend paid to NCI is shown under:

"Cash flows from FINANCING activities".

Illustrations and further practice

Now work through TYU 3 to illustrate the calculation of dividends paid to NCI within the CSCF, from Chapter 17.

Notes

2.2 Dividends received from associates

Investment in associate

Balance brought forward	**x**	**Dividend received**	**x β**
Associate share of profit/OCI	x		
		Balance carried forward	x

Dividend received from associates is shown under:

"Cash flows from INVESTING activities".

Illustrations and further practice

Now work through TYU 6 to illustrate the calculation of dividends received from associates within the CSCF from Chapter 17.

Notes

2.3 Impacts of mid-year acquisition or disposals

If a group acquires a new subsidiary during the year:

- cash will be paid by the group
- 100% of Sub's assets and liabilities will be consolidated
- GW and NCI will increase.

This will cause impacts in the CSCF.

- Cash paid will be included in "Cash flows from investing activities"
  - Net of any cash received on consolidation.
- Workings will need to take into consideration the impact of the acquisition **e.g. Add to PPE, GW, NCI**.
- Movements in working capital will take into consideration the assets and liabilities consolidated **e.g. inventory, trade receivables, trade payables.**

If a disposal occurs, the same effects will be represented but with the opposite impact e.g. cash received to sell sub, sub's assets and liabilities removed from workings.

Notes

Illustrations and further practice

Now work through TYU 7 to illustrate the impact of mid-year acquisitions and disposals on a PPE working from Chapter 17.

Could use TYU 8 to show impact to the reconciliations of a mid-year acquisition and disposal from Chapter 17.

If you prefer to show the overall impact on the entire CSCF, use TYU 9 from Chapter 17.

Notes

OT Questions

You should now be able to answer TYU 1–11 from Chapter 17 of the Study Text and questions 133–134 & 136–141 from the Exam Practice Kit.

For further reading, visit Chapter 17 of the Study Text.

Chapter 18

Foreign currency translation

Outcome

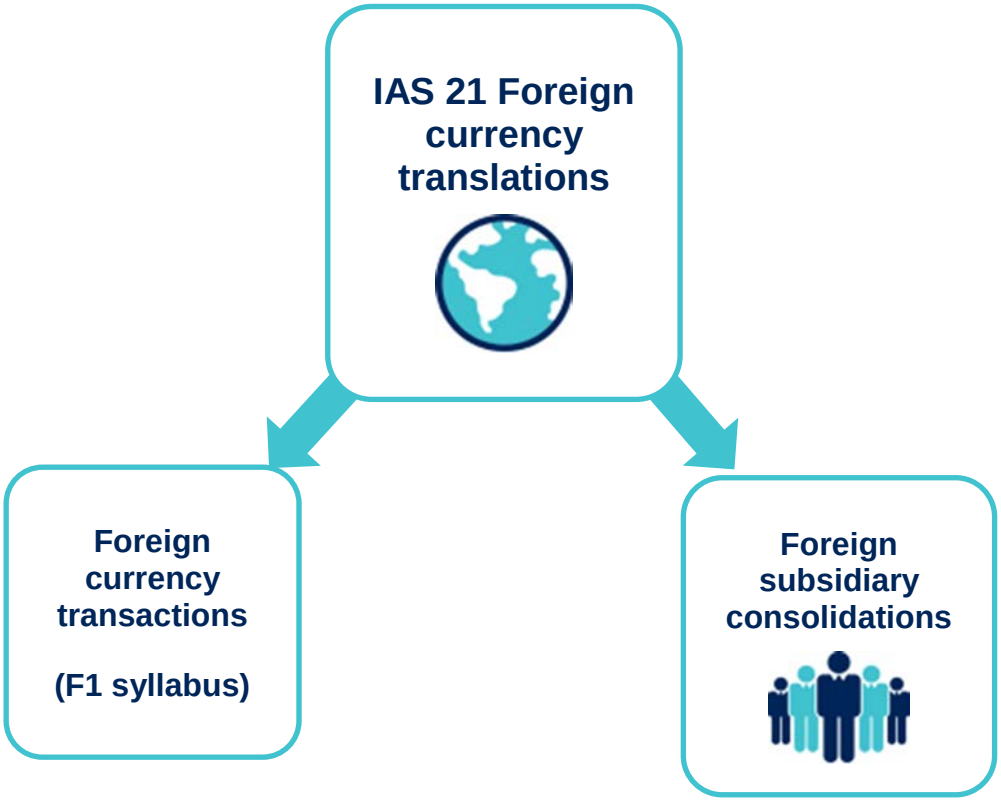
By the end of this session you should be able to:

- Determine the functional currency of an entity
- Translate a foreign subsidiary's financial statements
- Prepare the consolidated financial statement of a group including a foreign subsidiary

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 18 of your Study Text.

Overview


IAS 21 Foreign currency translations
Foreign currency transactions
(F1 syllabus)
Foreign subsidiary consolidations

1 Definitions

1.1 Important definitions for foreign currency consolidations

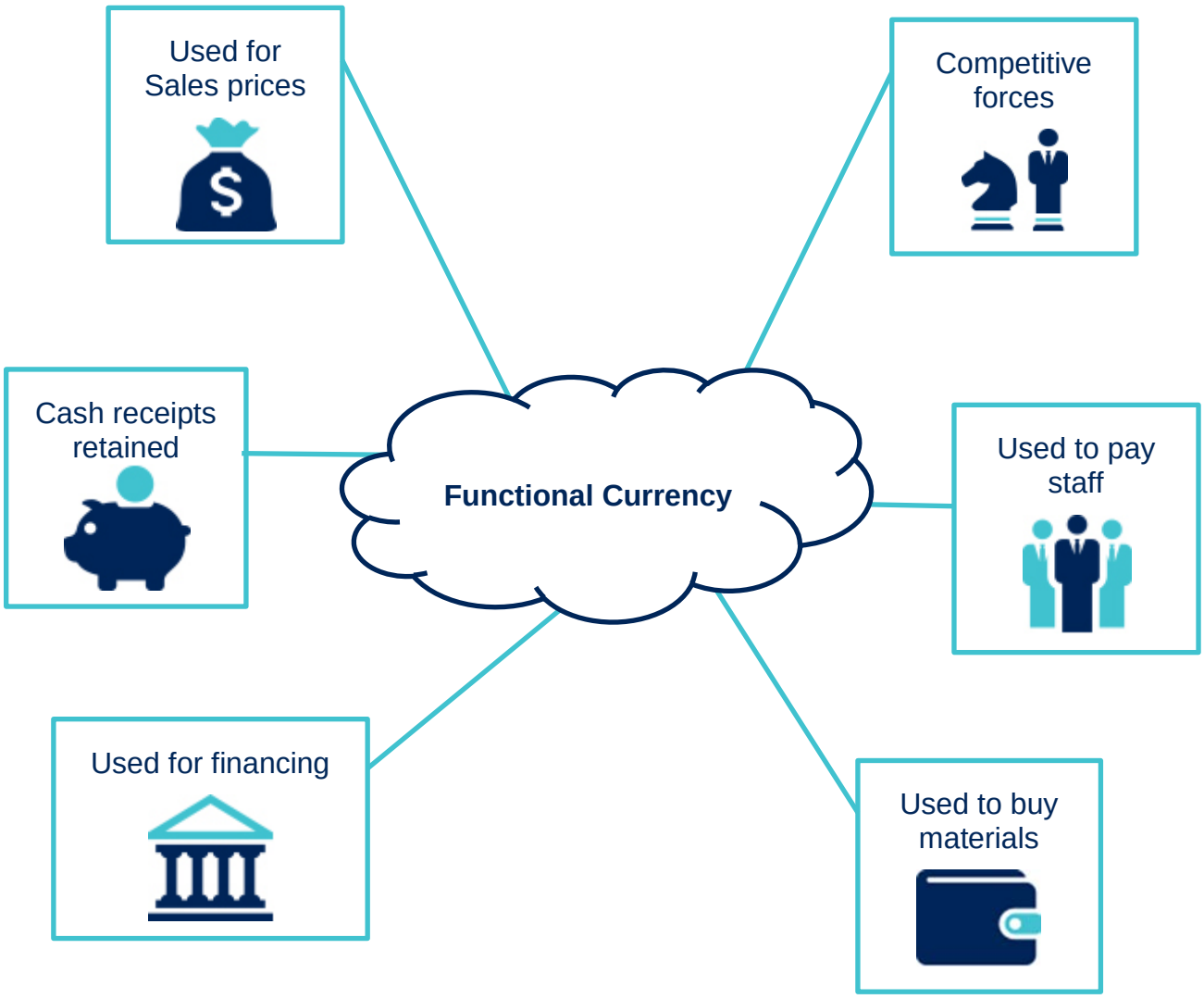
- **Functional currency** – currency of the primary economic environment in which the entity operates.
- **Presentation currency** – currency used to prepare the financial statements.

Rates

- **Closing rate (CR)** – rate of exchange in existence as at the year end.
- **Historic rate (HR)** – rate of exchange in existence at the time a transaction occurs (AKA spot rate).
- **Opening rate (OR)** – rate of exchange in existence at the start of a period.
- **Average rate (AR)** – average rate of exchange for a period.

Notes

1.2 Determining the functional currency



Notes

2 Foreign currency subsidiary consolidations

2.1 Foreign currency consolidations

Foreign currency consolidations are required if a group contains a subsidiary with a **DIFFERENT** functional currency to the parent.

To consolidate the foreign subsidiary:

(1) Translate the subsidiary into P's functional currency

(2) Consolidate using normal techniques.

Notes

2.2 Translation of foreign subsidiary into P's functional currency

Statement of financial position

Assets and liabilities @ CR

Statement of profit or loss and other comprehensive income

Income and expenses @ AR

ALL foreign currency exchange differences from translating a foreign subsidiary will be taken to **GROUP RESERVES.**

Notes

2.3 Consolidation of foreign subsidiary

Once the foreign subsidiary has been translated, the subsidiary can be consolidated using normal techniques.

Foreign currency exchange differences will arise from the translation of the subs net assets and goodwill.

They are taken to **GROUP RESERVES.**

Annual exchange differences are shown in **OCI.**

Notes

2.4 Annual foreign exchange differences from translation of a foreign subsidiary

Exchange difference on net assets

Closing NA's @ CR	x	
less		
Opening NA's @ OR	(x)	
Comprehensive income for the year @ AR	x	
	———	
Foreign exchange difference on S's net assets	x	Split between P and NCI using %
	———	Held in OCI

Notes

Exchange difference on goodwill

Goodwill @ CR	x	
less		
Goodwill @ OR	(x)	
Impairment(@ AR	x	
Foreign exchange difference on GW	x	Check whether FV method or proportionate method If proportionate, all P's If full, split between P and NCI.

Always calculate S's goodwill in functional currency of the sub to determine the exchange differences.

Illustrations and further practice

Now work through TYU 1 to illustrate the translation and consolidation of a group containing a foreign subsidiary from Chapter 18.

Notes

OT Questions

You should now be able to answer TYU 1–3 from Chapter 18 of the Study Text and questions 142–150 from the Exam Practice Kit.

For further reading, visit Chapter 18 of the Study Text.

Chapter 19

Analysis of financial performance and position

Outcome

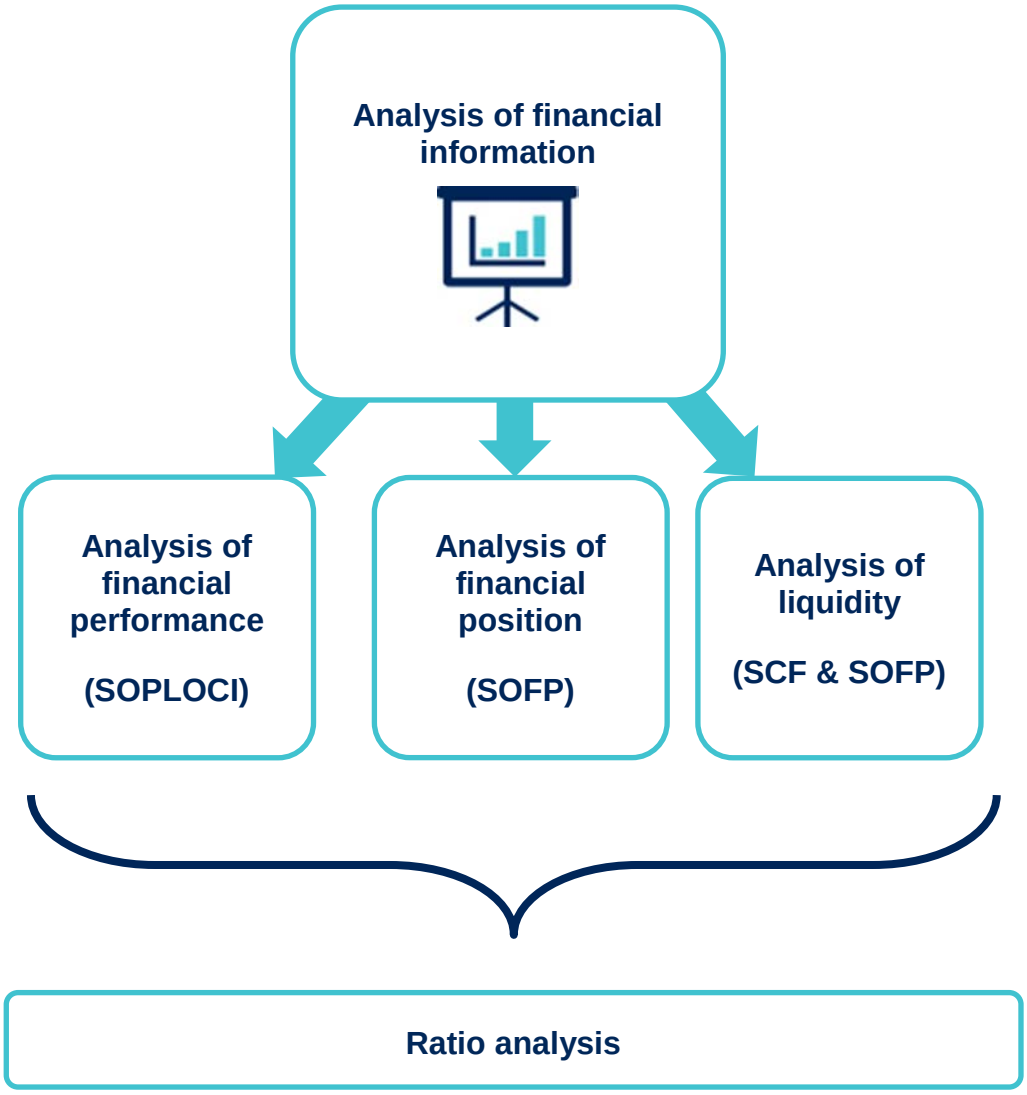
By the end of this session you should be able to:

- evaluate the financial performance, position and financial adaptability of an entity based on information within the financial statements
- calculate ratios for profitability, performance, efficiency, liquidity and investor analysis
- prepare the consolidated financial statement of a group including a foreign subsidiary
- advise on action that could be taken to improve an entity's financial performance and financial position
- discuss the limitations of financial analysis

and answer questions relating to those areas.

The underpinning detail for this chapter in your Notes can be found in Chapter 19 of your Study Text.

Overview


Analysis of financial information
Analysis of financial performance
(SOPLOCI)
Analysis of financial position
(SOFP)
Analysis of liquidity
(SCF & SOFP)
Ratio analysis

1 Introduction to analysis

1.1 Introduction to analysis of performance and position

Chapters 3 – 18 look at preparing the financial statements.

- Why do entities prepare financial statements in the first place?
- What is the purpose of the financial statements?

To allow the **USERS** of the financial statements to analyse the performance and position of an entity.

Analysis makes up 25% of the F2 exam. You will get 15 questions on this topic area.

Notes

1.1 Introduction to analysis of performance and position (cont'd)

When performing analysis of financial data, the following must be considered before making any conclusions:

➢ Who is the user?	Each user will have a different objective for analysis.
➢ What industry/market is the entity operating in?	Acceptable results can be industry specific e.g. current ratios.
➢ What sources of data is available?	FS from one year to next, FS for 2 separate companies, Industry averages, Operating segments.
➢ Any other information required for conclusions?	Other FS's, further detail re financing terms, accounting policy details, breakdown of aggregated FS figures.

Notes

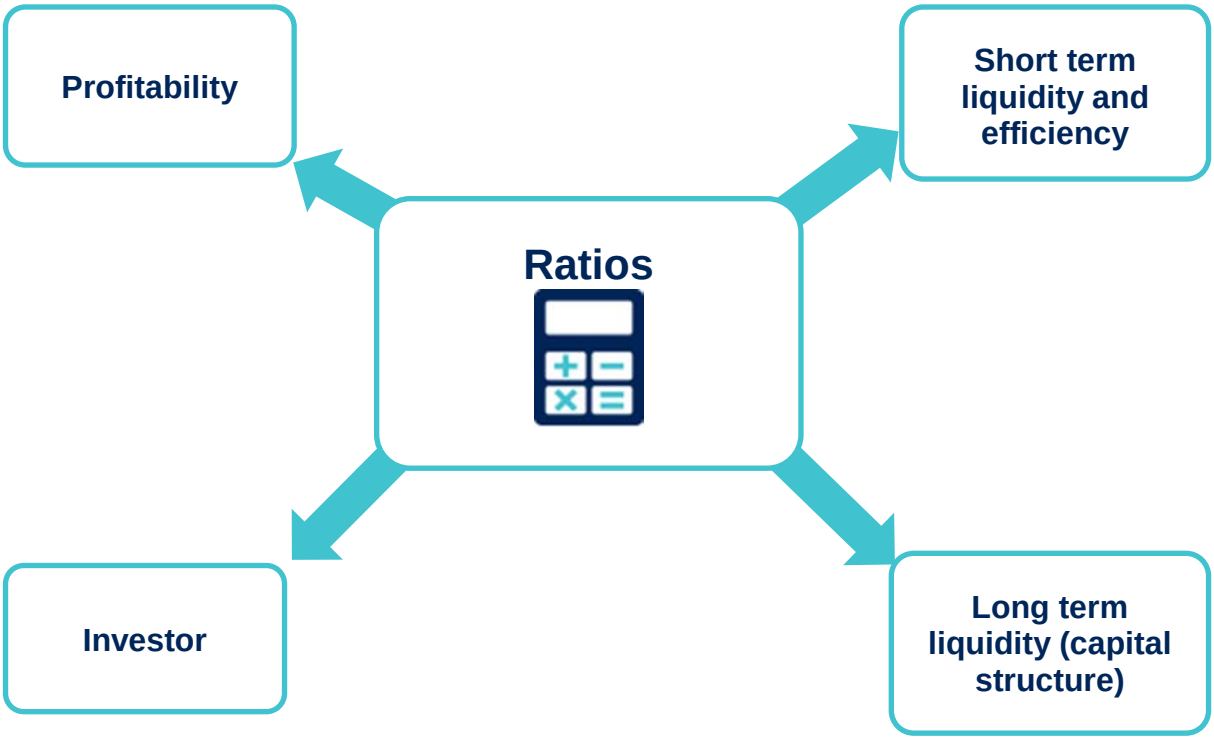
1.2 Users of financial analysis

	User	Objective of analysis
	➢ Shareholders (potential and current)	To determine if: – they will receive a dividend – the share price will grow – the business will continue to operate.
	➢ Providers of finance	To determine if: – they will get their money back – should they provide the finance.
	➢ Suppliers	To determine if: – they will get paid for their supplies.
	➢ Customers	To determine if: – the company will be able to continue to supply the customer.
	➢ Employees	To determine if: – jobs are secure.
	➢ Government	To determine if: – appropriate taxes were paid.

Notes 

2 Ratio analysis

2.1 Types of ratio



Notes

2.2 Profitability ratios

The main profitability ratios are:

- Gross profit margin (GP%)
- Operating profit margin (OP%)
- Return on capital employed (ROCE)
- EBITDA

Notes

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Use TYU 1 from Chapter 19 to illustrate any calculations you deem to be particularly important. More time should be spent on the discussion of the meaning and causes for fluctuations in the ratios.

Gross profit margin (GP%)

$$\frac{\text{Gross profit}}{\text{Revenue}} \times 100$$

Notes

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Common reasons for movements in GP%:

- sales prices movement – product launched at lower (or higher) prices, changes in prices to react to market conditions
- cost price movement – use foreign suppliers therefore foreign currency gains/losses in COS, new suppliers charge different rates
- changes in sales mix
- changes in efficiency
- changes in inventory valuation policies e.g. FIFO to AVCO when prices falling will cause closing stock to be higher thus COS lower and GP% improves.

Operating profit margin (OP%)

$$\frac{\text{Operating profit (PBIT)}}{\text{Revenue}} \times 100$$

Notes

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Common reasons for movements in OP%:

- If in line with GP% reason are the same.
- If not in line with GP%, changes caused by movement in operating expenses e. g:
  - redundancies
  - marketing costs
  - exceptional writes off of PPE
  - salary savings due to directors leaving posts
  - larger delivery networks.

Return on capital employed (ROCE)

This ratios outlines how effectively the entity has generated profit from its capital invested.

$$\frac{\text{Operating profit (PBIT)}}{\text{Capital employed}} \times 100$$

Capital employed = equity + interest bearing borrowing

Acceptable variants do exist e.g. equity + interest bearing borrowings – non–current assets that do not contribute to operating profit (associates).

Notes

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Common reasons for movements in ROCE:

- Caused by movements in OP%(see above) or asset turnover
- If not in line with OP% movements, movement caused by asset turnover (how well entity generates revenues from its NCA's)

  e.g:

  - revaluations
  - investments in PPE near end of year – no time for asset to generate profits
  - changes in leases.

Earnings before interest, tax, depreciation and amortisation (EBITDA)

EBITDA is used to analyse the profitability of a company. It is a popular method of comparing operating performance of companies without the impacts of accounting policies and financing decisions.

Earnings = PAT – NCI share of profits – irredeemable preference share dividends

	$000
PAT (from SPLOCI)	x
Add back	
Interest	x
Tax	x
Depreciation	x
Amortisation	x
EBITDA	x

Notes

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EBITDA is commonly quoted by large companies who have significant depreciation and amortisation charges as a basis for assessing their operating performance. It can be used as a gimmick to improve the perception of a company's performance.

It is commonly but inaccurately used as a measurement of cash flows. EBITDA can be used to measure profitability but is only an approximation of operating cashflows. This is because no impacts of accruals or working capital movements have been considered when determining EBITDA.

2.3 Short term liquidity and efficiency ratios

The main short term liquidity ratios are:

- Current ratio
- Quick ratio

The main efficiency ratios are:

- Inventory holding period (inventory days)
- Receivables collection period (receivable days)
- Payables payment period (payable days)

Notes

Short term liquidity ratios

Current ratio

Current assets		
–––––––––––––––––––	**=**	**n:n**
Current liabilities		**Expressed as a ratio**

Notes

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- Healthy level typically considered as 2:1.
- If too low – may not be able to repay creditors, risk of being forced in liquidation.
- If too high may suggest:
  - obsolete inventory
  - poor credit control
  - poor cash management.
- Must consider industry averages when determining a healthy current ratios

  e.g. retailers will have lower CR than manufacturers.

Quick ratio (Acid test ratio)

$$\frac{\text{Current assets – inventory}}{\text{Current liabilities}} = \text{n:n}$$

Expressed as a ratio

Notes

TUTOR GUIDANCE

- Better indication of short term liquidity as remove the illiquid inventory balance.
- Healthy level typically considered as 1:1.
- If current ratio healthy but quick ratio low, suggests risk of obsolete inventory.

Efficiency ratios

Inventory holding period (inventory days)

$$\frac{\text{Inventory}}{\text{Cost of sales}} \times 365 = \text{n days}$$

Receivables collection period (receivable days)

$$\frac{\text{Trade receivables}}{\text{Revenue}} \times 365 = \text{n days}$$

Payables payment period

$$\frac{\text{Trade payables}}{\text{Cost of sales}} \times 365 = \text{n days}$$

Notes

2.4 Long term liquidity (capital structure) ratios

The main long term liquidity ratios are:

- Gearing
- Interest cover

Notes

Gearing

Alternative 1

$$\frac{\text{Debt}}{\text{Equity}} = \text{n:n}$$

Expressed as a ratio

Alternative 2

$$\frac{\text{Debt}}{\text{Debt + Equity}} \times 100$$

Expressed as a percentage

Notes

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- Gearing is used to determine risk associated with an entity.
- If an entity is highly geared there is a greater risk of:
  - failing to service the entities debt finance (pay the interest)
  - having finance withdrawn
  - failing to obtain further finance from new financiers.
- Comparison to industry averages would be required to determine if gearing is deemed high.

Interest cover

$$\frac{\text{Operating profit}}{\text{Finance cost}} = \text{n times}$$

Notes

TUTOR GUIDANCE

- Interest cover outline how many times an entity can pay interest out of its profit.
- The higher the better.
- If low, indicates high risk of failing to service the finance and potential going concern issues.

2.5 Investor ratios

The main investor ratios are:

- EPS (see Chapter 5)
- P/E
- Dividend cover
- Dividend yield

Notes

P/E ratio

$$\frac{\text{Current market price}}{\text{EPS}} = \text{Typically to 1 decimal place}$$

Illustrations and further practice

Now work through TYU 12 or 13 to illustrate an exam standard question involving P/E from Chapter 19.

Notes

TUTOR GUIDANCE (NOT IN STUDENT NOTES)

- P/E ratio used by investors to as a comparison of the markets interpretation of the risk associated with entities.
- If P/E is higher, suggests that the market has confidence in the entities prospects. They are willing to pay more for the shares of that company.

Dividend cover

$$\frac{\text{EPS}}{\text{Dividend per share}} = \text{n times}$$

Dividend yield

$$\frac{\text{Dividend per share}}{\text{Market price per share}} = \text{Expressed as a \%}$$

Notes

TUTOR GUIDANCE – NOT IN STUDENT NOTES

- Dividend yield give the return on capital investment as a % of market price.
- Dividend cover outlines how many times out of earnings the entity can pay its dividends.
- Higher the cover, the more likely dividend yield will be maintained.

3 Limitations of financial statement analysis

3.1 Limitations of financial reporting information

- Only provides historic data.
- Only provides financial information.
- Filed at least 3 months after reporting date so reducing relevance.
- Limited information for trend analysis over time.
- Lack of detailed information (aggregation).

3.2 Limitations of comparing different entities

- Different accounting policies used between entities.
- Different accounting practices between entities.
- Non coterminous accounting periods.
- Entities in same industry can have different market sectors.
- Incomparability due to size.
- Different regulatory systems in different countries.

3.3 Limitations of ratio analysis

- Acceptable variants of certain ratios exist (Gearing, ROCE).
- Distortion of results e.g. seasonality.
- Absence of additional information to establish a conclusion.
- Can be affected by creative accounting (profit smoothing, off-balance sheet finance, teeming and lading).

Notes

OT Questions

You should now be able to answer TYU 1–17 from Chapter 19 of the Study Text and questions 150–200 from the Exam Practice Kit.

For further reading, visit Chapter 19 of the Study Text.

Appendix

Formula sheet and tables

Appendix

Present value table

Present value of 1.00 unit of currency, i.e. $(1 + r)^{-n}$ where r = interest rate, n = number of periods until payment or receipt.

Periods (n)	Interest rates (r)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	.990	.980	.971	.962	.952	.943	.935	.926	.917	.909
2	.980	.961	.943	.925	.907	.890	.873	.857	.842	.826
3	.971	.942	.915	.889	.864	.840	.816	.794	.772	.751
4	.961	.924	.888	.855	.823	.792	.763	.735	.708	.683
5	.951	.906	.863	.822	.784	.747	.713	.681	.650	.621
6	.942	.888	.837	.790	.746	.705	.666	.630	.596	.564
7	.933	.871	.813	.760	.711	.665	.623	.583	.547	.513
8	.923	.853	.789	.731	.677	.627	.582	.540	.502	.467
9	.914	.837	.766	.703	.645	.592	.544	.500	.460	.424
10	.905	.820	.744	.676	.614	.558	.508	.463	.422	.386
11	.896	.804	.722	.650	.585	.527	.475	.429	.388	.350
12	.887	.788	.701	.625	.557	.497	.444	.397	.356	.319
13	.879	.773	.681	.601	.530	.469	.415	.368	.326	.290
14	.870	.758	.661	.577	.505	.442	.388	.340	.299	.263
15	.861	.743	.642	.555	.481	.417	.362	.315	.275	.239
16	.853	.728	.623	.534	.458	.394	.339	.292	.252	.218
17	.844	.714	.605	.513	.436	.371	.317	.270	.231	.198
18	.836	.700	.587	.494	.416	.350	.296	.250	.212	.180
19	.828	.686	.570	.475	.396	.331	.277	.232	.194	.164
20	.820	.673	.554	.456	.377	.312	.258	.215	.178	.149

Periods (n)	Interest rates (r)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	.901	.893	.885	.877	.870	.862	.855	.847	.840	.833
2	.812	.797	.783	.769	.756	.743	.731	.718	.706	.694
3	.731	.712	.693	.675	.658	.641	.624	.609	.593	.579
4	.659	.636	.613	.592	.572	.552	.534	.516	.499	.482
5	.593	.567	.543	.519	.497	.476	.456	.437	.419	.402
6	.535	.507	.480	.456	.432	.410	.390	.370	.352	.335
7	.482	.452	.425	.400	.376	.354	.333	.314	.296	.279
8	.434	.404	.376	.351	.327	.305	.285	.266	.249	.233
9	.391	.361	.333	.308	.284	.263	.243	.225	.209	.194
10	.352	.322	.295	.270	.247	.227	.208	.191	.176	.162
11	.317	.287	.261	.237	.215	.195	.178	.162	.148	.135
12	.286	.257	.231	.208	.187	.168	.152	.137	.124	.112
13	.258	.229	.204	.182	.163	.145	.130	.116	.104	.093
14	.232	.205	.181	.160	.141	.125	.111	.099	.088	.078
15	.209	.183	.160	.140	.123	.108	.095	.084	.074	.065
16	.188	.163	.141	.123	.107	.093	.081	.071	.062	.054
17	.170	.146	.125	.108	.093	.080	.069	.060	.052	.045
18	.153	.130	.111	.095	.081	.069	.059	.051	.044	.038
19	.138	.116	.098	.083	.070	.060	.051	.043	.037	.031
20	.124	.104	.087	.073	.061	.051	.043	.037	.031	.026

Cumulative present value of 1.00 unit of currency per annum

Receivable or payable at the end of each year for n years $\frac{1-(1+r)^{-n}}{r}$.

Periods (n)	Interest rates (r)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods (n)	Interest rates (r)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.685	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.968	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Appendix

FORMULAE

DVM

$$P_0 = \frac{d_1}{k_e - g}$$

$$k_e = \frac{d_1}{P_0} + g$$

$$g = r \times b$$

Cost of Irredeemable Debt

$$k_d = \frac{I(1-t)}{P_0}$$

WACC

$$WACC = k_{eg}\left[\frac{V_E}{V_E + V_D}\right] + k_d[1-t]\left[\frac{V_D}{V_E + V_D}\right]$$