

ACCA Passcards

Paper F7

Financial Reporting

Passcards for exams
up to June 2015



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Fundamentals Paper F7

Financial Reporting

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Welcome to BPP Learning Media's ACCA **Passcards** for Paper F7 Financial Reporting.

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Run through the **Passcards** as often as you can during your final revision period. The day before the exam, try to go through the **Passcards** again! You will then be well on your way to passing your exams.

Good luck!

	Page		Page
1	1	13	73
2	9		
3	13	14	77
4	19	15	87
5	25	16	101
6	31	17	107
7	39	18	113
8	47	19	117
9	51	20	123
10	61	21	127
11	67	22	133
12	69	23	137

1: The conceptual framework

Topic List

Conceptual framework

GAAP

Objectives: assumptions

Qualitative characteristics

Elements

Capital maintenance

The IASB's Framework for the Preparation and Presentation of Financial Statements has now been replaced by the Conceptual Framework for Financial Reporting.

Conceptual framework – a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

Advantages

- Avoids 'patchwork' or firefighting approach
- Less open to criticism of political/external pressure
- Some standards may concentrate on the income statement, others on the balance sheet

Disadvantages

- Financial statements are intended for a variety of users – single framework may not suit all
- May need different standards for different purposes
- Preparing and implementing standards is still difficult with a framework

Conceptual
framework

GAAP

Objectives:
assumptions

Qualitative
characteristics

Elements

Capital
maintenance

GAAP signifies all the rules, from whatever source, which govern accounting.

Sources for individual countries

- National company law
- National accounting standards
- Local stock exchange requirements
- IASs/IFRSs if applicable

Non-mandatory sources

- Other countries' statutory requirements

In many countries, like the UK, GAAP does not have any statutory or regulatory authority or definition. GAAP is a dynamic concept.

Conceptual
framework

GAAP

**Objectives:
assumptions**

Qualitative
characteristics

Elements

Capital
maintenance

Objectives of financial statements

Financial position

Statement of financial position

Financial performance

Statement of profit or loss and other comprehensive income

Statement of cash flows

Changes in financial performance

Statement of profit or loss and other comprehensive income

Statement of cash flows

Statement of changes in equity

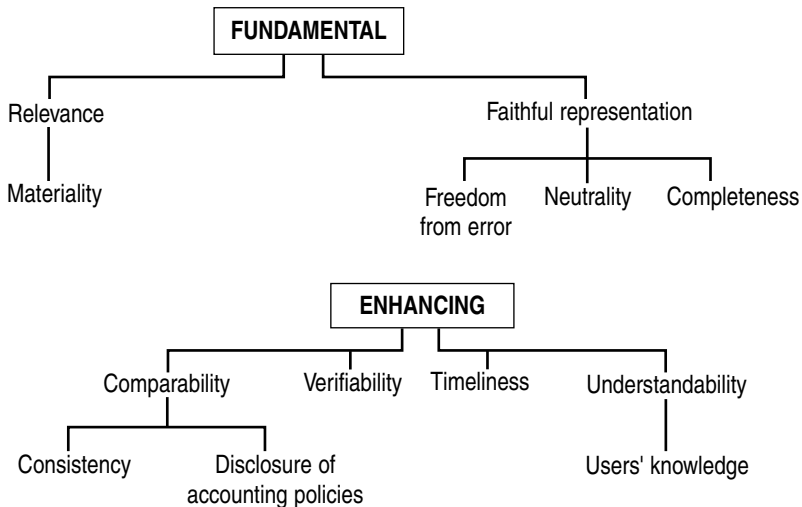
Notes to the financial statements

Directors' report

Underlying assumption



Going concern



Conceptual
framework

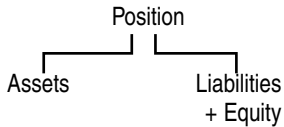
GAAP

Objectives:
assumptions

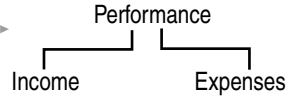
Qualitative
characteristics

Elements

Capital
maintenance



Elements



Probable that any future economic benefit associated with the item will flow to the entity

Recognition

The item has a cost or value that can be measured with reliability

Probability = a degree of uncertainty that the future economic benefits will flow to or from the entity.

Measurement

Historic cost
(acquisition value)



Current cost (amount if
acquired currently)



How should an item
be valued?



Present value (present
discounted value of future
net cash inflows item
expected to generate)



Realisable (settlement)
value (amount selling
in current state)

Conceptual
framework

GAAP

Objectives:
assumptions

Qualitative
characteristics

Elements

Capital
maintenance

Financial capital maintenance

Profit is earned if the financial amount of the net assets at the end of a period exceeds the financial amount of net assets at the beginning of a period after excluding any distributions to, and contributions from, owners during period.

Can be measured in either nominal monetary units or units of constant purchasing power.

Physical capital maintenance

Profit is earned if the physical productive capacity (or operating capacity) of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to and contributions from, owners during the period. This concept requires the current cost basis of measurement.

The selection of the measurement bases and concept of capital maintenance together determine the accounting model used.

2: The regulatory framework

Topic List

IASB

IFRS

Criticisms

You'll already have covered the IASB in your earlier studies.

IASB

Financial reporting is governed on a worldwide basis by the International Accounting Standards Board. Decisions on accounting principles are made by the Board and issued in the form of IFRS (IAS).

Remember!

May 2000 – IOSCO gave qualified backing to 30 IAS.

Remember!

EC directive: since 2005 consolidated accounts of listed entities must use IFRS.

Remember!

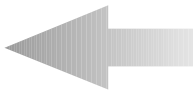
Detailed comparison of international and national standards – *The Convergence Handbook*.

The IASB issued 41 IASes. Standards are now called IFRS and 14 IFRSs have been issued so far. The procedure for issuing an IFRS can be summarised as follows.

- 1 During the early stages of a project, IASB may establish an **Advisory Committee** to give advice on issues arising in the project. Consultation with the Advisory Committee and the Standards Advisory Council occurs throughout the project.
- 2 IASB may develop and publish **Discussion Documents** for public comment.
- 3 Following the receipt and review of comments, IASB would develop and publish an **Exposure Draft** for public comment.
- 4 Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

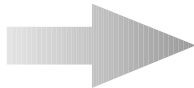
Criticisms

Rigidity



- Lack of flexibility in applying rules
- Recent standards eg IFRS 9 very detailed and prescriptive
- Rules may not be applicable in all circumstances

Criticisms



Too much choice

- Benchmark treatment and allowed alternatives. These have been largely eliminated.
- Standards may be subject to lobbying or government pressure.

3: Presentation of published financial statements

Topic List

Statement of financial position

Statement of profit or loss and other comprehensive income

Changes in equity

Other matters

All of your studies for Paper F7 will be concerned with the accounts of limited liability companies, so it is important that you are familiar with the IAS 1 formats.

Statement of financial position (IAS 1 revised)

	20X7		20X6	
	\$'000	\$'000	\$'000	\$'000
Assets				
Non-current assets				
Property, plant & equipment	X		X	
Goodwill	X		X	
Other intangible assets	X		X	
Investments in associates	X		X	
Available-for-sale investments	X	X	X	X
Current assets				
Inventories	X		X	
Trade receivables	X		X	
Other current assets	X		X	
Cash and cash equivalents	X		X	
Total assets	X	X	X	X
Equity and liabilities				
Equity attributable to owners of the parent				
Share capital	X		X	
Other reserves	X		X	
Retained earnings	X		X	
Non-controlling interest				
Total equity		X		X
Non current liabilities				
Long-term borrowings	X		X	
Deferred tax	X		X	
Long-term provisions	X		X	
Total non-current liabilities		X		X
Current liabilities				
Trade and other payables	X		X	
Short term borrowings	X		X	
Current portion of long-term borrowings	X		X	
Current tax payable	X		X	
Short-term provisions	X		X	
Total current liabilities		X		X
Total equity and liabilities		X		X

Statement of financial position
Statement of profit or loss and other comprehensive income
Changes in equity
Other matters

Statement of profit or loss and other comprehensive income (IAS 1 revised)


	Statement of financial position	Statement of profit or loss and other comprehensive income	Changes in equity	Other matters
Revenue				
Cost of sales				
Gross profit				
Other income				
Distribution costs				
Administrative expenses				
Other expenses				
Finance costs				
Share of profit of associates				
<i>Profit before tax</i>				
Income tax expense				
<i>Profit for the year</i>				
Other comprehensive income:				
<i>Items that will not be reclassified to profit or loss:</i>				
Investments in equity instruments				
Gains on property revaluation				
Income tax relating to components of other comprehensive income				
Other comprehensive income for the year, net of tax				
Total comprehensive income for the year				
Profit attributable to:				
Owners of the parent				
Non-controlling interest				
Total comprehensive income attributable to:				
Owners of the parent				
Non-controlling interest				

IAS 1

The standard suggests that all sets of financial statements should apply the disclosures. An entity must explain all departures and, if relevant, why by following IAS/IFRS fair presentation is not achieved.

Current assets

- Expected to be realised/held for sale in normal course of entity's operating cycle
- Held for trading purposes and expected to be realised within twelve months
- Cash or cash equivalent asset not restricted in use



All other assets are non-current. Each entity must decide whether to present current/non-current assets/liabilities separately. If not, present them in order of liquidity.

Notes

4: Non-current assets

Topic List

IAS 16

IAS 40

IAS 23

IAS 16 should be familiar to you from your earlier studies.

Borrowing costs are covered by IAS 23 (revised).

IAS 16 *Property, plant and equipment* covers all aspects of accounting for these items, which are most tangible non-current assets.

Probable that future economic benefits associated with the assets will flow to the entity



Cost of asset can be reliably measured

Initial measurement

Purchase price

Import duties
 Non-refundable purchase taxes
 LESS
 Trade discounts/rebates

Directly attributable costs

Site preparation
 Delivery/handling
 Testing
 Professional fees

Other costs

Estimate of dismantling/removal costs and site restoration (IAS 37)
 Finance costs (IAS 23)

Subsequent expenditure

Same criteria as initial costs. Otherwise do not capitalise but charge to profit or loss.

Subsequent measurement

Cost model

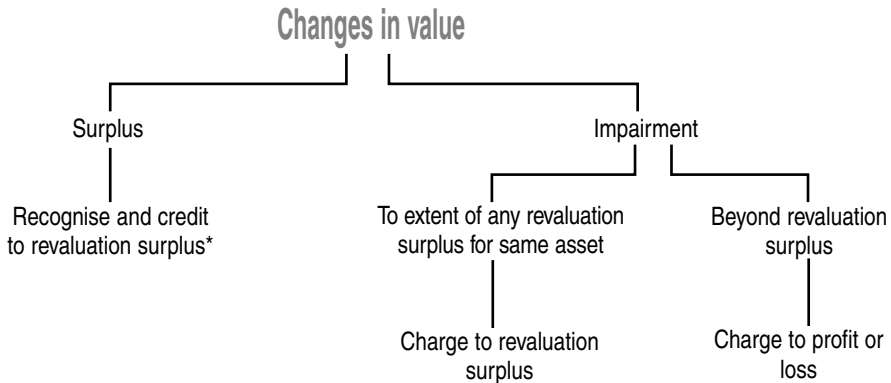
- Cost less accumulated depreciation and accumulated impairment losses

Revaluation model

- Revalued amount (fair value at the date of revaluation) less subsequent accumulated depreciation and impairment losses
- Revalue sufficiently regularly so carrying amount not materially different from fair value
- All items of same class should be revalued

Depreciation

- Systematic basis over useful life reflecting pattern of use of asset's economic benefits
- Periodic review of useful life and depreciation method and any change accounted for as change in accounting estimate



* Unless reversing a previously recognised revaluation decrease of the same asset, in which case recognise as income to the extent of reversal of the previous decrease.

Investment Property is property held to earn rentals or for capital appreciation or both, rather than for:

- a) use in the production or supply of goods or services or for administrative purposes
- b) sale in the ordinary course of business

Owner – occupied property cannot be classified as investment property.

Accounting treatment

An entity can choose to hold investment property under either:

- a) the fair value model; or
- b) the cost model

This choice will apply to all of its investment property.

IAS 23 Borrowing costs

The standard deals with borrowing costs for **self-constructed assets**.


Included in borrowing costs

Borrowing costs

Interest and other costs incurred by an entity in connection with the borrowing of funds

Qualifying asset

An asset that necessarily takes a substantial period of time to get ready for its intended sale or use

- 
- Interest on bank overdrafts and short and long term borrowings
 - Amortisation of discounts or premiums related to borrowings
 - Amortisation of ancillary costs incurred with the arrangement of borrowings
 - Finance charges in respect of finance leases under IAS 17
 - Exchange differences as far as they are an adjustment to interest costs

Capitalisation is mandatory if the costs are **directly attributable** to the acquisition, construction or production of a qualifying asset.

5: Intangible assets

Topic List

IAS 38

Goodwill

IAS 38 aims to prescribe the accounting treatment for intangible assets not dealt with under another IFRS. The standard deals with the criteria for recognition and measurement.

Goodwill is a controversial area. It comes up again in connection with group accounts.

Definition

An intangible asset is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Recognition

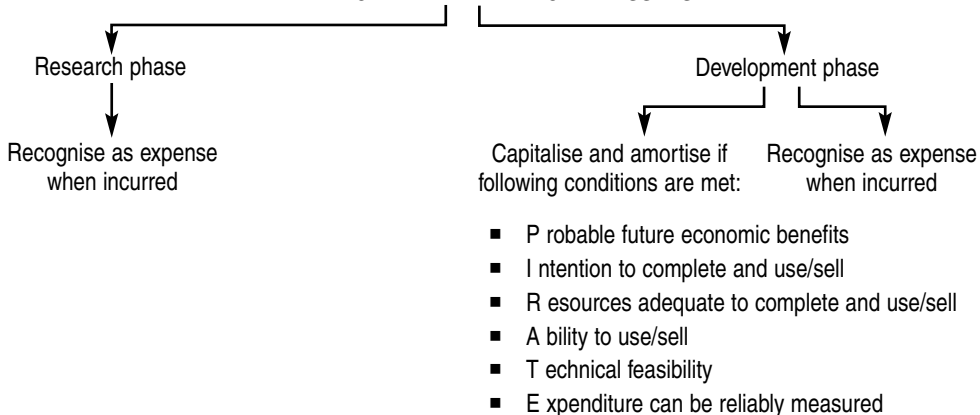
Recognise if and only if:

- It is probable that the future economic benefits that are attributable to the asset will flow to the entity
- The cost of the asset can be measured reliably

Initial measurement

Intangible assets should initially be measured at cost.

INTERNALLY GENERATED INTANGIBLE ASSETS



Internally generated bands, mastheads, publishing titles, customer lists and similar items should not be recognised as intangible assets.

Subsequent expenditure

Subsequent expenditure must meet the original recognition criteria to be added to the cost of the intangible asset.

Amortisation

Should be charged on a systematic basis over the useful life of the asset. Should commence when asset available for use. Period and method to be reviewed at each year end.

Intangibles with indefinite useful life are not amortised, but reviewed at least annually for impairment.

Subsequent re-measurement

Cost model: cost less accumulated amortisation and impairment losses

Revaluation model: revalued amount less subsequent accumulated amortisation and impairment losses

Revalued amount is fair value at date of revaluation by reference to an active market

All other assets in the same class should be revalued unless there is no active market for them, in which case the cost model value should be used for those assets.

Revaluations so that the carrying value does not offer materially from fair value

Impairment losses

The recoverable amount of the asset should be determined at least at each financial year end and any impairment loss should be accounted for in accordance with IAS 36.

Disclosures

Need to make the following disclosures.

- Distinguish between internally generated and other intangible assets
- Useful lives of assets and amortisation methods
- Gross carrying amount and accumulated amortisation at start and end of period
- Where the amortisation is included in the statement of profit or loss and other comprehensive income
- A reconciliation of opening balance to closing balance
- If research and development, how much was charged as expense

Goodwill can be purchased or be acquired as part of a business combination. In either case, the treatment is capitalisation at cost or fair value under IFRS 3.

Negative goodwill

Arises when acquirer's interest in identifiable net assets exceeds the cost of the combination. Results from **errors** or a **bargain**

Reassess cost of combination and assets.

Recognise **any remaining** goodwill **immediately** in **profit or loss**.

Goodwill

Future economic benefits arising from assets that are not capable of being individually identified and separately recognised

Recognise as an asset and measure at cost/excess of purchase cost over acquired interest

Do **not amortise**

Test at least annually for **impairment** (IAS 36)

You may be asked for a complicated calculation of goodwill as part of a group accounts question.

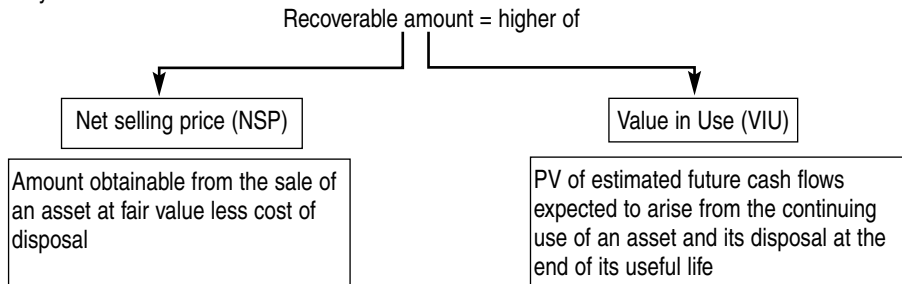
6: Impairment of assets

Topic List

IAS 36

IAS 36 covers impairment of assets.

The aim of IAS 36 *Impairment of assets* is to ensure that assets are carried in the financial statements at no more than their **recoverable amount**. Note that IAS 36 does not apply to non-current assets held for sale which are covered by IFRS 5.



Where it is not possible to estimate the recoverable amount of an individual asset, an entity should determine the recoverable amount of the **cash-generating unit** to which it belongs.

The standard also specifies when an entity should reverse an impairment loss and prescribes certain disclosures for impaired assets.

Indicators of impairment

A review for impairment of a non-current asset or goodwill should be carried out if events or changes in circumstances indicate that the carrying amount of the non-current asset or goodwill may not be recoverable.

External indicators

- Fall in market value
- Change in technological, legal or economic environment
- Increase in market interest rate likely to affect discount rates
- Carrying amount of entity's net assets > market capitalisation

Internal indicators

- Obsolescence or physical damage
- Adverse changes in use
- Adverse changes in asset's economic performance

It may not be possible to associate cash flows with individual assets so the review of the recoverable amount will often have to be applied to **cash generating units** that contain groups of related assets.

Calculation of value in use

Include cash flows

- Directly attributable
- An appropriate proportion that can be allocated on a reasonable and consistent basis
- Net cash flows to be received or paid for the disposal of the asset at the end of its useful life on a fair value basis

Exclude cash flows

- Any future restructuring to which the enterprise is not yet committed
- Future capital expenditure that will improve/enhance asset in excess of originally assessed standard of performance
- Financing activities
- Income tax receipts or payments

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

Allocation of impairment loss

- 1 To the goodwill allocated to the cash generating unit
- 2 To all other assets in the cash generating unit on a pro rata basis

Recognition of losses

- Assets carried at historic cost – profit or loss
- Revalued assets – under rules of applicable IAS
- Depreciation adjusted in future periods to allocate the asset's revised carrying amount less residual value over its remaining useful life

Reversal of past impairments

Where the recoverable amount increases, the resulting reversal should be recognised in the current period to the extent that it increases the carrying amount up to the amount that it would have been (net of amortisation or depreciation) had no impairment loss been recognised in prior years.

- *Individual assets*: recognise as income immediately unless the asset is carried at revalued amount under another IFRS in which case apply the rules of that IFRS
- *CGUs*: exact opposite of its original recognition while ensuring that assets are not increased above the lower of their recoverable amount and their carrying amount (after depreciation or amortisation) had there been no impairment loss
- *Goodwill*: not reversed in subsequent period unless:
 - The impairment was caused by a specific external event of an exceptional nature not expected to recur
 - Subsequent external events have occurred which reverse the effect of that event

Disclosure

- The amount of impairment losses recognised in the statement of profit or loss and other comprehensive income during the period and the line items affected
- The amount of impairment loss reversals recognised in the statement of profit or loss and other comprehensive income during the period and the line items affected
- The amount of impairment losses debited directly against equity in the period
- The amount of impairment loss reversals credited directly to equity in the period for material impairment losses or loss reversals:
 - The events and circumstances
 - The amount
 - The nature of the asset or cash generating unit
 - For initial losses whether recoverable amount is NSP or VIU (and details of basis of selling price or discount rate as appropriate)

Notes

7: Reporting financial performance

Topic List

IAS 8

IFRS 5

This chapter is largely concerned with the statement of profit or loss. There is no one single IFRS concerned with reporting financial performance as there is in the UK.

IAS 8

Should include all items of income and expense for the period (ie not hidden in reserves) unless an IAS requires/permits otherwise.

Accounting policies

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

An entity follows extant Standards and Interpretations when determining its accounting policies.

In the absence of a Standard or Interpretation covering a specific transaction, other event or condition, management uses its judgement to develop an accounting policy which results in information that is relevant and reliable, considering in the following order:

1. Standards or Interpretations dealing with similar and related issues
2. The *Conceptual Framework* definitions and recognition criteria
3. Other national GAAPs based on a similar conceptual framework (providing the treatment does not conflict with extant Standards, Interpretations or the *Conceptual Framework*)

Changes in accounting policy

Only allowed if:

- Required by standard or interpretation
- The change will provide more relevant or reliable information about events or transactions

Accounting treatment:

- Restate prior year statement of profit or loss and other comprehensive income and statement of financial position
- Restate opening balance of retained earnings
- Include as second line of SOCIE
- Show effect on prior period at foot of prior year SOCIE

Changes in accounting estimates

Apply **prospectively**, ie in the current period (and future periods if also affected)

Prior period errors

Omissions from and misstatements in the entity's financial statements for one or more periods



Correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery.

- Restate comparative amounts for each prior period presented in which the error occurred
- Restate the opening balances of assets, liabilities and equity for the earliest prior period presented
- Include any adjustment to opening equity as the second line of the statement of changes in equity
- Disclose the nature of the error and the amount of the correction to prior periods for each line item in each period affected

Where it is impracticable to determine the period-specific effects or the cumulative effect of the error, the entity corrects the error from the earliest period/date practicable (and discloses that fact).

IFRS 5 *Non-current assets held for sale and discontinued operations* was published in 2004.

Definitions

Discontinued operation	A component of an entity that either has been disposed of or is classified as held for sale and: <ul style="list-style-type: none"> (a) Represents a separate major line of business or geographical area of operations (b) Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or (c) Is a subsidiary acquired exclusively with a view to resale
Component of an entity	Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity
Disposal group	A group of assets to be disposed of (by sale or otherwise) together as a group in a single transaction; and liabilities directly associated with those assets that will be transferred in the transaction
Asset held for sale	Its carrying amount will be recovered principally through sale rather than continuing use

Non-current assets held for sale

Criteria

- The asset (or disposal group) must be available for immediate sale in its present condition, subject only to usual and customary sales terms and
- The sale must be highly probable.
For this to be the case:
 - The appropriate level of **management** must be **committed** to a plan to sell;
 - An **active programme to locate a buyer** and complete the plan must have been initiated
 - The asset (or disposal group) must be **actively marketed** for sale at a price that is reasonable in relation to its current fair value
 - The sale should be expected to qualify for recognition as a completed sale **within one year** from the date of classification as held for sale (subject to limited specified exceptions)
 - Actions required to complete the plan should indicate that it is **unlikely** that **significant** changes to the plan will be made or that the plan will be withdrawn

Presentation

Assets and disposal groups (including associated liabilities) classified as held for sale are presented:

- On the face of the statement of financial position
- Separately from other assets and liabilities
- Normally as **current** assets and liabilities (not offset)

Measurement

An entity must measure a non-current asset or disposal group classified as held for sale at the **lower of**:

- Carrying amount
- Fair value less costs to sell.

Immediately before initial classifications, measure asset per applicable IFRS. Any impairment loss accounted for as normal.

Non-current assets/disposal groups classified as held for sale are **not depreciated**.

Proforma disclosure

XYZ GROUP – STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7 \$'000	20X6 \$'000
<i>Continuing operations</i>		
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year from continuing operations	<u>X</u>	<u>X</u>
<i>Discontinued operations</i>		
Profit for the year from discontinued operations	X	X
Profit for the year	<u>X</u>	<u>X</u>
Profit attributable to		
Owners of the parent	X	X
Non-controlling interest	X	X
	<u>X</u>	<u>X</u>

Notes

8: Introduction to groups

Topic List

Group accounts

IFRS 10

Consolidation is a very important area of your Paper F7 syllabus, likely to appear as a long question in Part B.

This chapter looks at the basic definitions and relevant accounting standards.

Subsidiary

An entity that is controlled by another entity known as the parent

Control: An investor controls an investee when the investor is exposed, or has rights to, variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee.

Associate

An entity in which an investor has significant influence and which is neither a subsidiary nor a joint venture of the investor

Significant influence: the power to participate in the financial and operating policy decisions of an economic activity but not control or joint control over those policies

Easy marks can be gained for reproducing these definitions. But make sure you understand them!

Summary of classification and treatment

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control (>50% rule)	Full consolidation (see Chapter 9)
Associate	Significant influence (20% + rule)	Equity accounting (see Chapter 11)
Investment which is none of the above	Assets held for accretion of wealth	As for single entity accounts

Other provisions of IFRS 10

Consolidated financial statements:

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

Exemption

- A parent need not prepare group accounts if it is itself a wholly owned subsidiary
- If it is partially owned and the other owners do not object
- Its securities are not publicly traded
- The ultimate or intermediate parent publishes IFRS – compliant consolidated accounts
- Disclosures apply

Exclusion

IAS 27 effectively removed any exclusions. Subsidiaries held for sale must be accounted for in accordance with IFRS 5.

Other

- Different reporting dates – adjustments should be made
- Uniform accounting policies – if not, disclose why. Adjustments should be made on consolidation

9: The consolidated statement of financial position

Topic List

Consolidated statement of financial position

IFRS 3 revision

Method

Fair values

This chapter introduces the basic techniques you will need to prepare a consolidated statement of financial position.

The revision to IFRS 3 has brought another issue into consolidation questions. There is now the option to value the non-controlling interest at fair value. Look out for this.

Purpose	To show the assets and liabilities which it controls and their ownership
Assets and liabilities	Always 100% P plus S providing P has control
Share capital	P only
Reason	Simply reporting to the parent's shareholders in another form
Retained earnings	100% P plus group share of post-acquisition retained reserves of S less consolidation adjustments
Reason	To show the extent to which the group actually owns assets and liabilities included in the statement of financial position
Non-controlling interest	NCI share of S's consolidated assets less liabilities or fair value*
Reason	To show the extent to which other parties own assets and liabilities but under the control of the parent

* **Note.** If the NCI is at fair value you may be given a) the share price or b) the fair value of the NCI

IFRS 3 revision

IFRS 3 now introduces the option to value the non-controlling interest at **fair value**. This affects the goodwill and non-controlling interest calculations. The options are as follows: [P holds 60% of S. Goodwill impaired by \$100,000. Fair value of NCI \$900,000]

Non-controlling interest at share of net assets

Goodwill	\$'000
Consideration transferred	1,600
Non-controlling interest (2,000 × 40%)	800
Net assets	<u>(2,000)</u>
Goodwill	400
Impairment	<u>(100)</u>
Carrying value	<u><u>300</u></u>

Non-controlling interest at fair value

Goodwill	\$'000
Consideration transferred	1,600
Non-controlling interest	900
Net assets	<u>(2,000)</u>
Goodwill	500
Impairment	<u>(100)</u>
Carrying value	<u><u>400</u></u>

Note that the total goodwill is now \$400,000, reflecting the \$100,000 goodwill attributable to the non-controlling interest.

Non-controlling interest at end of reporting period

The option to value the non-controlling interest at fair value applies to non-controlling interest **at acquisition**. However, it will affect the valuation of non-controlling interest **at the year end**.

Under the two options above, this will be as follows (net assets now \$3m)

Non-controlling interest at share of net assets

	\$'000
S net assets	<u>3,000</u>
NCI 40%	<u><u>1,200</u></u>

Non-controlling interest at fair value

	\$'000
Fair value of NCI	900
NCI share of increase in net assets ($(3,000 - 2,000) \times 40\%$)	400
Goodwill impairment ($100 \times 40\%$)	<u>(40)</u>
	<u><u>1,260</u></u>

Fair value options

If you are required to account for NCI at fair value there are two options:

- 1) You may be told what fair value of the NCI is
- 2) You may be given the share price at the date of acquisition

The examiner has said that he will usually examine NCI at FV, so be prepared for this.

- 1 Read the question and the requirements.
- 2 Group structure noting dates of acquisition.
- 3 Prepare necessary proforma required by question.
 - Level of detail is dictated by level of detail in question
 - Leave out cost of investment
 - Include line for non-controlling interest
- 4 Consider adjustments and note on question paper.
 - Dividends
 - PUP
 - Revaluation to fair value
 - Reconciliation of intra-group balances
 - Support adjustments by working eg PUP
- 5 Aggregate adjusted assets and liabilities.
 - Incorporate adjustments
 - Cancel any intra-group items eg current a/c balances, dividends, loan notes
- 6 Share capital of P only.

7	Goodwill	
	Consideration transferred	X
	Non-controlling interest	X
	Net assets acquired as represented by	
	Share capital	X
	Share premium	X
	Reserves	X
	Retained earnings	<u>X</u>

Goodwill (gain on bargain purchase)

(X)
X/(X)



Remember that goodwill is retained in the statement, subject to impairment reviews. Remember rules for gain on a bargain purchase.

8	Per question	P	S
	Adjustments as noted on question paper	<u>X/(X)</u>	<u>X/(X)</u>

Share of S post acquisition %

Any impairment of goodwill

X
X
X
(X)
X

Y

9

Non-controlling interest

Fair value at acquisition

Share of post-acquisition retained earnings (per 8)

Share of any goodwill impairment

X

X

(X)XX

Fair values (IFRS 3)

On consolidation, the *fair value* of the consideration paid for a subsidiary is compared with the *fair value* of the net assets.

IFRS 3 sets out rules determining the fair value of the purchase consideration, the fair value of identifiable assets and liabilities acquired and the fair value of specific net assets.

Fair value (IFRS 3)

The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

New definition (IFRS 13)

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

Fair value adjustment calculations

Goodwill is the difference between the cost of the acquisition and the acquirer's interest in the fair value of the identifiable assets and liabilities. So far we have used book value for the assets and liabilities. However, IFRS 3 states that we should use fair value. Therefore revaluations may be necessary to ensure that book value is equal to fair value.

Subsidiary

Revalues assets and liabilities to fair value

OR

Parent

Revalues assets and liabilities as a consolidation adjustment

Subsidiary's books unchanged

In the exam the usual scenario is that the subsidiary has not revalued to fair value and so a consolidation adjustment is needed.

10: The consolidated statement of profit or loss and other comprehensive income

Topic List

Consolidated statement of profit or loss

Consolidated statement of profit or loss and other comprehensive income

Under the revised IAS 1 the full statement is now called the 'statement of profit or loss and other comprehensive income'. At F7 level some questions will only require the first part of the statement, which will be referred to as the 'statement of profit or loss.'

Purpose	To show the results of the group for an accounting period as if it were a single entity
Sales revenue to profit after tax	100% P + 100% S (excluding dividend receivable from subsidiary and adjustments for intra-group transactions)
Reason	To show the results of the group which were controlled by the parent
Intra-group sales	Strip out intra-group activity from both sales revenue and cost of sales
Unrealised profit on intra-group sales	(a) Goods sold by P: increase cost of sales by unrealised profit (b) Goods sold by S: increase cost of sales by full amount of unrealised profit and decrease non-controlling interest by their share of unrealised profit
Depreciation	If the value of S's non-current assets have been subjected to a fair value uplift then any additional depreciation must be charged in the consolidated statement of profit or loss. The non-controlling interest will need to be adjusted for their share

<p>Transfer of non-current assets</p>	<p>Expenses must be increased by any profit on the transfer and reduced by any additional depreciation arising from the increased carrying value of the asset.</p> <p>The net unrealised profit (ie the total profit on the sale less cumulative 'excess' depreciation charges) should be eliminated from the carrying amount of the asset and from the profit of the company that made the profit.</p> <p>For instance, H transfers an asset with a carrying value of \$1,000 to S for \$1,100. Depreciation is 10% p.a. The net unrealised profit is \$90. This is debited to H's statement of profit or loss and to the carrying value of the asset</p>
<p>Non-controlling interests</p>	<p>NCI% of S's PAT</p>

Consolidated statement of profit or loss

Adjustments required

- Eliminate **intra group sales and purchases**
- Eliminate **unrealised profit** on intra group purchases still in inventory at the year end
- Eliminate **intra group dividends**
- Split profit for the year between group and NCI

Procedure

- **Combine all P and S results** from revenue to profit after tax. Time apportion where the acquisition is mid-year
- Exclude **intra group investment** income
- **Calculate NCI** ($\text{NCI}\% \times \text{PAT}$)

Unrealised profits and losses:

Only where S sells to P, allocate the unrealised profit between NCI and P: *Debit* group retained earnings, *Debit* NCI, *Credit* inventory

Consolidated statement of comprehensive income

If there is a revaluation gain or loss in the parent or subsidiary you will prepare a consolidated statement of profit or loss and other comprehensive income. This will only require a few additions to the consolidated statement of profit or loss.

Revaluation gain in parent

	\$'000
Profit for the year	8,000*
Other comprehensive income:	
Gains on property revaluation	<u>2,000</u>
Total comprehensive income for the year	<u><u>10,000</u></u>
Total comprehensive income attributable to:	
Owners of the parent (5,000+2,000)	7,000
Non-controlling interest	<u>3,000</u>
	<u><u>10,000</u></u>

*3,000 attributable to NCI

Revaluation gain in subsidiary (80%)

	\$'000
Profit for the year	8,000*
Other comprehensive income:	
Gains on property revaluation	<u>2,000</u>
Total comprehensive income for the year	<u><u>10,000</u></u>
Total comprehensive income attributable to:	
Owners of the parent (5,000+(2,000 × 80%))	6,600
Non-controlling interest (3,000+(2,000 × 20%))	<u>3,400</u>
	<u><u>10,000</u></u>

Notes

11: Accounting for associates

Topic List

Associates

As you know, an investment can be carried at cost, fully consolidated or accounted for using the equity method, depending on the degree of control exercised. An associate is accounted for using the equity method.

Individual investor's books

- Carry at cost, or
- In accordance with IFRS 9 as an equity investment

Statement of financial position

Initial cost	X
Add/less: post acquisition share of profits/losses (before dividends)	X/(X)
Less: post-acquisition dividends received to avoid double counting	<u>(X)</u>
Carrying value	<u><u>X</u></u>

Consolidated financial statements

Use equity method unless:

- Investment acquired and held exclusively with a view to disposal soon
- Investor ceases to have significant influence

In these cases record at cost.

Statement of profit or loss

Group share of associate's PAT

12: Inventories and biological assets

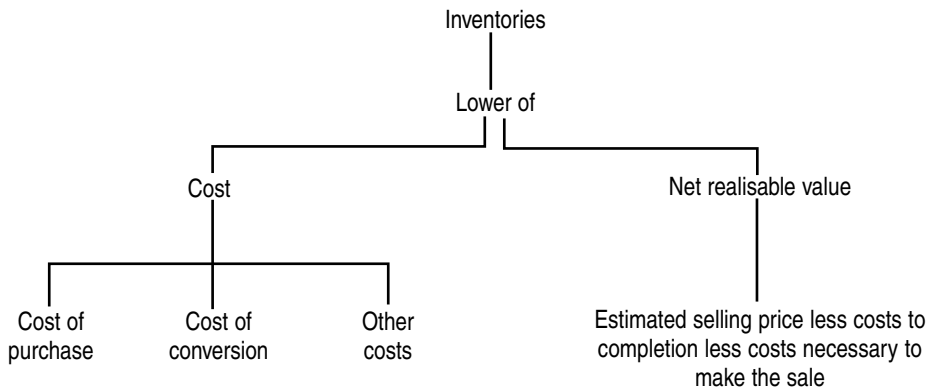
Topic List

IAS 2

IAS 41

You've met inventory and inventory valuation in your earlier studies, so only a brief summary is given here.

Biological assets are regulated by IAS 41 Agriculture – a new standard for this syllabus.



Permitted treatment of cost: FIFO or weighted average

LIFO is not permitted under IAS 2.

IAS 41: Agriculture

IAS 41 identifies the **critical events** associated with biological transformation as growth, procreation, production and degeneration.

In the statement of financial position biological assets should be measured at **fair value** less estimated point-of-sale costs. Agricultural produce derived from biological assets is also measured at fair value less estimated point-of-sale costs.

Notes

13: Provisions, contingent liabilities and contingent assets

Topic List

IAS 37

IAS 37 should be familiar to you from your earlier studies. It is particularly topical in the light of increasing environmental awareness.

IAS 37

IAS 37 *Provisions, contingent liabilities and contingent assets* was brought in to remedy some abuses of provisions.

- Entities should **not provide** for **costs** that need to be incurred to **operate in the future**, if those **costs could be avoided** by the entity's future actions
- **Costs of restructuring** are to be recognised as a provision only when the entity has an **obligation** to carry out the restructuring
- The **full amount** of any **decommissioning costs** or environmental liabilities should be **recognised from the date on which they arise**

Provision

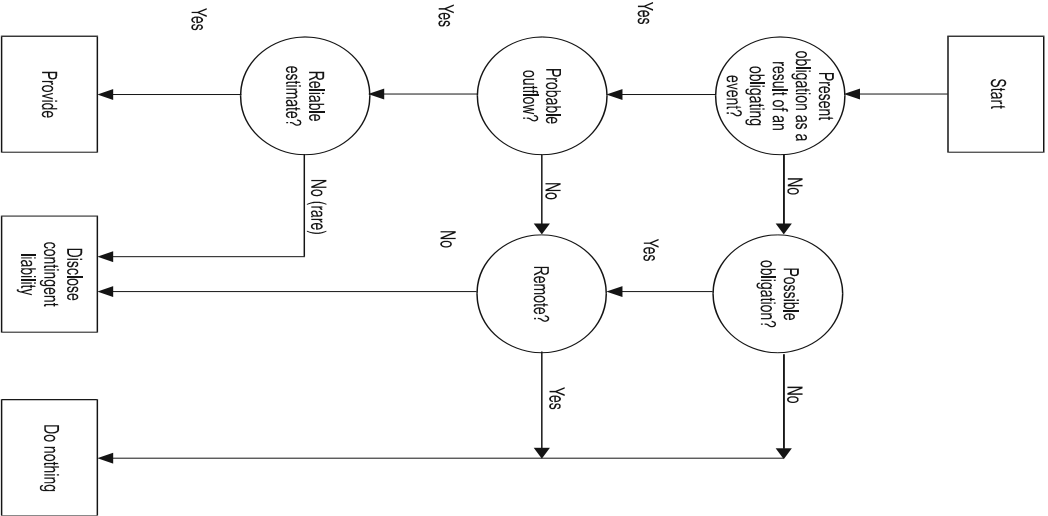
A liability of uncertain timing or amount. Liabilities are obligations to transfer economic benefits as a result of past transactions or events.

Contingent liability

Should be disclosed unless the possibility of any outflow of economic benefits to settle it is remote

Contingent asset

Should be disclosed where an inflow of economic benefits is probable



Notes

14: Financial instruments

Topic List

IAS 32

IFRS 9

IFRS 7

A financial instrument is defined in IAS 32 as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another. IAS 39 deals with how financial investments are measured and IFRS 7 covers disclosure.

IFRS 9 is the most recent standard which deals with classification and measurement of assets. It now replaces IAS 39 for all issues covered by the F7 syllabus.

Because of the inherent difficulties in this complex area, it is hard for users to assess the nature, amount and cost of an entity's debt and equity resources.

Before IAS 32 and IAS 39 many financial instruments were treated as off balance sheet finance and invisible to the user of accounts. Because of their significance, the IASB tackled the project in 3 phases:

1. IAS 32: Presentation (1995) ensured the user was aware of the instruments and risks
2. IAS 39: Recognition and Measurement (1998) prescribed specific accounting treatment as an interim measure

Both standards were revised in December 2003 and IAS 39 is now being replaced by IFRS 9.

3. IFRS 7: Disclosure (2005) effective from 1 January 2007 specifies disclosures required for financial instruments

Financial instrument:

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

Financial asset:

Cash; equity instrument of another entity; contractual right to receive cash/other financial assets; contract that can be settled in the entity's own equity instruments and may be either a derivative or a non-derivative

IAS 32 presentation

- Financial instruments should be classified as either
 - Liability (debt) or
 - Equity
- Compound instruments (exhibiting characteristics of both) must be split into their debt and equity components
- Substance rather than legal form applies (eg redeemable preference shares are a financial liability)
- Interest, dividends, loss or gains relating to a financial instrument claimed as a liability are reported in the I/S, while distributions to holders of equity instruments are debited directly to equity (in the SOCIE)
- Offset of a financial asset and liability is only allowed where there is a legally enforceable right and the entity intends to settle net or simultaneously

Financial liability:

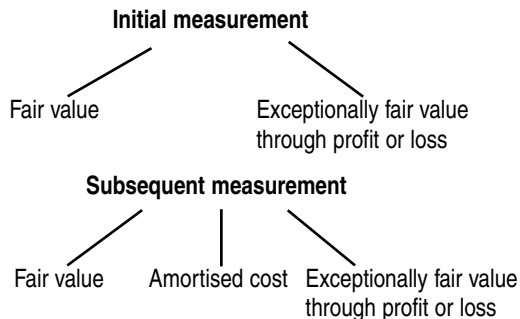
Contractual obligation to deliver cash/other financial asset; contractual obligation to exchange financial instruments under potentially unfavourable conditions

Equity instrument:

Contract that evidences a residual interest in the assets of an entity after deducting all its liabilities

IFRS 9

IFRS 9 deals with recognition and measurement of financial assets and liabilities. It classifies assets on the basis of the entity's business model and the cash flow characteristic of the financial asset.



**Subsequent measurement:
financial assets (FA)**

Amortised cost

Fair value

- Where held to collect contractual cash flows as specified dates
- Financial assets at fair value through profit or loss
- Equity investments

**Subsequent measurement:
financial liabilities (FL)**

Fair value

Amortised cost

- Financial liabilities at fair value through profit or loss
- FL arising when transfer of FA does not qualify for derecognition
- All others

Calculations

The method used in the following example applies to deep discount bonds and other similar instruments (including zero coupon bonds).

Debt issued for \$400,000 (nominal) on 1.1.20X1 for proceeds of \$315,526; redeemed for \$400,000 (ie par) on 31.12.20X5

Interest rate = 4%

Effective interest rate = 9.5%

			\$
		Annual interest payments (4% × \$400,000 × 5)	80,000
		Deep discount \$(400,000 – 315,526)	<u>84,474</u>
			<u>164,474</u>
At inception	DEBIT	Cash	\$315,526
	CREDIT	Liability	\$315,526

<i>Year</i>	<i>P or L charge</i> *\$	<i>Actual interest payable</i> \$	<i>Rolled up interest charged to P or L</i> \$	<i>Closing liability</i> \$
20X1	29,975	16,000	13,975	329,501
20X2	31,303	16,000	15,303	344,804
20X3	32,756	16,000	16,756	361,560
20X4	34,348	16,000	18,348	379,908
20X5	<u>36,092</u>	<u>16,000</u>	<u>20,092</u>	400,000
	<u>164,474</u>	<u>80,000</u>	<u>84,474</u>	

*9.5% × opening liability in statement of financial position (315,526).

Fair value is measured as quoted market price in an active market where possible.

Gains and losses (on remeasurement to fair value)

Held at fair value: profit or loss

Investments in equity instruments:
reported in equity and under other
comprehensive income

Impairment

Impairment review where evidence of financial asset being impaired

Original effective interest rate should be used when discounting
future cash flows to calculate the impairment

Impairment loss is charged to profit or loss

Where investment in equity instrument suffers impairment loss, this
is recognised in statement of changes in equity and under other
comprehensive income.

IFRS 7: Financial instruments: Disclosure

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- (a) The significance of financial instruments for the entity's financial position and performance
- (b) The nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks

This information can influence a user's assessment of the financial position and performance of an entity and of the nature of its future cash flows.

In addition to the numerical disclosures required by IFRS 9, IFRS 7 encourages a **narrative commentary** by issuers of financial instruments, which will enable users to understand their attitude to risk.

You will not be examined on the risks inherent in financial instruments.

Notes

15: Revenue

Topic List

Off balance sheet finance

Substance over form

Conceptual Framework

Revenue recognition

IAS 20

IAS 11

This is a very topical issue given the financial scandals of recent years. You must be aware of the various forms of off-balance sheet finance and the measures taken to prevent it.

Off balance sheet finance

The funding or refinancing of an entity's operations in such a way that, under legal requirements and existing accounting conventions, some or all of the finance may not be shown on its statement of financial position

Perceived benefits

- *Stock market advantages*: lower gearing ratio
- Keep a company within *loan covenants*
- Exclude highly geared subsidiary from consolidation for reasons of dissimilar activities and thereby reduce gearing
- Expectation of rights issue (to reduce gearing) decreased, thereby maintaining share price

The problem

A situation is created where users of accounts do not have a clear view on the state of the entity's affairs. Insufficient disclosure creates problems.

Consignment inventory

Benefits

- The future cash flows from sales to 3rd parties
- Insulation from changes to the transfer price charged by the manufacturer

Risks

- Being compelled to retain inventory that is not easily saleable or is obsolete
- The risk of slow movement resulting in higher costs of financing and holding costs

Factoring of debts

Benefits

- Future cash flows from payment by debtors

Risks

- Slow payment
- Non payment

Off balance
sheet finance

**Substance
over form**

Conceptual
Framework

Revenue
recognition

IAS 20

IAS 11

Substance over form

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form (IAS 1).



Examples

- IAS 17 *Leases*: if risks and rewards of ownership transferred lease is an asset of the lessee even though title has not passed
- IAS 11 *Construction contracts*: taking attributable profits
- IAS 24: related party transactions
- IFRS 3: definition of subsidiary based on control

Learn these – they may well come up!

Conceptual Framework

Faithful representation implies that items are accounted for according to their substance and economic reality.

- *Majority of transactions*: no difference, so no issue
- *Other transactions*: substance and form diverge; choice of treatment can give different results due to non-recognition of an asset/liability even though benefits/obligations result

Determining the substance of transactions

Does the transaction change the existing assets/liabilities of the entity, either by creating new ones, or altering the existing ones?

Assets

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

Liabilities

Present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of economic benefits

Off balance
sheet finance

Substance
over form

Conceptual
Framework

Revenue
recognition

IAS 20

IAS 11

Recognition

The process of incorporating an item into the primary financial statements with appropriate headings. It involves depiction of the item in words and by monetary amount and the inclusion of that amount in the statement totals.

Recognise asset and liability

Where significantly all the risks and benefits will flow to the entity

Sufficient evidence that benefits exist

Able to measure in monetary terms with sufficient reliability

Do not recognise

Where significantly all the risks and benefits have been transferred

IAS 18

Revenue is that which arises in the course of ordinary activities such as that from sales, services provided, interest, royalties and dividends.



Measurement

- **Fair value** of consideration received/receivable. Deferred amounts discounted
- In a sale financed by the seller, any difference between the fair value of the item and the nominal sales value should be accounted for as interest revenue

Includes only those amounts receivable by the entity on its own account. Not sales, goods and sales tax (eg VAT) collected by agent to be passed to the principal.

Recognition

Goods

When the following conditions are met:

1. Transfer of significant risks and rewards of ownership (usually legal title)
2. No more control over goods sold
3. Amount of revenue can be reliably measured
4. Probable that debt will be repaid
5. Transaction costs can be reliably measured

Services

- Conditions 3 to 5 as for goods
- The stage of completion of the transaction at the balance sheet date can be measured reliably and a proportion applied to the revenue
- Interest – time proportion basis (effective yield)
- Royalties – accruals basis
- Dividends – when the right to the dividend is established

Disclosure

Accounting policy for each recognition; the amount of each significant category of revenue; amount of revenue from exchange of goods or services

IAS 20 *Accounting for government grants and disclosure of government assistance* requires the following accounting treatment.

Grants related to income

Either show as credit in profit or loss (other income) or deduct in reporting the related expense

Disclose:

- Accounting policy
- Nature and extent of grants recognised
- Unfulfilled conditions and other contingencies relating to grants recognised

Grants related to assets

Treat as deferred income and credit to profit or loss on systematic rational basis over useful life of asset OR deduct grant in arriving at carrying value of asset and recognise as income over asset's life by means of reduced depreciation charge



Recognise only when reasonable assurance that any conditions will be met and monies received.

Construction contracts



A contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate use.



Any expected loss should be recognised as an expense immediately.

Outcome can be estimated reliably.



Recognise contract revenue and contract costs by reference to stage of completion of contract.



Outcome cannot be estimated reliably.



Recognise revenue only to extent of contract costs incurred that it is probable will be recovered.
Recognise as expense in period incurred.

Where the outcome of a contract can be estimated reliably, a proportion of contract revenue and costs should be recognised in profit or loss by reference to the stage of completion (ie a proportion that fairly reflects the amount of work done).

The stage of completion can be calculated in various ways including:

Proportion of contract costs incurred:

$$\frac{\text{Costs to date}}{\text{Total estimated costs}} \times \text{Estimated total revenue/costs}$$

Surveys of work performed:

$$\frac{\text{Work certified}}{\text{Contract price}} \times \text{Estimated total revenue/costs}$$

Physical proportion completed

Off balance
sheet finance

Substance
over form

Conceptual
Framework

Revenue
recognition

IAS 20

IAS 11

Disclosure

Statement of profit or loss

Revenue (x% × total contract revenue)	X
Expenses (x% × total contract cost)	<u>(X)</u>
	X
Expected loss	<u>(X)</u>
Recognised profit/loss	<u><u>X</u></u>

Statement of financial position

<i>Gross amount due from/to customers</i>	
Contract costs incurred	X
Recognised profits less recognised losses	<u>X</u>
	X
Less progress billings to date	<u>(X)</u>
	<u><u>X/(X)</u></u>
<i>Trade receivables</i>	
Progress billings to date	X
Less cash received	<u>(X)</u>
	<u><u>X</u></u>

The following, not covered above, must also be disclosed under IAS 11 (revised).

- Methods used to determine contract revenue
- Methods used to determine stage of completion of contracts in progress
- Any contingent gains and losses, eg due to warranty costs, claims, penalties or possible losses, in accordance with IAS 37
- Amount of advances received
- Amount of any retentions (progress billings not paid until the satisfaction of certain conditions)

Notes

16: Leasing

Topic List

Types of lease

Accounting treatment

Disclosures: lessees

Leasing transactions are very common in practice. It is important that you get to grips with the basics of IAS 17.

IAS 17

IAS 17 *Leases* standardises the accounting treatment and disclosure of assets held under lease. It follows the **substance over form** principle.

Finance lease

A lease that transfers substantially all the risks and rewards of ownership of an asset

Lease

An agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time

Operating lease

A lease other than a finance lease

Accounting treatment

Finance lease

- Capitalise asset (lower of fair value and present value of minimum lease payment)
- Set up finance lease liability
- Repayments split between finance charge and capital
- Statement of financial position
 - Carrying amount
 - Finance lease liability
- Statement of profit or loss
 - Depreciation
 - Finance charge

Operating lease

- Charge rentals on a systematic basis over lease period
- Statement of financial position
 - Only accruals/prepayments for rentals
- Statement of profit or loss
 - Rental expense

Statement of financial position

1 Non current assets

Included in the net book value of plant and equipment is \$X in respect of assets held under finance leases

2 Non current liabilities

Finance lease liabilities (note 4) X

3 Current liabilities

Finance lease liabilities (note 4) X

Accruals (note 4) X

4 Finance lease liabilities: reconciliation of minimum lease payments and present value

Within one year X (gross)

Later than one year and not later than five years X (gross)

Later than five years X (gross)

Less future finance charges (X)

Present value of finance lease liabilities X

Statement of financial position (continued)

5 Present value of finance lease liabilities

Within one year	X (net)
Later than one year and not later than five years	X (net)
Later than five years	<u>X (net)</u>
	<u>X</u>

Note. The minimum lease payments include the finance charge element. The present value is the capital element only of the lease liability.

6 Operating leases

The future minimum lease payments under non-controllable operating leases are as follows:

Within one year	X
Later than one year and not later than five years	X
Later than five years	<u>X</u>
	<u>X</u>

Statement of profit or loss and other comprehensive income

Although not specifically required by IAS 17, companies tend to also disclose the following in the notes.

7

Profit from operations

Profit from operations is stated after charging:

Depreciation on assets held under
finance leases X

8

Finance cost

Finance charge on finance leases: X

17: Accounting for taxation

Topic List

Current tax

Deferred tax

Taxable temporary differences

Deductible temporary differences

Disclosure

In nearly all countries entities pay tax on their trading income. There are two aspects to this: current tax and deferred tax.

Most students find deferred tax more difficult than current tax, so study this section carefully. Questions in Paper F7 should not generally be too complicated.

IAS 12

IAS 12 covers both current and deferred tax. Current tax is fairly easy.

Tax charge

Current tax	X
Under/overstatement of prior periods	X/(X)
Deferred tax	<u>X</u>
	<u>X</u>



Current tax: an estimate of income tax payable for the current year



Under/overstatement of prior periods: as the income tax charge on taxable profits is only an estimate, there may be adjustments required in the next accounting period



Deferred tax: see next card

The tax charge in the income statement often bears little relationship to the profit before tax figure because of the differences which exist between tax rules and financial accounting principles.

Accounting for deferred tax

Is recognition of the item different for tax and accounts purposes? ————— No —————> No deferred tax implications

Yes

Is the difference potentially only temporary in nature? ————— No —————> No deferred tax implications (permanent difference)

Yes

Liability method

Recognise a deferred tax asset or liability using the rate of income tax enacted by end of reporting period that is expected to apply to the period when the asset is realised or the liability settled.

1 Timing differences

Temporary timing differences arise as a result of the fact that certain items of income/expenditure are dealt with for tax purposes on a receipts basis and on an accruals basis for accounts purposes.

At the end of the reporting period, the timing difference is equivalent to the difference between the accrued income asset and the tax base of the income (amount received ie nil).

2 Specific timing differences – accelerated capital allowances

When tax (or 'capital') allowances/tax depreciation rates are available at a rate higher than the accounting depreciation rates applied to the same assets.



On a cumulative basis calculated as:

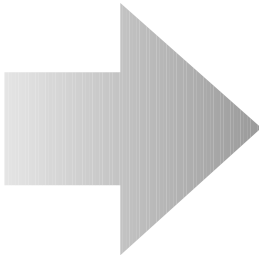
Net book value (NBV)	X
Less tax written down value (TWDV)	<u>(X)</u>
	<u>X</u>

3 Revaluations

The revaluation of an asset will create a temporary difference when it is incorporated in the statement of financial position, insofar as the profit or loss that would result from realisation at the revalued amount is taxable. Deferred tax is normally provided out of the revaluation surplus.

Deductible temporary differences

Deductible temporary differences arise since certain items of expenditure are dealt with for tax purposes on a payments basis and on an accruals basis for accounts purposes.



At the end of the reporting period, the timing difference is equivalent to differences between the accrual and the tax base of the payment (amount paid ie nil).

Current
tax

Deferred
tax

Taxable temporary
differences

Deductible
temporary differences

Disclosure

Disclosure

Statement of financial position

Deferred tax liability

Balance brought forward	X
Amount charged/(credited) to profit or loss	X/(X)
Amount charged/(credited) to equity	<u>X/(X)</u>
Balance carried forward	<u><u>X</u></u>

Statement of profit or loss and other comprehensive income

Current tax	X
Under/overstatement of prior periods	X/(X)
Deferred tax	<u>X</u>
	<u><u>X</u></u>

18: Earnings per share

Topic List

Basic EPS

Changes in capital structure

Diluted EPS

Earnings per share is a widely used measure of an entity's performance. It is useful for comparing the results of one entity over time and comparing the performance of an entity's equity against the performance of another entity's equity.

IAS 33

This standard aims to improve the **comparison** of different entities in the same period and of the same entity in different periods.

Basic calculation

$$\frac{\text{Net profit/loss attributable to ordinary shareholders}}{\text{Weighted average no. of shares in issue during the period}}$$


The net profit or loss used is after interest, tax and deductions in respect of non-equity shares.

Changes in capital structure

It is necessary to match the earnings for the year against the capital base giving rise to those earnings.

Bonus issue

The earnings of the entity will not rise (no new funds injected); to calculate the number of shares:

Treat bonus shares as if in issue for the full year

Apply retrospectively, reducing the reported EPS for the previous year by the reciprocal of the bonus fraction

Issue at full market price

New capital is introduced therefore earnings would be expected to rise from date of new issue; to calculate the number of shares:

Use time weighted average number of shares for period

No retrospective effect

Rights issue

For purposes of calculating the number of shares, treat this as an issue at full market price followed by a bonus issue:

Use weighted average number of shares in issue for the period modified by the retrospective effect of the bonus element

Bonus element

$$\frac{\text{Actual cum – rights price}}{\text{Theoretical ex – rights price}}$$

Diluted EPS

Required where a listed entity has outstanding convertible loan notes, preferred shares, debentures, options or warrants

Must be shown on the face of the statement of profit or loss and other comprehensive income and given equal prominence with basic EPS

- Numerators of calculations must be disclosed. Denominators must be disclosed and reconciled to each other
- Other amounts per share may be shown but profit used must be reconciled to a line item in the statement of profit or loss.

Convertible loan notes or preference shares

Earnings

Net basis earnings	X
--------------------	---

Add back loan note interest net of tax (or preference dividends) 'saved'	<u>X</u>
--	----------

Diluted earnings	<u><u>X</u></u>
------------------	-----------------

No of shares

Basic weighted average	X
------------------------	---

Add additional shares on conversion (use terms giving max dilution available after y/e)	<u>X</u>
---	----------

Diluted number	<u><u>X</u></u>
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19: Analysing and interpreting financial statements

Topic List

Profitability

Liquidity

Gearing

Investors' ratios

*The emphasis here is on **interpretation**. Calculation of ratios will provide only a fraction of available marks. There are many standard ratios, so variations of those shown here may come up and will be acceptable.*

The exercise must be done with a clear objective in mind – and apply your general financial knowledge, don't just rely on the ratios. And acceptable values will depend on industry, market strategy etc.

Return on capital employed

$$\text{ROCE} = \frac{\text{PBIT}}{\text{Capital employed}} = \frac{\text{PBIT}}{\text{Total assets less current liabilities}}$$

- When interpreting look for:
 - How risky is the business?
 - How capital intensive is it?
 - What ROCE do similar businesses have?
- Problems: which items to consider to achieve comparability?
 - Revaluation reserves
 - Policies, eg goodwill, R&D
 - Bank overdraft: short-long-term liability
 - Investments and related income: exclude
- Examine
 - Change year to year
 - Comparison to similar entities
 - Comparison with current market borrowing rates

Return on equity

$$\text{ROE} = \frac{\text{PAT and pref div}}{\text{Ord share capital+reserves}} \%$$

- More restricted view of capital than ROCE, but same principles

Profit margin

$$\text{Profit margin} = \frac{\text{PBIT}}{\text{Sales}} \% \quad \text{Gross profit} = \frac{\text{Gross profit}}{\text{Sales}}$$

- Useful to compare profit margin to profit % to investigate movements which do not match

Asset turnover

$$\text{Asset turnover} = \frac{\text{Sales}}{\text{Total assets less current liabilities}}$$

- Measures efficiency of use of assets; can amend to just non-current assets for capital intensive business

Current ratio

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

- Assume assets realised at book value
- 2:1 acceptable? 1.5:1? Depends on industry

Quick ratio

$$\text{Quick ratio (acid test)} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

- Eliminates illiquid and subjectively valued inventory
- Could be high if overtrading with rec'bles, but no cash
- 1:1 OK? But supermarkets etc on 0.3 (no rec'bles)

A/cs receivable collection period

$$\frac{\text{Trade receivables}}{\text{Credit sales}} \times 365$$

- Consistent with quick/current ratio? If not, investigate

Inventory turnover/days

$$\text{Turnover} = \frac{\text{Cost of sales}}{\text{Av inv}} \quad \text{Days} = \frac{\text{Av inv}}{\text{Cost of sales}} \times 365$$

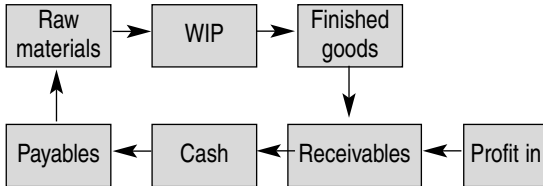
- Higher the better? But remember:
 - Lead times
 - Seasonal fluctuations in orders
 - Alternative uses of warehouse space
 - Bulk buying discounts
 - Likelihood of inventory perishing or becoming obsolete

A/cs payable payment period

$$\frac{\text{Trade accounts payable}}{\text{Purchases}} \times 365$$

- Use cost of sales if purchases not disclosed

Cash cycle



- Cash flow timing \neq sales/cost of sales timing as credit is taken
- Holding inventory delays time between payments for goods to suppliers and sales receipts from customers

Why liquidity changes

- *Credit control efficiency* altered
- *Altering payment period of suppliers*: many companies in the recession used their suppliers as a source of funding
- *Inventory control*: in the recession many companies reduced their inventory holdings to maintain their liquidity

In an economic downturn, liquidity becomes a crucial issue.

Example

Just think of all those dot.com businesses!

Gearing

$$\text{Gearing ratio} = \frac{\text{Prior charge capital}}{\text{Total capital}} \%$$

Interest cover

$$\text{Interest cover} = \frac{\text{PBIT (incl int receivable)}}{\text{Interest payable}}$$

- Is interest cover a better way to measure gearing?
 - Company must generate enough profit to cover interest
 - Is 3+ safe? Consider relevance of profit vs cash

Debt/equity ratio

$$\text{Debt/equity ratio} = \frac{\text{Prior charge capital}}{\text{Ordinary share capital and reserves}} \%$$

(> 100% = high)

These ratios deal with long-term liquidity.

There are difficulties in assessing gearing.

- Use of equity accounting to lower gearing
- Elements included are subjective. Following could have an impact.
 - Convertible loan notes
 - Preference shares
 - Deferred tax
 - Goodwill and development expenditure capitalisation
 - Revaluation surplus

Used by someone contemplating investment. Consider an entity's shares as a source of income (dividends) and/or source of capital growth (share price).

Dividend yield

$$\text{Dividend yield} = \frac{\text{Div per share}}{\text{Mid-market price}} \quad \%$$

- Low yield: retains large proportion of profits to reinvest
- High yield: risky company or slow-growing

Dividend cover

$$\text{Dividend cover} = \frac{\text{EPS}}{\text{Net div per ordinary share}} \quad \text{or} \quad \frac{\text{Profit after tax and pref div}}{\text{Div on ordinary shares}}$$

- Shows how safe the dividend is, or extent of profit retention. Variations due to maintaining dividend vs declining profits

P/E ratio

$$\text{P/E ratio} = \frac{\text{Mid-market price}}{\text{EPS}}$$

- Higher the better; reflects confidence of market
- Rise in EPS will cause decrease in P/E ratio, but maybe not to same extent: context of market, industry norms

Earnings yield

$$\text{Earnings yield} = \frac{\text{EPS}}{\text{Mid-market price}}$$

- Shows dividend yield if no retention
- Compare entities with different dividend policies
- Shows growth rather than earnings

20: Limitations of financial statements and interpretation techniques

Topic List

Limitations of financial statements

Accounting policies and the limitations of ratio analysis

In this chapter we look at some of the issues which may make financial statements, and ratios based upon them, less reliable than they appear.

Limitations of financial statements

A number of factors may make financial statements less reliable than they appear:

- Problems of historic cost information – especially in periods of inflation
- Creative accounting – often aimed at reducing gearing
- The effect of related parties, in particular involving group companies
- Seasonal trading – timing of year end
- Asset acquisition – especially just before the year end

Accounting policies

Choice of accounting policy can affect the financial statements – such as whether to revalue assets or capitalise interest costs.

Change of accounting policy can only be justified on grounds of fairer presentation.

Limitations of ratio analysis

- In first year of trading no comparative figures
- Comparison against industry averages may not be very revealing
- If based on historic cost, undervalued assets may distort ROCE and gearing
- Ratios influenced by choice of accounting policy
- May be distorted by creative accounting measures
- Results may be distorted by inflation
- No two companies have the same risk profile, therefore comparison difficult

Notes

21: Statements of cash flows

Topic List

IAS 7

Workings

Interpretation

Statements of cash flows were brought in because profit does not always give a useful picture of an entity's operations.

You've covered statements of cash flow earlier, so this should serve as revision.

Indirect method

STATEMENT OF CASH FLOWS FOR YEAR ENDED 31.12.X1

Cash flows from operating activities

Net profit before taxation	X
Adjustments for	
Depreciation	X
Investment income	(X)
Interest expense	<u>X</u>
Operating profit before working capital changes	<u>X</u>
Increase in trade and other receivables	(X)
Decrease in inventories	X
Decrease in trade payables	<u>(X)</u>
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	<u>(X)</u>
<i>Net cash from operating activities</i>	<u><u>X</u></u>

Think carefully about what you are adding and subtracting.

<i>Net cash from operating activities brought forward</i>		X
<i>Cash flows from investing activities</i>		
Purchase of property, plant and equipment	(X)	
Proceeds from sale of equipment	X	
Interest received	X	
Dividends received	<u>X</u>	
		(X)
<i>Cash flows from financing activities</i>		
Proceeds from issuance of share capital	X	
Proceeds from long-term borrowings	X	
Payment of finance lease liabilities	(X)	
Dividends paid	<u>(X)</u>	
<i>Net cash used in financing activities</i>		<u>(X)</u>
<i>Net increase in cash and cash equivalents</i>		X
Cash and cash equivalents at beginning of period		<u>X</u>
Cash and cash equivalents at end of period		<u><u>X</u></u>

Cash equivalents

Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value

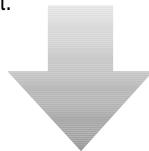
Note. Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money market instruments. Cash and cash equivalents included in the statement of cash flows comprise the following amounts.

	20X1	20X0
	\$m	\$m
Cash on hand and balances with banks	X	X
Short-term investments	X	X
Cash and cash equivalents	<u>X</u>	<u>X</u>

Direct method

The operating activities element of the cash flow statement is different.



	\$'000
Cash flows from operating activities	
Cash receipts from customers	X
Cash paid to suppliers and employees	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
<i>Net cash from operating activities</i>	<u>X</u>

Note. These can be presented as T accounts (shown here) or as shown in the corresponding text chapter.

TAX PAID

		Deferred tax b/d	X
∴ Tax paid	X	Income tax b/d	X
Deferred tax c/d	X	Charge for year	X
Income tax c/d	X		
	<u>X</u>		<u>X</u>

FINANCE LEASE LIABILITY

∴ Finance lease payments	X	B/d liability	
		< 1 year	X
		> 1 year	X
C/d liability		New finance lease in	
< 1 year	X	year	X
> 1 year	X		
	<u>X</u>		<u>X</u>

NON-CURRENT ASSETS

Bal b/d (NBV)	X	Depreciation	X
Revaluation	X		
∴ Addition	X		
		Bal c/d (NBV)	X
	<u>X</u>		<u>X</u>

Extra information

Extra information not found in other primary statements

- Relationships between profit and cash shown
- Cash equivalents are included in cash balances, giving a better picture of the liquidity of the company
- Financing inflows and outflows must be shown, rather than simply passed through reserves

Examining relationships

- Cash flow gearing: compare operating cash flows and financing flows, particularly borrowing
- Operating cash flows to investment flows: match cash recovery from investment to investment
- Investment to distribution: indicates the proportion of total cash outflow designated specifically to investor return and reinvestment

22: Alternative models and practices

Topic List

Capital maintenance

CPP/CCA

There are different theories of capital maintenance.

In the UK, when inflation was high, attempts were made to introduce a form of CCA, but companies consistently ignored it and the standard was eventually abandoned.

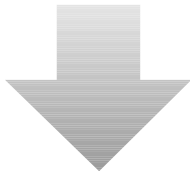
Without the impetus of high inflation, there is unlikely to be any more need to address capital maintenance issues.

You are unlikely to be asked anything complex in these areas; make sure you can explain the main terms.

Financial capital maintenance

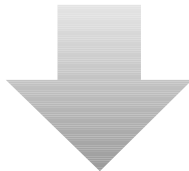
Under historical cost accounting (HCA), the amount maintained is the capital sum put into the business by the owner.

Focusing on the equity ownership of the entity is often referred to as the *proprietary concept of capital*: if we pay all profits out as dividends and inflation exists then in future our business will gradually run down, as our cash will become insufficient to buy replacement inventory.



Operating capital maintenance

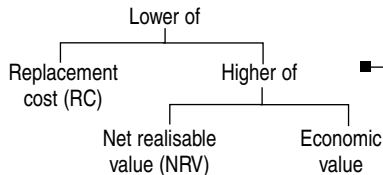
Capital is looked at as the capacity to maintain a level of assets, alternatively referred to as the *physical capacity capital maintenance concept*, or the *entity concept*. By using replacement cost for our cost of sales we will set aside enough cash to buy replacement assets.



Current purchasing power (CPP)

The idea behind CPP accounting is that all accounts items are restated in terms of a stable monetary unit: the \$CPP.

- Changes in purchasing power are based on the general level of inflation using the RPI
- CPP measures profits as the increase in the *current purchasing power* of equity; profits are stated after allowing for the declining purchasing power of money due to price inflation



Current cost accounting (CCA)

CCA uses the operating capital maintenance concept. The assets consumed or sold, and those in the BS, are stated at their value to the business, the deprival value, defined as shown in the diagram adjacent.

- Depreciation is charged on non-current assets on the basis of gross replacement cost of the asset (where RC is the deprival value)
- Where NRV or EV is the deprival value, the charge against CCA profits will be the loss in value of the asset during the accounting period
- Goods sold are charged at their replacement cost
- A typical set of CCA is prepared by adjusting BS values with a supporting current cost reserve, and taking a HC P&L and making CCA adjustments

Notes

23: Not-for-profit and public sector entities

Topic List

Primary aims

Regulatory framework

Performance measurement

Any questions on this will only be general ones.

Primary aims

Public sector entities

Examples:

- Government departments
- Health services (if government funded)
- Education services

Aims

- To provide services to the public
- To make good use of taxpayers' funds

Private sector entities

Examples:

- Charities

Aims

- To provide services to beneficiaries
- To raise funds for this purpose

Regulatory framework

Public sector

International Public Sector Accounting Standards (IPSASs), based on IFRS

Private sector

Regulated nationally eg by Charities Commission in UK

Statement of Recommended Practice (SORP) 2005. Charities must use **accruals** basis (unless revenue below £100,000 p.a.) and apply UK standards.

In other countries, requirements will be different.

Performance measurement

Not judged by bottom line profit but must show that they have managed their funds properly.

Performance measured in terms of **achievement of stated purpose**

Possible performance measures are:

- **3Es** – Economy, Efficiency, Effectiveness
- **KPIs** – Key performance indicators – specific to that organisation
- **VFM** – Value for money – and **best value** for outside services
- **Impact report** – produced by some charities to show measure of achievement – what impact did they have?