CIMA
Operational Level – Paper F1
FINANCIAL OPERATIONS
(REVISION SUMMARIES)

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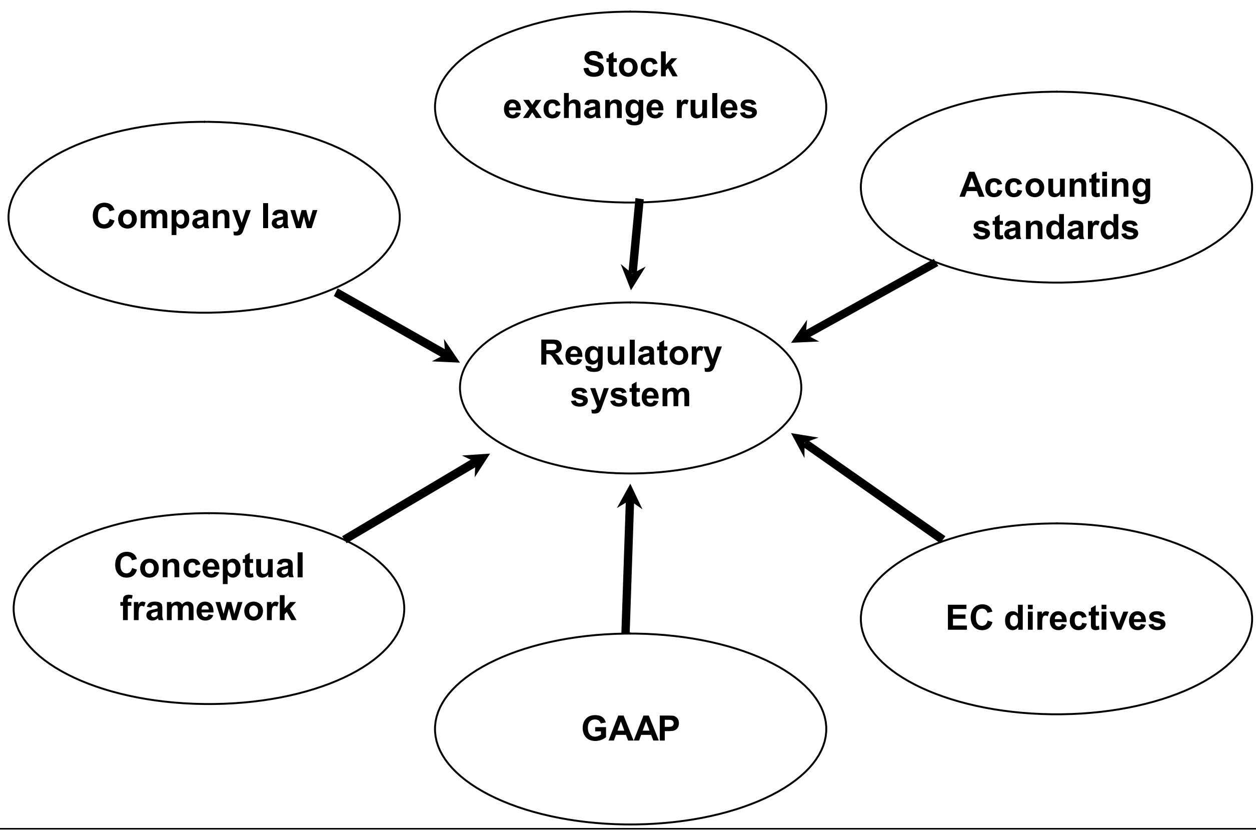
Chapter

1

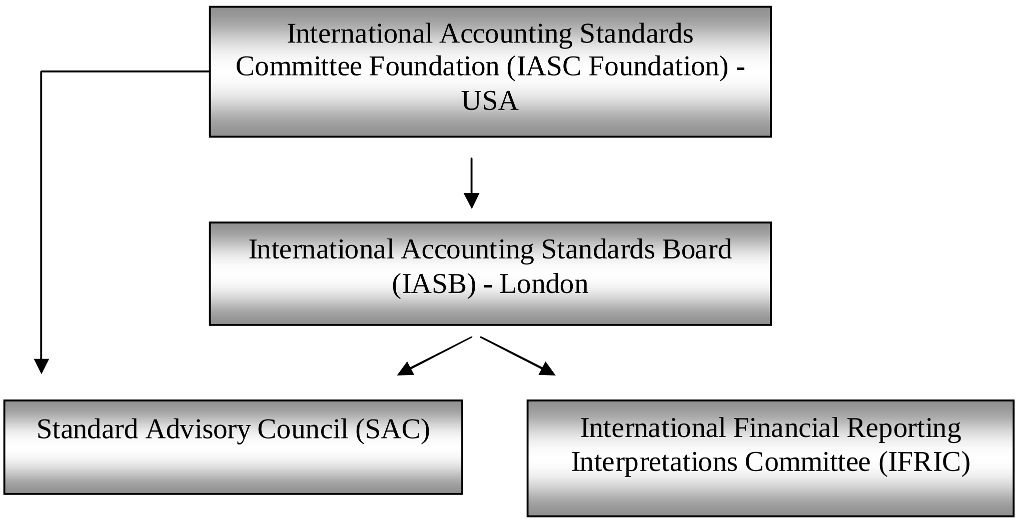
The Regulatory Framework

Key summary of chapter “the regulatory framework”

Regulatory system for financial statement production



International Accounting Standard Board (IASB)



Accounting standards and the IASB

The objectives of the IASB

- Develop a single set of accounting standards, which are of the highest quality and give users of the accounts transparency and comparability.
- To promote the use of these standards in the correct manner.
- To achieve convergence of national accounting standards all around the world

Development of accounting standards ï 5 stages

The conceptual framework

The framework is **a conceptual accounting framework** that sets out the concepts that underlie the preparation and presentation of financial statements for external users. It was produced by the IASC and has been adopted by the IASB. It is not an accounting standard, and nothing in the framework overrides a specific international accounting standard.

1. Objectives of financial statements
2. Underlying assumptions
3. Qualitative characteristics of financial statements
4. Elements of financial statements
5. Recognition of the elements of financial statements
6. Measurement of the elements of financial statements
7. Concept of capital and capital maintenance

Developments in accounting harmonisation

IASs and IFRS are used in many parts of the world. Many countries are converging their local GAAP with IASs / IFRSs. Often there is a time lag in adopting an IFRS as local GAAP.

Convergence with US GAAP
The largest capital market remaining with its own standards is the US. The United States Securities and Exchange Commission (SEC) requires all overseas companies listed in the US to prepare their financial statements using either US GAAP or their local GAAP but doing a reconciliation between their local GAAP and US GAAP.

Governance and social responsibility

Governance is the system by which organisations are directed and controlled. Good governance would not only emphasise achieving the main purpose of the organisations, following the law and industry regulations but also being ethical, accountable, manage risks and have effective internal controls by employing experts.

Social responsibility is the responsibilities that the organisation has to others outside of the direct owners. These may include the environment, employees, customers, suppliers, government, pressure groups and the public at large.

Ethics

Ethics is the code of moral principles about what is right and wrong in an organisation. Ethics is a set of moral principles within employee or corporate culture and therefore culture plays a big part. Law does not necessarily enforce it nor do government organisations, and can relate to social responsibility

Ethics for accountants

Qualified professional accountants must act ethically to ensure that they are not acting illegally; ensure that reporting and professional standards are being met, the professionôs reputation is protected and that they serve the public interest.

Qualified accountants are governed by their professional bodies such as CIMA or ACCA and provide a code of ethics to which they need to comply.

Fundamental principles

- Integrity.
- Objectivity.
- Confidentiality.
- Professional behaviour.
- Professional competence and due care.
- Professional and technical standards.

Personal qualities of accountants

- Reliability.
- Responsibility.
- Timelines.
- Courtesy.
- Respect.

Professional qualities of an accountant

- Independence ï in mind and appearance.
- Scepticism ï question information given.
- Accountability ï for your own judgements and decisions.
- Social responsibility - to the public, employer or clients.

Personal development and lifelong learning

Personal development is important for the accountant as these will make him a far better rounded professional. There should be development of interpersonal skills, writing skills, organisational skills, presentation skills, client management skills and relationship building skills.

Lifelong learning is also important as a professional accountant must be up to date with the latest techniques, skills and legislation to give better advice to the client.

The CIMA and IFAC "Codes of Ethics for Professional Accountants"

In 2005 CIMA launched their code of ethics designed to govern its members. It is the minimum standard expected of all members when carrying on their business in a professional and personal capacity. The code has three parts:

Part A – General Applications of the Code
Part B – Professional Accountants in Public Practice
Part C – Professional Accountants in Business

In 2005 IFAC also launched its code of ethics and must be followed by all members of IFAC which includes CIMA. It overrides any codes created by national accountancy bodies and are more stringent. CIMAôs code of ethics fully complies with IFACôs code of ethics and bears a lot of similarity as CIMA had contributed heavily to IFAC's development of their code of ethics.

Chapter

2

Format of Financial Statements

Key summary of "Formats of financial statements"

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

The financial statements of a company consists of	
Old titles	**New titles**
Income statement	Statement of comprehensive income
Balance sheet	Statement of financial position
Cash flow statement	Statement of cash flows
Statement of changes in equity	Statement of changes in equity

Statement of comprehensive income (income statement)

The statement of comprehensive income (income statement) shows all the income and expenses during the period for the organisation. Income statements should help investors and other users determine the past performance of the organisation and help them to predict future performance.

The revised IAS 1 (Sept 2007) allows 2 formats to be adopted showing all income and expenses.

(1) In a single statement called ñStatement of comprehensive incomeò: or

(2) In two separate statements called ñincome statementò and ñstatement of other comprehensive incomeò.

Items that normally appeared in the statement of changes in equity before IAS 1 was revised in 2007 will now be shown on the face of the comprehensive income statements as either part 1 or 2 formats detailed above.

Expenses by function or nature

IAS 1 allows two further formats for the income statement relating to how the expenses are analysed (function or nature). This would relate to the income statement part in the ñstatement of comprehensive incomeò and to the separate statement ñincome statementò for the part 2 format detailed above.

Expenses analysed by **function** are analysed according to their function, this includes cost of sales, administration or distribution activities. You will be more familiar with this. If the organisation categorises by function, additional information on the nature of expenses (depreciation, amortisation, wages etc) must be disclosed.

Expenses analysed by **nature**, are not analysed by their function but by their nature, so for example purchase of goods, wages, depreciation.

Dividends

Dividends are shown the statement of changes in equity.

Statement of financial position (the balance sheet)

The statement of financial position (balance sheet) is a snapshot of the company's financial position on a given date. The statement of financial position (balance sheet) is the only financial statement, which applies to a single point in time, instead of a period of time. The statement of financial position (balance sheet) represents the accounting equation: -

Assets – liabilities = Shareholders funds / equity

The top half of the statement of financial position (balance sheet) shows all the assets and the bottom half shows all liabilities and equity.

Statement of changes in equity

The statement of changes in equity shows the reconciliation between opening equity and closing equity. IAS 1 requires an organisation to present a statement of changes in equity as a separate component of the financial statements. This is a period statement just like the income statement and cash flow statement.

The statement of changes in equity is a summary of all changes in equity arising from transactions with owners in their capacity as owners. The statement of changes in equity must show:

1	Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests;
2	For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with IAS 8
3	For each component of equity, reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from (a) profit or loss, (b) each item of other comprehensive income and (c) transactions with owners directly.

Notes to the financial statements

Notes to the financial statements give users of the accounts more information about the figures. Each company will have their own set of unique notes, but IAS 1 does require certain order and detail of particular items. The notes must be prepared in an orderly manner and cross referenced to the figures on the face of the financial statements.

The notes to the financial statements under IAS 1 must:

- Present information about the **basis of preparation of the financial statements** and the specific accounting policies used.
- **Disclose any information required by IFRSs** that is not presented on the face of the balance sheet, income statement, statement of changes in equity, or cash flow statement.
- Provide **additional information** that is not presented on the face of the balance sheet, income statement, statement of changes in equity, or cash flow statement that is deemed relevant to an understanding of any of them.

Chapter

3

Preparing Financial Statements For Single Company

Key summary of chapter – "Preparing financial statements for single company"

Exam technique for preparing financial statements

Preparation of financial statements under exam conditions is very time constraint. To ensure maximisation of marks, the following approach should be taken.

Step 1	**Layout pro-forma's** For the statement of comprehensive income (income statement) and statement of financial position (balance sheet), allow for 2 whole A4 sides for each statement. For the statement of changes in equity allow 1 whole A4 side. For the statement of cash flows all 2 whole A4 sides.
Step 2	**Work through the notes** On the workings page, start off by working through the additional information provided, systematically, note by note. In your answer script detail exactly what needs to be done. **It is imperative that you show all your workings!**
Step 3	**Additional calculations** After the notes have been dealt with, do the following calculations before completing the financial statements: **(i) Depreciation** **(ii) Cost of sales** **(iii) Carrying value of tangible and intangible assets** **(iv) Taxation charge**
Step 4	**Complete the financial statements** Pick the figures from the trial balance and insert into the pro-forma financial statements (ensuring you tick and bash the trial balance and also incorporate the workings done during step 2 and step 3). Ensure the workings are cross referenced. Order of completion: 1 Statement of comprehensive income (income statement) 2 Statement of changes in equity 3 Statement of financial position (balance sheet)

Manual journals		
Accruals for expenses	Dr Expense IS	Cr Current liability BS
Prepayments of expenses	Dr Current asset BS	Cr Expense IS
Dividends proposed	Dr SOCE	Cr Current liability BS
Depreciation	Dr Expense IS	Cr Provision for depreciation BS
Amortisation	Dr Expense IS	Cr Provision for amortisation BS
Impairment of assets	Dr Expense IS	Cr Provision for amortisation BS

Chapter

4

Statement of Cash Flows For Single Company

Key summary of chapter "statement of cash flows for single company"

IAS 7 deals with statement of cash flows; itôs a period statement and shows all the cash inflows and outflows during the accounting period.

Statement of cash flows provides users information, which is not available from statement of comprehensive income and statement of financial position.

The statement of cash flows helps users of the accounts in assessing how well the business is generating cash.

It shows the relationship between the profitability and cash generated; therefore comparisons can be made with other organisations, without having to worry about different accounting policies (which affect the profit figure)

The statement of cash flows will also show how liquid the business is and from past cash flow statements, the history can be established, which will highlight any problems to the user of the accounts.

Format of statement of cash flows

The main headings as per IAS 7 are:

Cash flow from **operating** activities
Cash flow from **investing** activities
Cash flow from **financing** activities
Net increase in cash and cash equivalents
Cash and cash equivalents at the beginning of the period
Cash and cash equivalents at the end of the period

Cash flow from operating activities - there are 2 methods which IAS 7 allows in calculating cash flow from operating activities:

Method 1 – Direct method
The direct method shows operating cash receipts and payments made during the period. To the users of the account this gives details of exactly where the cash has come from and where it has been spent.

<u>Cash flows from operating activities</u>	$
Cash received from customers	X
Cash paid to suppliers and employees	(X)
Other operating expenses	<u>(X)</u>
Cash generated from operations	**X**
Interest paid	(X)
Income taxes paid	(X)
Dividends paid	<u>(X)</u>
Net cash flow from operating activities	**<u>X</u>**

Method 2 – Indirect method
With the indirect method, the profit before taxation (or profit before interest and tax) is taken from the statement of comprehensive income and adjusted for non cash items (i.e. depreciation, provisions). It is also adjusted for profit or loss on disposal of assets. Other items which will be classified under investing or financing are also adjusted for. Finally adjustments are made for the changes during the period in inventories, trade and other receivables and payables. This requires looking at the current and prior yearÕs statement of financial position.

<u>Indirect method</u>	$
**Profit before taxation	X
Adjustment for:	
Depreciation and amortisation	X
Finance cost	X
Interest income	(X)
Profit on sale of asset	(X)
Working capital changes	
(Increase) decrease in inventories	(X) / X
(Increase) decrease in trade and other receivables	(X) / X
Increase (decrease) in trade payables	<u>X / (X)</u>
Cash flow from operating activities	**X**
Interest paid	(X)
Income taxes paid	(X)
Dividends paid	<u>(X)</u>
Net cash flow from operating activities	**<u>X</u>**

Cash flow from investing activities
The items included in this heading are:
- Acquiring property, plant and equipment.
- Capitalising developing expenditure and cash payments for other intangible assets
- Acquisition of shares (equity) in other entities
- Sale of property, plant and equipment
- Sale of shares in other entities

Cash flows from financing activities
The items included in this heading are:
- Cash receipts from issuing new shares (rights or full market issue).
- Cash received from issuing debentures, bonds or from a loan (short and long term)
- Cash payments to redeem debt.
- Cash payments to redeem or buy back shares.
- Capital repayment of a finance lease.

Dividends and interest payments
The payment of dividends and interest can either be shown under financing activities or under operating activities.

Cash and cash equivalents include bank & cash balances, short term investments which are highly liquid and can be converted into cash within 3 months. Cash equivalents will be shown under current assets in the balance sheet.

Using ñTò accounts helps establishing cash flows.

Adopt a step by step technique for maximising marks.

Chapter

5

Group Accounts: What is a group?

Key summary of chapter "Group accounts : what is a group?"

What is a group?

A group is where there is one or more companies being controlled by one parent company. Usually having greater than 50% of the equity share capital of the other company gives control, but there are exceptions to this rule. The holding company or parent is the one that controls, and the subsidiary company is the one being controlled.

A subsidiary is when there is control of another entity exercised through
(i) Dominant influence - Influence over the financial and operating policies of the company
(ii) Participating interest - An interest in shares held for the long-term for the purpose of gaining economic benefits in future

If a company has a subsidiary at its year-end, it must prepare group accounts, which must be in the form of consolidated accounts.

IAS 27 consolidated and separate financial statements

IAS 27 has two objectives:

(1) Preparation and presentation of consolidated financial statements for a group of entities under the control of a parent; and

(2) In accounting for investments in subsidiaries, jointly controlled entities and associates in the separate individual (non-consolidated) financial statements.

Exemptions for the parent company - A parent company can be exempt from preparing consolidated financial statements when the following conditions exist:

- The parent company is subsidiary of another company.
- The parent company is not listed on a stock exchange (i.e. not a public company)
- The parent loses control of subsidiary
- The parent has temporary control and subsidiary is held for resale under IFRS 5

I**AS 27 specifically does not allow the following reasons as exemptions**:

- Different nature of business
- Severe long-term restrictions

IAS 27 states that the investment in the subsidiary must be shown in the statement of financial of the parent company's separate financial statement either:

(i) At cost or

(ii) Using IAS 39 financial instruments - recognition and measurement.

General provisions of IAS 27 for consolidation

- Accounting policies
- Accounting period and dates
- Date of acquisition or disposal.
- Inter company transactions
- Non controlling interest - minority interest

Chapter

6

Group Accounts: Consolidated Statement of Financial Position

Consolidated statement of financial position

All assets and liabilities are added together 100% line by line

Even though the subsidiary may not be 100% owned by the parent company, all the assets and liabilities are added together in full.

This shows what the parent company controls. You need to distinguish between ownership and control

Equity

The share capital and share premium will be of the **parent company only**. The reserves will be of the parent company plus the share of the subsidiaries since its acquisition ï know as post acquisition retained reserves (PARR).

Non controlling interest – (previously known as minority interest)

Where the parent company has less than 100% ownership in equity shares, the share of the net assets of subsidiaries owned by other parties is shown separately under equity.

Goodwill for 100% owned subsidiary

When a premium is paid above the fair value of the net assets acquired over a subsidiary, it results in goodwill. IFRS 3 business combinations states the positive purchased goodwill must be capitalised upon consolidation and reviewed for impaired at least annually under IAS 36 impairment of assets. The impairment goes through the consolidated income statement.

Negative goodwill is investigated and is taken to the consolidated income statement immediately as a credit. Negative goodwill is also known as ñbargain purchaseò.

	Parent in subsidiary	
Goodwill calculation for 100% owned subsidiary		
Cost of investment at fair value		X
Less share of net assets acquired at fair value at date of acquisition		
Share capital	X	
Reserves	X	
Fair value adjustment	X	
Other adjustments	X	
	X	
Group share		(X)
Goodwill at date of acquisition		X
Impairment		(X)
Goodwill at current year end		X

Pre and post acquisition profits

When a subsidiary is acquired, it will already have accumulated profits, these are known as pre-acquisition profits. These profits are not part of the group, and therefore are not shown in the consolidated reserves. All the profits earned after the subsidiary was acquired will belong to the group, but only to the extent to the share ownership. These are known as post acquisition retained reserves (PARR).

Therefore the pre-acquisition profits are included in the goodwill calculation, and the share of post acquisition profits are shown in the consolidated reserves. Post acquisition profits are easily established as profits at the balance sheet less profits at date of acquisition.

Non controlling interest – NCI – (previously known as minority interest)

The parent company may acquire equity shares in another company which are less than 100%, but they still have majority of the equity shares. This means there are third party shareholders that need to be accounted for. These are the non controlling interest (NCI) previously known as minority interest (MI). In the consolidated statement of financial position (balance sheet), 100% of the assets and liabilities are added together to show what the parent company controls.

To adjust for the less than 100% ownership, the NCI share of the subsidiary is included under equity in the consolidated statement of financial position. The basic calculation of NCI in the consolidated statement of financial position:

Net assets of subsidiary at balance sheet date	X
Consolidation adjustments *(to be covered later)*	X / (X)
Revised nets assets of subsidiary at balance sheet date	X
NCI *(revised net assets x NCI %)*	X

IFRS 3: Business combinations (January 2008) - Goodwill and non controlling interest (NCI)

The new revised IFRS 3 method of calculating goodwill now gives the parent company a choice between 2 methods of calculating goodwill and dealing with NCI:

(i) **NCI's share of net assets** - this is the old method (also known as the **partial goodwill**). Here the goodwill is calculated in the traditional way. The NCI are basically ignored in the goodwill calculation and just the parentôs share is shown.

(ii) **Fair value** ï this is the new method (also known as the **full goodwill**). Both the parentôs and the NCIôs goodwill is established and shown in the consolidated financial statements.

Pro-forma for the goodwill calculation under the fair value (new) method Full goodwill	$m	$m
Cost of investment at fair value		X
Less share of net identifiable assets acquired at fair value at date of acquisition		
Share capital	X	
Reserves	X	
Fair value adjustments	X	
Other adjustments	X	
	X	
Group share x %		(X)
Goodwill parent's share		**X**
Fair value of NCI at date of acquisition	X	
Less: share of NCI net identifiable assets at fair value at date of acquisition	(X)	
Goodwill – NCI share		**X**
Total goodwill (parent + NCI)		**X**

NCI share of goodwill other side to the journal entry is to add to NCI under equity

Pro-forma for the goodwill calculation under the old method **Partial goodwill**	$m	$m
Cost of investment at fair value		X
Less share of net identifiable assets acquired at fair value at date of acquisition		
Share capital	X	
Reserves	X	
Fair value adjustments	X	
Other adjustments	X	
	X	
Group share x %		(X)
Goodwill		**X**

The 7 steps to consolidation in summary	
Step 1	**Determine group structure**
Step 2	**Layout the pro-forma**
Step 3	**Consider the adjustments**
Step 4	**Calculate goodwill**
Step 5	**Combine the financial statements**
Step 6	**Calculate non controlling interest (NCI) for subsidiary**
Step 7	**Proof of consolidated reserves**

Inter company transactions

The purpose of consolidation is to present the holding company and its subsidiaries as if they are trading as one entity. Therefore only amounts owing to or from outside the group should be included in the consolidated statement of financial position and any assets should be stated at cost to the group.

Consolidated assets at cost to the group
Consolidated liabilities owed to third parties

1 Inter-company balances

Trading transactions are recorded in current accounts. The current account receivable in one companyǿs book should equal the current account payable in the other. These two balances are cancelled upon consolidation.

Current accounts may not agree at year-end, due to **transit items** such as cash and inventory. Prior to consolidation adjustments will need to be made for the items in transit, by following through the transaction to its ultimate destination. The easiest way to do this is adjust the individual accounts and then begin the consolidation process.

2 Provision for unrealised profit (PUP) in inventory

Unrealised profit will arise on inter-company transactions where the **inter-company inventory is still held at the year end date.** Secondly the company which made the inter-company sale will have recorded a profit. From a group point of view, this profit is unrealised, it will only become realised once the goods are sold to third parties.

In exam questions:

(i) Establish company that made the profit. It will be this company that has the unrealised profit.

(ii) Calculate the provision for unrealised profit (PUP) on **unsold inter company inventory**.

For consolidation purposes, eliminate the profit from inventory, consolidated reserves and NCI (if subsidiary has made the sale).

3 Sale of non current assets within group

The adjustments required when non current assets are sold within the group are very similar to PUP on inventory.

Dividends payable by the subsidiary

Dividends paid by the subsidiary will be received by their shareholders, which mean the parent company and non controlling interest (NCI).

At the year end, the subsidiary may have proposed dividends but the financial statements may not have been adjusted to reflect this. Always read the question carefully and establish whether the financial statements reflect the dividends proposed. If they donôt, then they need to be accrued manually. Remember under IAS 10 only dividends declared by the balance sheet date can be accrued.

The parent company will also need to account for their share of the dividends payable by the subsidiary. Again read the question and establish whether the parentôs individual financial statements include the dividends receivable.

At the year end any **<u>inter-company dividends payable and receivable will be cancelled upon consolidation</u>**. Remember the consolidated statement of financial position must only show liabilities which are owed to third parties. So the only dividends payable in the consolidated balance sheet will be the parentôs and dividends payable to the NCI from the subsidiary shares.

The treatment is the same for preference share dividends and interest on debentures and loan stock.

IFRS 3 – Business combinations (revised 2008)

All business combinations within the scope of IFRS 3 must be accounted for using the **acquisition method** (previously knows as <u>purchase method</u>). The pooling of interests method is prohibited under IFRS 3. Under the old accounting standard (IAS 22) the pooling method of accounting was required if an acquirer could not be identified. Under IFRS 3, an acquirer must be identified for all business combinations. The acquirer is the organisation that **<u>obtains control</u>** of the other combining entities or businesses.

Steps in applying the acquisition method are:

1. Identification of the 'acquirer' (the parent company) - the combining entity that obtains control of the acquiree (the subsidiary).
2. Determination of the 'acquisition date' - the date on which the acquirer obtains control of the acquiree.
3. Recognition and measurement of the identifiable assets, liabilities and any non-controlling interest (NCI, formerly called minority interest) in the acquiree.
4. Recognition and measurement of goodwill or a gain from a bargain purchase option (negative goodwill).

<u>Positive purchased goodwill</u> is capitalised in the consolidated statement of financial position and reviewed for impairment under IAS 36.

<u>Negative purchased goodwill</u> is also known as a ñ**bargain purchase**ò. This arises when the share of the fair value of the identifiable nets assets are greater than the fair value of the consideration paid. IFRS 3 states that negative goodwill must be checked to ensure its accuracy and taken to the consolidated income statement immediately.

IFRS 3 - The objectives of a fair value exercise upon acquisition

Acquisition method of accounting to be used for all business combinations.

To ensure at acquisition all separately identifiable assets, liabilities and contingent liabilities acquired are recorded at fair value reflecting their condition at that date.

Goodwill is not amortised but tested for impairment annually. Negative goodwill is recognised in the consolidated income statement immediately.

Future re-structuring costs must not be included as part of the goodwill calculation unless the liability exists at the date of acquisition. An acquirer must not recognise provisions for future losses or restructuring costs expected to be incurred as a result of the business combination. These must be treated as post-acquisition expenses.

To ensure all changes to assets and liabilities and resulting gain after acquisition are reported as post acquisition of the group.

The fair value of the consideration paid (cost) for a subsidiary should be compared with the fair value of its net assets.

IFRS 3 prevents 'big bath' provisions, used to reduce or smooth post acquisition results. This was done by setting up large provisions for future re-organisation costs among the net assets acquired; this increased the positive purchased goodwill. Any future losses were set off against these large provisions.

Goodwill and non-controlling interest (NCI previously known as minority interest)

The revised IFRS 3 (2008) now gives an **option** to an organisation to recognise 100% of the goodwill rather than just the parent's share (as was the case previously). The NCI share of the goodwill is established using various fair value methods which will be given in the exam. The other side of the journal entry goes to the NCI under equity.

The standard states that the method used should be decided on a transaction by transaction basis. Using the full method of goodwill means the net assets will be increased in the consolidated statement of financial position. However there will be a higher impairment charge if the goodwill does suffer impairment.

Fair value adjustments – date of acquisition and year end date

It is also necessary to look at the assets and liabilities that had a fair value adjustment at the year end date (i.e. looking at the status of the asset / liability subjected to fair value adjustment at the balance sheet date).

(i) If the asset or liability still exists at the year end date, the fair value adjustment will be included with the relevant item.

(ii) If the asset or liability does not exist at the balance sheet date, the fair value adjustment goes through the reserves of the subsidiary as a consolidation adjustment

Investment in borrowings and non equity shares

Borrowings

When the parent company invest in borrowings of the subsidiary (i.e. it buys the subsidiaries loan stock or debentures), then upon consolidation, the two items are cancelled out. This is because in the parent company's books it will be shown as an asset and in the subsidiary it will be shown as a liability.

If the borrowings are not 100% owned by the parent company, the remaining will appear in the consolidation financial statements, as these are debts owed to third parties.

There is usually no goodwill associated with investment in borrowings and it doesn't affect the NCI working.

Preference shares

Preference shares are non equity shares. The parent company may own all or part of the total preference shares issued by the subsidiary. There may be goodwill associated with the preference shares, which is just the difference between the value of the preference shares and the price paid.

If the preference shares are not 100% owned by the parent company, there will be NCI. The preference share owned by the parent company will be cancelled upon consolidation, and the remaining preference shares will be shown under NCI as non equity NCI.

It is important to note that the ownership in preference shares does not determine the group structure; this is only with ordinary equity shares (which give voting rights). Preference shares do not give voting rights and are normally classified as liability under IAS 32.

Chapter

7

Group Accounts: Consolidated Income Statement

Key summary of chapter "consolidated income statement"

The consolidated income statement shows all the revenue and expenses of the parent and subsidiary/s during the accounting period. The workings on the consolidated income statement are very similar to consolidated statement of financial position.

1	**Turnover to total comprehensive income** The statement of comprehensive income (income statement) is added together 100% line by line from turnover to total comprehensive income. If the subsidiary was acquired part way through the accounting year, the items are pro-rated.
2	**Inter company sales** If there has been trading between the group companies, then the sales and the purchases have to be removed 100% from the consolidated turnover and consolidated cost of sales. This is because they were originally added to together as 1 above.
3	**Provision for unrealised profit (PUP)** The PUP on unsold year-end inter-company inventory will need to be <u>added back</u> to the consolidated cost of sales (increase expenses).
4	**Sale of non current assets** The unrealised profit on inter-company sale of non current asset, is removed from the consolidated income statement as a consolidation adjustment (decreases profits). The additional depreciation is also removed (increases profits).
5	**Fair value adjustments on non current assets** If the subsidiary's assets were subjected to fair value adjustments upon acquisition and if the subsidiary hasn't incorporated the fair value adjustments in its individual financial statement, the adjusted depreciation charge will need to go through as a manual consolidation adjustment in the consolidated income statement.
6	**Investment income** The consolidated income statement must only show investment income from other investments and <u>not</u> from subsidiaries, associate and joint ventures. This is because the actual returns from the investment companies are being replaced with individual items.
7	**Non controlling interest (NCI)** With the consolidated comprehensive income statement, NCI needs to be calculated for: (i) <u>Profit for the year</u> (subsidiary's profit for year adjusted for consolidated adjustments x NCI %) (ii) <u>Other comprehensive income</u> (other comprehensive income x NCI %) The NCI is also pro-rated if the subsidiary was acquired part way through the year.

8	**Dividends** The dividends paid and proposed will only ever be of the parent company which is shown in the consolidated statement of changes in equity under the reserves column. .
9	**Consolidated profit reserves brought forward – consolidated statement of changes in equity** The consolidated reserves bought forward will be the parentôs bought forward reserves plus share of post acquisition retained reserves (PARR) of subsidiary bought forward. The working is exactly is the same as in the consolidated statement of financial position step 7.

The 7 steps to consolidation in summary

Step 1	**Determine group structure**
Step 2	**Layout the pro-forma**
Step 3	**Consider the adjustments**
Step 4	**Calculate goodwill**
Step 5	**Combine the financial statements**
Step 6	**Calculate non controlling interest (NCI) for subsidiary**
Step 7	**Proof of consolidated reserves bought forward for consolidated statement of changes in equity – reserves extract**

Formats of the consolidated income statement (revised IAS 1)

The revised IAS 1 (Sept 2007) allows 2 formats to be adopted showing all income and expenses.

(1) In a single statement called ñstatement of comprehensive incomeò: or
(2) In two separate statements called ñincome statementò and ñstatement of other comprehensive incomeò.

The income statement will show the realised profit and loss for the period. Other comprehensive income is income and expenses that are not recognised in the realised profit and loss but would normally appear in the reserves. These would now appear on the face of the ñstatement of comprehensive incomeò or ñstatement of other comprehensive incomeò.

Examples of other comprehensive income include:
(i) Revaluation gains (IAS 16 and IAS 38)
(ii) Exchange differences on translation of foreign operations (IAS 21)
(iii) Gains or losses on re-measuring available for sale financial assets (IAS 39)
(iv) Actuarial gains or losses on defined pension schemes (IAS 19)
(v) Gains / losses on hedging instruments in a cash flow hedge (IAS 39)

Basically all the above items would normally have appeared in the statement of changes in equity before IAS 1 was revised in 2007. They will now be shown on the face of the comprehensive income statements as either part 1 or 2 formats detailed above.

The above shows that all the non-owner changes in equity are presented in the comprehensive income statements (part 1 or part 2 formats). Components of comprehensive income may not be presented in the statement of changes in equity. Non-owner movements in equity may not be presented as separate items in the statement of changes in equity. This revision has been made so as to clearly segregate changes in equity arising from transactions with owners in their capacity as owners from non-owner changes in equity.

For consolidation purposes, the examiner will normally give guidance on which format to use.

Chapter

8

Associates

Key summary of chapter "Associates"

IAS 28 investments in associates
An associate is an investment in which there is significant influence and participating interest.

Participating interest
An interest in shares held for the long-term for the purpose of gaining economic benefits in future

Significant influence
This involves participating in the financial and operating policy decisions, including dividend policies and strategic issues. There is no control over these activities, just influence.

IAS 28 requires the **equity method** of accounting to be used for associate undertakings.

Equity method of accounting includes the following

Consolidated income statement:
The groupφs share of the associates profit after tax is shown in the consolidated income statement. This can either be shown as a single line or two lines: -
(i) Share of associateφs profit before tax
(ii) Share of associateφs taxation

The dividends received or receivable from the associate are excluded in the consolidated financial statements. There is no NCI for associates.

Consolidated statement of financial position:
Under the equity method of accounting, an equity investment is initially recorded at cost and is subsequently adjusted to reflect the parentφs (investor's) share of the net profit or loss of the associate. The investment (interest) in associate undertaking is shown as a one liner under non current asset in the consolidated statement of financial position.

Pro forma workings:	
Method 1	
Group share of net assets at year end date	X
Plus goodwill (calculated as per IFRS 3)	X
Less impairment of goodwill	(X)
Investment in associate undertaking	X
Method 2	
Cost of investment in associate	X
Plus group share of post-acquisition retained reserves	X
Less impairment of goodwill	(X)
Investment in associate undertaking	X

Dividends paid by the associate

When the associate pays dividends to its shareholders, there is no impact on the way the consolidated income statement is established. The dividends received by the parent company are shown in the consolidated income statement and the share of the associates profit after tax is calculated as normal.

However, note that in the parentôs individual accounts the dividends will be recorded and the reserves will have increased by the dividend income.

For the consolidated statement of financial position, the investment in associate undertaking is reduced by share of dividends. This is because the investment that is shown under non current assets in the consolidated statement of financial position is increased each year by the ñretained profits since acquisitionò.

Impairment of associates goodwill

The goodwill of the associate is established in exactly the same way as for subsidiaries using the provisions of IFRS 3. The amount of impairment loss reduces the carrying value of the investment in the associate in the consolidated statement of financial position and also reduces the share of associates profit in the consolidated income statement.

Journal for impairment loss on goodwill in associate

Debit	Share of associates profit (consolidated income statement)
Credit	Investment in associate undertaking (consolidated statement of financial position)

Inter company transactions between group companies and associates

Just with subsidiaries, inter company transactions between associates are eliminated upon consolidation. Rule: Always take group share of every adjustment.

Parent (investor) selling to associate (investee) – downstream transactions

Debit	Consolidated cost of sales (consolidated income statement)
Credit	Investment in associate undertaking (consolidated statement of financial position)

It is not clear under IAS 28 if the parent company should make an adjustment for the sales it has made. But it could be argued that it should reduce its sales and cost of sales (share of) with the inter company sale to its associate.

Debit	Consolidated turnover (consolidated income statement)
Credit	Consolidated cost of sales (consolidated income statement)

Associate sells to parent – upstream transactions

Debit	Share of associates profit (consolidated income statement)
Credit	Consolidated inventories (consolidated statement of financial position)

Chapter

9

Reporting Financial Performance: IAS 1, IAS 8, IFRS 5, IFRS 8 and IAS 18

Key summary of chapter "reporting financial performance"

IAS 1- Presentation of financial statements

The objective of IAS 1 is to set out the overall framework for presenting general purpose financial statements, including guidelines for their structure and the minimum content.

1	**Fundamental principles** underlying the preparation of financial statements (going concern, accruals, consistency and materiality.
2	**No offsetting** of assets and liabilities, and income and expenses unless permitted or required by another IFRS.
3	A **complete set of financial statements** (balance sheet, income statement, statement of changes in equity, cash flow statement, accounting policies and explanatory notes). *The names of the financial statements have been changed under the 2007 revision – see below.*
4	**Comparative prior-period** information must be shown in the financial statements and notes.
5	**Annual preparation** of financial statements. If year end changes then this requires disclosure.
6	IAS 1 specifies **minimum line** items to be shown on the face of the balance sheet, income statement and statement of changes in equity, and gives guidance on additional line items
7	In the income statement analysis of expenses must be by **nature** or by **function**. If presented by function, classification by nature must be provided in the notes.
8	The **minimum note disclosures** include the accounting policies followed and the judgements / assumptions made by the management in arriving at estimations.
9	The 2005 amendment (effective 2007) requires disclosures about the organisationֳs **capital structure** and compliance with capital requirements. Capital structure includes long term debt and equity.

In September 2007 the IASB issued a revised IAS 1. The revisions to the standard are minor. Changes include:

- Present all non-owner changes in equity (comprehensive income) either in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income). Components of comprehensive income may not be presented in the statement of changes in equity.
- Disclose income tax relating to each component of other comprehensive income.
- Disclose reclassification adjustments relating to components of other comprehensive income.

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

IAS 8 details the criteria for selecting and changing accounting policies. It ensures that users of the accounts have sufficient information relating to any changes, how these changes or correction of errors compares with the results over time and comparisons with other companies.

Accounting policies

These are specific principles, bases, conventions, rules and practices which have been adopted by the organisation to prepare the financial statements.

Changes in accounting policies

IAS 8 only allows changes in accounting policies if:

- It is required by a standard, accounting setting body or statute
- The change will result in the financial statements being more relevant and appropriate.

IAS 8 states that the following are not changes in accounting policies:

- The transaction is of a new type not encountered by the entity in the past, so a new policy is adopted.
- The accounting policy is new and relates to transactions not occurred in the past.

Retrospective application

This is when the new accounting policy is applied to all the affected transactions in the past (i.e. if the policy had always been in existence). Retrospective application means adjusting the opening balance of equity which are affected by the change from the earliest prior period shown and the other comparative figures disclosed adjusted for the change in accounting policy as if the new accounting policy had always been applied.

Prospective application

If it is not practical to determine the affect of the change in accounting policy to prior years, then the IAS 8 states that the comparative figures should be adjusted from the earliest date practical, which may be the current period and make a corresponding adjustment to the opening balance of each affected component of equity for that period.

Changes in accounting estimates

Estimates are made to the best ability of the organisation with all the information that is available. New information may come to light, which means these estimates need to be changed. A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability. A change in an accounting estimate must be **recognised prospectively** by including it in the income statement in the period of the change and future periods (if appropriate), or to the extent that a change in estimates gives rise to a change in assets, liabilities or equity it should be recognised by adjusting the relevant carrying amount.

Errors

Errors may be discovered which relate to previous years accounts (prior periods), which will require correction and explanation if material. Because these errors have already occurred, they are known as prior period errors. IAS 8 states that as soon as the errors are discovered they must be **rectified retrospectively** in the first set of financial statement and comparatives amounts must be restated, which means after the correction, the financial statements should be stated as if the error had never occurred.

Change in accounting policy	***Retrospective application – change past accounts***
Change in accounting estimate	Prospective application ï change current and future accounts
Errors found	Retrospective application ï change past accounts

IFRS 5 Non-current assets for sale and discontinued operations

IFRS 5 details the treatment of assets held for sale. IFRS 5 is a new accounting standard issued by the IASB under the convergence project with US Financial Accounting Standards Board (FASB). IFRS 5 replaces the IAS 35 discontinued operations.

IFRS 5 states that assets that meet the criteria to be classified as held for sale to be measured at the **lower of carrying amount and fair value less costs to sell**, and depreciation on such assets to cease.

Non current asset or disposal group
Is classified as held for sale if its carrying amount will be recovered through sale and not through continuing use of it.

(i) Measurement of the disposal group or asset held for re-sale
The assets should be measured at the lower of carrying value and fair value less costs to sell (i.e. its net realisable value NRV).

(ii) Impairment
If the fair value less costs to sell is lower than the assets carrying amount, then an impairment loss is recognised. This is different to the normal rule under IAS 36 impairment of assets (measured at recoverable amount). Assets held for sale are outside the scope of IAS 36. Under IAS 36 impairment is when the assets recoverable amount is lower than its carrying value.

(iii) Depreciation
No depreciation is charged on assets held for sale.

Discontinued operations
A discontinued operation is either disposed of or held for sale by the organisation.
- Itõs a major separate line of business or in a different geographical area
- Will be disposed in a single go
- Is a subsidiary held for sale

Presentation in the financial statements of discontinued operations

Income statement
One single amount on the face of the income statement, under discontinued operations - post tax profit for the period from discontinued operations

In the notes to the accounts, the post tax profit is analysed into revenue, expenses, pre-tax profit or loss and tax.

Or show in columnar format on the face of the income statement, continuing and discontinued operations.

The statement of financial position
Assets and disposal groups classified as held for sale must be presented separately on the face of the statement of financial position. The assets or group of assets for disposal should be measured at the lower of carrying value and fair value less costs to sell (i.e. its net realisable value NRV)

Impairment must be considered both at the time of classification as held for sale and subsequently.

IFRS 8 operating segments

The IASB issued IFRS 8 operating segments in November 2006 (which replaced IAS 14). This continues the IASBôs work in its joint short-term convergence project with the US Financial Accounting Standards Board (FASB) to reduce differences between IFRSs and US generally accepted accounting principles (GAAP). IFRS 8 is now aligned with the US standard SFAS 131 disclosures about segments of an enterprise and related information.

Many organisations now do business in lots of different geographical areas and carry on with different classes of business. These different sections will have different levels of profitability, growth and risk. Analysing the different business ñsegmentsò will give users of accounts more information for their decision-making purposes.

Segmented accounts give the users information relating to the different areas of business or location for the enterprise.

IFRS 8 requires an organisation to adopt the **management approach** to reporting on the financial performance of its operating segments. The general idea is that:

- Information that would be reported would be what **management uses internally for decision** making of the segments (management accounts).
- This therefore means that information may be **different** from what is used to prepare the income statement and statement of financial position.
- The IFRS therefore requires **explanations** of the basis on which the segment information is prepared and **reconciliations** to the amounts recognised in the income statement and statement of financial position.
- Management approach to segmental reporting will allow users of financial statements to **review the operations from the management’s point of view** and see how the organisation is controlled by the senior decision makers.
- As this information is produced internally by the management it will **incur few costs**.
- This will also allow **interim reporting of the segment information**, as internally this is produced anyway for management accounts purposes.

Operating segments

An operating segment is a component of an organisation

- That engages in business activities from which it may **earn revenues and incur expenses** (this also includes inter-company trading).
- Whose operating results are r**eviewed regularly** by the management who then assign resources accordingly whilst reviewing the performance of the operating segment
- For which **discrete financial information is available**. This means separate data is kept for each operating segment.

Reportable segments

Reportable segments are operating segments or aggregations of operating segments that meet specified criteria (core principle):

- The segments revenue (internal and external) is **10% or more** than the combined internal and external revenue of all operating segments or
- The segments profit is 10% or more than the combined operating segments profit. The segments loss is 10% or more than the combined operating segments losses or
- The segments assets are 10% or more than the combined assets of all operating segments.

If the total external revenue reported by operating segments is less than 75 per cent of the organisationôs entire revenue, additional operating segments must be identified as reportable segments (even if they do not meet the 10% criteria above) until at least 75 per cent of the organisationôs revenue is included in reportable segments. IFRS 8 requires an entity to report financial and descriptive information about its reportable segments.

IAS 14 had a **risk and return approach** to identifying segments. The risk and return approach identifies segments on the basis of different risk and returns arising from different lines of business and geographical areas.

IFRS 8 adopts the **managerial approach**. This approach identifies the segments based on the information used internally for the decision making, so therefore is based on the internal organisation structure.

Revenue recognition – IAS 18

The IASB framework states that income is recognised when there is an increase in future economic benefits relating to an increase in an asset or a decrease in a liability.

IAS 18 deals with revenue, which is income that arises in the ordinary course of business. Revenue consists of:

- Sale of goods ï a company buys / manufactures goods and sells them to buyers.
- Rendering of services ï a company provides a service to the buyers.
- Interest, royalties and dividends.

Sale of goods revenue should only be recognised in the financial statements when:

Significant **risks and rewards** have been passed onto the buyer (remember the definition of an asset)

Ownership of the goods has been passed to the buyer, meaning that the business selling the goods has no control over the goods, and therefore no influence over them.

The **revenue** can be **measured reliably**

Reasonably certain that the seller will be gaining **economic benefit** from selling the goods.

The **selling costs** can be **measured reliably.**

Rendering of services should only be recognised in the financial statements when:

The **revenue** can be **measured reliably.**

Reasonably certain that the seller will be gaining **economic benefit** from rendering the services.

Stages of **completion** can be **measured reliably** at the year end date.

The **selling costs** of supplying the service can be **measured reliably.**

Interest, royalties and dividends should be recognised in the financial statements, when the amount is known with certainty and it is likely to be received

Interest

The revenue from interest is recognised on a time proportion basis. This takes into account the effective yield, which involves discounting the future cash flows including the carrying value of the asset.

Royalties

These are recognised on an accrual basis under the contractual agreement.

Dividends

These are recognised once the right to receive them has been established.

Chapter

10

Non-Current Tangible Assets

Key summary of chapter "tangible non current assets"

Tangible assets
These are assets that have physical substance and are held for use on a continuing basis in the reporting entityôs activities. This includes plant, property and equipment.

Intangible assets
These are assets other than goodwill, without physical substance but are identifiable and controlled by the entity through custody or legal rights. This includes patents, copyrights and licenses

IAS 16 plant property and equipment became effective from 1st January 2005 and deals with tangible assets.
1 Recognition of the assets
2 Determining the carrying value of the assets
3 Calculating depreciation

The cost of the asset will be all the costs associated with the asset to bring it to its **present location and condition**. This also applies for assets that are constructed by the business.

Initial measurement at cost for assets purchased and constructed

- Purchase price less trade discounts (but not early settlement discounts)
- Import duty and any other non-refundable purchase taxes
- Transport and handling costs
- Professional fees
- Installation costs & site preparation costs
- Estimated costs of removing and dismantling an asset and site restoration costs (if it qualifies under IAS 37 ñprovisions, contingent assets and contingent liabilities as a liability
- Interest borrowed to finance the production or construction of the asset (optional under IAS 23 borrowing costs)
- Production costs including raw materials, consumables, other direct costs and reasonable indirect

Subsequent expenditure (repairs and maintenance) must be recognised in the income statement as it is incurred (i.e. canôt capitalise it). The only time subsequent expenditure can be capitalised is when:

- It enhances the economic benefits
- A component of an asset that is treated separately for depreciation purposes has been restored or replaced
- It relates to a major inspection/ overhaul restoring economic benefits consumed and reflected in depreciation.

Measurement after initial recognition of assets
IAS 16 states that once the assets have been capitalised initially (and subsequent capitalisation), the business must apply either the cost model or revaluation model to the assets as its accounting policy. The chosen policy must be applied consistently to an entire class of property, plant and equipment.

Depreciation

IAS 16 states that all assets with a limited useful life must be depreciated. The depreciation charge goes to the income statement. IAS 16 also states that each significant part of an item of property, plant and equipment must be depreciated separately.

- **Depreciable amount** - The cost or valuation of the asset
- **Finite life** - Only land has infinite life (unless itôs used for mining). All other assets have a finite life.
- **Useful economic life (UEL)** - The period of time the asset is being used by the business (which may be different from the actual physical life of the asset).
- **Residual value** - The value that the asset can be sold for at the end of its UEL
- **Depreciation methods** - Straight line, reducing balance, sum of digits

The double entry for depreciation:

Debit	Depreciation expense in income statement
Credit	Accumulated depreciation in statement of financial position

When preparing the statement of financial position, the carrying value of the asset is cost / revalued amount less accumulated depreciation.

Straight line

$$\frac{\text{Original cost of asset ï residual value at end of useful life}}{\text{Useful life of the asset}}$$

Reducing balance (decreasing charge)

Depreciation % x carrying value

Sum of digits

Sum of digits fraction x (original cost ï residual value)

Revaluations

Revaluations of non current assets are done to better reflect the fair values of the assets, and therefore ensures that the statement of financial position is up to date, making it more useful to users of account.

Revaluation is optional under IAS 16. If an item of property, plant or equipment is revalued, then the entire class in that category must be revalued. This ensures that the organisation doesnøt choose and select certain items as it pleases.

Revaluations are usually done by professionals on an annual basis. This may be extended to every three to five years if the value doesnøt fluctuate too much. If the organisation chooses to revalue it assets, then it has adopted the revaluation model.

Revaluation surplus

If the asset is revalued upwards (i.e. the revalued amount is greater than the current carrying value), then the asset is increased by this amount and gain or surplus goes to the revaluation surplus, which is shown under ñ**other comprehensive income**ò. The revaluation surplus is part of the ownersô equity. So therefore the **initial revaluation surplus** is **not part of the profit for the year** but forms part of the **total comprehensive income.** In the statement of changes in equity, the revaluation surplus will appear under the revaluation reserve which forms equity.

Journal entry for revaluation surplus

Debit	Accumulated depreciation (statement of financial position)
Debit	Non current asset (statement of financial position) (*revalued amount less original cost)*
Credit	Revaluation surplus (other comprehensive income)

Revaluation deficit

If the asset is revalued downwards (the revalued amount is less than the current carrying value), then the deficit is taken to the income statement as a loss. It is included in the profit for the year. The **initial revaluation deficit does not go to the revaluation reserve**; the loss is part of the profit or loss for the period.

Debit	Accumulated depreciation (statement of financial position)
Debit	Revaluation loss (income statement)
Credit	Non current asset (statement of financial position) (*revalued amount less original cost)*

Previously revalued assets

1 If an asset was previously revalued downwards, which resulted in the revaluation deficit being taken to the income statement as a loss (included in the profit or loss for the year), then subsequent upward revaluation can recognised in the income statement BUT only to the extent that it reverses the previous loss. This means the subsequent revaluation surplus forms part of the profit for the year, to offset the loss in the previous revaluation. Any remaining revaluation surplus (after the loss has been covered) is shown as part of other comprehensive income and goes to the revaluation reserve.

Debit	Non current asset (statement of financial position)
Credit	Revaluation gain (income statement)

2 If an asset was previously revalued upwards, which resulted in the revaluation surplus being taken to the revaluation surplus under other comprehensive income, then a subsequent downward revaluation loss can be taken as a debit to the revaluation surplus under other comprehensive income, BUT only to the extent it reverses the previous gain. Any remaining revaluation deficit (after the surplus has been covered) is taken to the income statement and forms part of the profit or loss for the year.

Debit	Revaluation surplus (other comprehensive income)
Credit	Non current asset (statement of financial position)

The accumulated depreciation is reset to zero and the new depreciation is calculated on the re-valued amount. The useful economic life may also need reviewing.

Disposal or retirement of non-current assets

When an asset is sold the sales proceeds are compared with the carrying value of the asset at the date of disposal. The resulting gain or loss on disposal is taken to the income statement, and the asset is de-recognised from the balance sheet (i.e. removed). When as asset is retired, it means there will no further economic benefits expected from the asset and is de-recognised in the same way.

IAS 36 impairment of assets

Impairment is a reduction in the recoverable amount of an asset (both tangible and intangible) below its carrying value. Assets must never be carried in the statement of financial position above their recoverable amount. If the carrying amount exceeds the recoverable amount, the asset is impaired and should be written down.
The recoverable amount of an asset is the higher of net realisable value and value in use.

- Net realisable value - fair value less any selling costs.
- Value in use - the present value of estimated future cash flows expected to arise from the continuing use of an asset, and from its disposal at the end of its useful life.

Impairment loss

Impairment loss is the reduction in the carrying value compared to its recoverable amount. The impairment loss is accounted for as follows:

Debit	Impairment loss (income statement)
Credit	Non current asset (statement of financial position)

However this rule is different on revalued assets. If an asset that was previously revalued and had a revaluation surplus, then the impairment loss is offset against this surplus under other comprehensive income and is treated as a revaluation decrease:

Debit	Revaluation loss (other comprehensive income)
Credit	Non current asset (statement of financial position)

Any impairment loss in excess of the revaluation surplus will be charged to the income statement.

Cash generating units and purchased goodwill

When a business acquires or takes over another business, purchased goodwill occurs (intangible non-current asset). This makes the acquirer the parent company and acquired business the subsidiary. For impairment purposes, the cash generating unit is all the assets and liabilities associated with the acquired entity plus the purchased goodwill allocated to it.

Debit	Impairment loss (income statement)
Credit	Firstly to goodwill (statement of financial position)
Credit	Then to all other assets in the cash generating unit on a pro-rata to their carrying amounts (statement of financial position)

The pro ï rata is done by taking the proportion of the individual assets compared to the total assets

IAS 23 borrowing costs

A company may need to borrow finance to construct its own non current asset or if it enters long term contracts (looked at later). The interest payments made on the borrowing can be treated as part of the cost of the asset (capitalisation of interest). However there are arguments for and against this treatment.

1 Treat borrowing costs as period costs and charge them to the income statement (this is the **preferred benchmark treatment** of IAS 23).

Debit	Interest expense (income statement)
Credit	Bank (statement of financial position)

Or

2 Capitalise borrowing cost for qualifying assets (the **allowed alternative treatment** by IAS 23).

Debit	Non-current asset (statement of financial position)
Credit	Bank (statement of financial position)

A **qualifying asset** is an asset that takes a substantial period of time to get ready for its intended use (e.g. property, plant, equipment, investment property during the construction period, intangible assets during the development period and manufacturing made to order inventories)

If capitalisation of borrowing costs is the policy adopted by the organisation then the interest rates / costs to be used are**:**

1 For **specific borrowings** on qualifying assets, use the actual interest cost calculated from actual interest rates, less any investment income from temporarily investing the borrowings.

2 For **general borrowings**, use the weighted average interest rate.

IAS 40 deals with investment properties

Investment properties are land and / or buildings held by a company for investment purposes only. They are not used for the company's own purposes and any rental income is at an arm's length transactions. Initial recognition of investment properties is at cost. After that the investment property can be shown under the cost model or the fair value model, the policy chosen must be consistent.

Cost model – the investment property is treated like any other property and is carried at cost less accumulated depreciation and accumulated impairment loss.

Fair value model – the investment property is revalued each year to its market value and any gain or loss is taken to the income statement.

Chapter

11

Non-Current Intangible Assets

Key summary of chapter "intangible assets"

Intangible assets are non monetary non current assets that do not have physical substance but are **identifiable** and **controlled** by the entity through custody or legal rights (i.e. purchase or self-creation) and are able to provide **future economic benefits**.

Intangible non current assets are **initially recognised at cost** in the statement of financial position. To recognise the asset in the statement of financial position it must meet the definitions and criteria set out by IAS 38 (i.e. identifiable, control and future economic benefits).

Subsequent expenditure on an intangible asset should be recognised as an expense when it is incurred, unless this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and the expenditure can be measured and attributed to the asset reliably.

Intangible non current assets must either be carried using the cost model or the revaluation model.

Intangible assets are classified as:

- **Indefinite life** (benefit generated from the asset will continue forever).
- **Finite life** (a limited period of benefit to the entity).

Finite life - all intangible assets that have been capitalised and that have a finite life must be **amortised** (except for purchased goodwill).

Indefinite life - an intangible asset with an indefinite useful life must not be amortised but must be reviewed annually.

Positive purchased goodwill – IFRS 3 business combinations

A very important purchased intangible asset is purchased goodwill, which is covered by IFRS 3 business combinations. When an organisation acquires another organisation on a going concern basis, they usually pay a higher price than the value of the net assets being acquired from the organisation. Purchased goodwill is capitalised in the consolidated financial statements of the parent company.

Negative purchased goodwill
When the price paid for a acquiring another business is less than the fair value of the net assets acquired, it will result in negative goodwill. This simply means that it was bought at a bargain price. The treatment of negative purchased goodwill is to recognise it immediately in the income statement as a credit.

Internally generated goodwill (also referred to as inherent goodwill) is never capitalised. This is goodwill that the business has created due to the way it conducts it business, for example the way it treats its customers, the quality of its customer services etc. IFRS 3 states that internally generated goodwill is never capitalised as it is hard to measure with reasonable certainty.

Research and development costs – IAS 38

Research - original and planned investigation carried out in order to gain new scientific or technical knowledge

Accounting treatment - all expenditure on research costs must be expensed in the income statement.

Debit	Expenses (income statement)
Credit	Bank (statement of financial position)

Development - once the research has been successful, development begins on a product or service that will generate economic benefits in the future.

Accounting treatment - **an intangible asset should only be created when the development phase meets the strict criteria set out by IAS 38**. If the criterion is not met, development expenditure is expensed in the income statement.

Capitalisation journal:

Debit	Intangible non current asse (statement of financial position)
Credit	Bank (statement of financial position)

The criteria for capitalisation of development expenditure under IAS 38 (SECT)

S Separately and clearly defined project
E Expenditure is separately identifiable
C Commercially viable, and overall profit is expected
T Technically feasible, and resources exist to complete the project

Disposal or retirement of intangible assets - when an intangible asset is sold or is no longer used by the organisation, it needs to be removed from the statement of financial position. The gain or loss on disposal is calculated in the same way as for tangible assets as: sales proceeds less carrying amount**.** The gain or loss is taken to the income statement.

Amortisation - Most intangible assets are expected to have a useful economic life of 20 years, apart from purchased goodwill. This may not be the case for some assets. Amortisation is to be charged on a systematic basis to reflect the use of the intangible asset. The amortisation is calculated in the same way as depreciation and is charged to the income statement.

Impairment - under IAS 36, all intangible assets must be reviewed for impairment every year, this means comparing their carrying value with the recoverable amount. The treatment of impairment losses is same as for tangible assets.

Disclosures required by IAS 38 for each class of intangible asset

- Reconciliation of the carrying amount at the beginning and the end of the period.
- Useful life, amortisation rate and method.
- Basis for determining that an intangible has an indefinite life.
- Description and carrying amount of individually material intangible assets
- Intangible assets acquired by way of government grants

Chapter

12

Inventories and Construction Contracts

Key summary of chapter "inventories and construction contracts"

The accounting standard which deals with inventories is **IAS 2**. It gives guidance on determining the cost of inventories, for subsequently recognising an expense in the income statement (including any write-down to net realisable value) and it also provides guidance on the cost formulas that are used to assign costs to inventories.

The basic fundamental rule of IAS 2 is that the closing inventories at the year end must be valued at the lower of cost and net realisable value.
Cost of inventories includes the following:

- **Cost of purchase**
- **Costs of conversion**.
- **Other costs**

Methods of valuing inventories
For inventory items that are not interchangeable, specific costs are attributed to the specific individual items of inventory. For items that are interchangeable, IAS 2 allows the FIFO or weighted average cost formulas:

- **FIFO – first in first out** - assumes goods sold in order they were purchased.
- **Weighted average cost** - all units are pooled and weighted average cost determined.

Net realisable value (NRV)
The net realisable value is the actual or estimated selling price (net of trade but before settlement discounts) less further costs to complete and costs of marketing, selling and distribution. Where the NRV is lower than the cost, the write down is taken to the income statement as an expense. If the situation reverses in subsequent periods, the reversal should be taken to the income statement as a reduction to the expense in the period in which the reversal occurs.

IAS 11 construction contracts

A construction contract is a contract entered into for the construction of a substantial asset or a combination of related assets, for which the duration of the contract falls into different accounting periods. The project doesnȇt have to be more than one year but it has to fall over different periods (i.e. building a bridge, aircraft manufacturing). IAS 11 deals with how to account for the revenues and costs associated with construction contracts.

1 Revenue and expenses (cost of sales)
The amount of revenue and expenses recognised will depend on the stage of completion of the contract. The main methods for establishing stage of completion are:

- **Contract cost to date** in relation to total estimated contract cost.
- **Physical proportion** of work completed.
- **Surveys** of work completed.

The revenue and expenses recognised in the income statement will be in relation to the % or proportion of work completed. Profit can be established as **total profit on contract x % completion.**

2 Expected losses
If the outcome of the construction contract is expected to be a loss, then the whole loss must be

recognised in the income statement **immediately**. This is underlying the prudence concept. It is taken to the cost of sales. A provision is set for the loss under IAS 37 provisions.

3 Outcome of the contract is uncertain
When the contract outcome cannot be predicted reliably, IAS 11 states that no profit must be recognised. This is done by recognising the costs in the period they are incurred and also recognising the same amount of revenue which then gives zero profit.

4 Costs incurred but not yet transferred to cost of sales
Any costs incurred on a contract that have not been transferred to the costs of sales will be shown as a current asset in the statement of financial position. It is like having work in progress, incurring contract costs that relate to future activity. This will be shown under current assets as construction contract in progress

5 Progress billing
Progress billing is a term used by IAS 11, meaning the invoicing that is done to the customer under the construction contract.

If there are **more revenue than progress payments** = debit = a current asset in the statement of financial position, as more revenue has been recognised, so this represents amount due from construction customer. It is shown under ñGross amounts **due from** customers for contract workò

If there are **more progress payments than revenue** = credit = a current liability in the statement of financial position. It is a liability because more money has been received than invoiced. It is shown under ñgross amounts **due to** customers from contract workò and is shown under current liabilities.

6 Foreseeable losses
If a contract is expected to make an overall loss, the entire loss is recognised immediately in the income statement. Rather than showing this loss as a liability IAS 11 permits these losses to be offset against gross amounts due from customers - foreseeable losses double entry:

Approach to questions

1. Compare the contract value and total expected costs, including foreseeable losses
2. If the total is a loss then recognise the whole loss in the income statement. If the total is a profit, establish the % completion and recognise these amounts in the income statement.
3. Prepare the income statement extracts from step 2, taking the total figures for more than one contract.
4. Calculate the construction contract balances on the statement of financial position.
5. Compare progress payments against revenue recognised, for either amounts due to or due from contract customers. Show under either current asset or current liabilities.

Chapter

13 Leasing

Key summary of chapter "leases"

Leasing is a way of acquiring the use of an asset without having to purchase it, this helps with cash flows.

IAS 17 is the accounting standard dealing with leases and identifies two types of leases, a **finance lease** and an **operating lease**.

IAS 17 applies the accounting principle of ñsubstance over formò, whereby the substance of the transaction is accounted for and not just its true legal form in the financial statements. Substance over legal form is embodied within the Framework.

The 2 types of leases detailed under IAS 17:

Finance lease	Operating lease
• Most of the risks and rewards of ownership of an asset goes to the lessee. This means that they have control over it. • Risks involved include damage, obsolescence and insurance. The lessee bears all this risk. • Rewards involve the cash generated through the use of the asset or cost savings. • Present value of the minimum lease payments is equal to substantially all of the fair value of leased asset. • The asset is leased for most of its useful economical life.	• A lease other than a finance lease. • Shorter lease term • Lessor usually maintains the asset
Accounting treatment for finance leases ▪ The asset is included in lesseeṏs statement of financial position as a non current asset at the lower of fair value and present value of minimum lease payments. A corresponding creditor liability is also set up. ▪ Initial direct costs of arranging the finance lease by the lessee are added to the finance lease when incorporating in the financial statements. ▪ The asset is depreciated over the shorter of the lease term and its useful life. ▪ Obligations under finance lease are shown as less than and greater than 1 year ▪ The lease rentals are split between finance charge (income statement) and capital repayment (statement of financial position) ▪ The finance charge made to the income statement is a constant periodic rate of charge on the outstanding lease obligation.	**Accounting treatment for operating leases** The rentals are charged to the income statement and the asset is not capitalised. Debit Income statement with rental payments Credit Bank

Finance leases

With finance leases the true substance of the transaction is reported in the financial statements. The characteristics of the leased asset meet the definition of assets under the Framework, so therefore can be capitalised in the statement of financial position. The lessee is mainly responsible for the repairs, maintenance and insurance of the finance leased asset, so therefore is exposed to the risk. This means the lessee has **control** over the asset.

Essentially what happens is the finance leased asset is capitalised and a "notional loan" is set up as obligations under finance lease. This notional loan is then repaid under capital repayment terms with notional interest and notional capital repayment over the lease term. The finance lease rentals are split between notional interest payment (finance charges) and notional capital repayment. The capitalised asset is depreciated over the lease term.

The total finance charge is the difference between the capitalised asset and total lease payments.

The two ways of charging the finance charge to the income statement:

1 **Actuarial method** – which uses the interest rate implicit
2 **Sum of digits method** – is similar to the actuarial method, but doesn't use the interest rate.

The lease rental payments are split between finance charge and reducing the outstanding liability.

Accounting by lessors

Finance leases

- At the start of the finance lease term, the finance lease is recorded as **receivable**. The value is the **net investment** in the lease and this is normally the same lessee's lease liability
- The lease receipts are split between finance income and reduction of receivable.

Essentially the accounting for the lessors mirrors the complete opposite of the lessee.

Operating leases

Under operating leases, the lessor has control of the asset. Therefore the asset is recognised in lessor's financial statements as an asset (IAS 16) and depreciated as normal. The operating lease rentals received by the lessor are accounted for as rental income.

Chapter 14

Various standards: (IAS 10, 37 and 24)

Summary of chapter "various accounting standards – IAS 10, IAS 37 and IAS 24"

IAS 10 - Events after the reporting period

Events occur which may be favourable or unfavourable between the accounting year end date and the signing of the financial statements. These events may or may not affect the figures in the financial statements. If they effect the financial statements they are known as adjusting events, if they donœt affect the financial statements they are known as non-adjusting events.

Adjusting events	Non-adjusting events
These require the accounts to be adjusted because they provide additional evidence of conditions existing at year end date.	These are events, which did not exist at the year end date, but need to be disclosed as they are material and to not to disclose them would mislead the users of the accounts.
Examples ▪ Non current assets ï their valuation if sold or impairment. ▪ Insurance claims ï if they were being negotiated at year end date ▪ Provision for bad debts - if new information about a debtor has come to light ▪ Inventories and WIP ï if sold after year end for less than cost & NRV. ▪ Changes in tax rate ▪ Errors or frauds discovered	Examples ▪ Issue of new share or loan capital after the year end date ▪ A major acquisition ▪ A major disposal ▪ Flood, fires or other catastrophes after balance sheet date
The financial statements need to be adjusted for any of the above events	*Disclosure needs to be made in the financial statements for the above if they are material*

Dividends

IAS 10 states that any dividends declared after the year end date must not be recognised as a liability. This is because at the year end date there was no obligation to pay dividends.

IAS 37: Provisions, contingent liabilities and contingent assets

A provision is a liability (an obligation to transfer economic benefits as a result of past transactions or events) of uncertain timing and amount. Uncertainty is what distinguishes a provision from another type of liability such as trade payables. A provision should be recognised in the financial statements when all the below are met. (PPR).

P	Present obligation (legal or constructive) as a result of past transaction or events
P	Probable transfer of economic benefits to settle (more likely than not)
R	Reliable estimate can be made of obligation

Specific areas: Onerous contract	These are contracts, which are expected to make a loss; provisions should be made of the net loss expected.
Future operating losses	No provisions for such losses, as there is no obligating event and at present there is no obligation. But future operating losses may require the assets to be reviewed for impairment.
Environmental liabilities	When there is a legal or constructive (past history) obligation, a provision needs to be made to rectify the damage caused. If the company's policy is to clean up even if there is no legal requirement to do so, there is a constructive obligation (public expectation created by the company's policy)
Major refurbishment / overhaul/ repairs	No provision is allowed as major refurbishment / overhaul/ repairs can be avoided. Remember a provision is only recognised when there is an obligation, not intention.
Warranties	Accrue for a provision (past event was the sale of defective goods). A reliable estimate is the past history of warranty claims as a % of sales.
Refunds	Accrue for a provision if the established policy is to give refunds (past event is the customer's expectation, at time of purchase, that a refund would be available). A reliable estimate is the past history of refunds as a % of sales.
Restructuring Sale of operations	Accrue a provision only after a binding sale agreement of the operation for direct costs only.
Restructuring Closure or re-organisation	Accrue a provision only after a detailed formal plan is announced publicly and adopted. A Board decision alone to restructure is not enough for a provision set up.
Restructuring Acquisition and merger	When a parent company acquires another business, there may be restructuring costs. A provision can only be made for redundancies, closing facilities etc. (direct costs) only if this is announced at the acquisition date and then only if a detailed formal plan is adopted 3 months after acquisition. Under IFRS 3 business combinations, a mere intention of future restructuring costs doesn't give rise to an obligation.

With long term provision the present value (discounting) of the provision needs to be established before incorporating into the financial statements.

There may be provisions that need to be set up which actually provide future economic benefits, in which case a non current asset is created and depreciated, and the present value of the provision is established.

Contingent liabilities
A contingency is a condition that exists at the year end date, but whose outcome can only be confirmed by the occurrence of one or more uncertain future events, which are may be outside the control of the company.

A contingent liability described by IAS 37 either a possible obligation or a present obligation that does not meet all the criteria for a provision.

Accounting treatment is:
- Do not recognise in the financial statements
- Only disclose the information if it is material. If the contingent liability is remote, then no disclosure is required.

Contingent asset
A possible asset that arises as a result of past transaction or events, but whose existence will only be confirmed by the occurrence or non occurrence of one or more uncertain future events, which may be outside the control of the company.

Accounting treatment is:
- Do not recognise in the financial statements as an asset or income in the income statement.
- Only disclose the information if it is material, and probable that there will be inflow of economic benefits.

IAS 24 related parties

IAS 24 related party disclosure is a disclosure requirement where a company might not be carrying out transactions at a normal arms length basis. Users of the accounts need to know if the organisation has undertaken any transactions with a related party as this could affect their decision making process

The key requirement is to:

1 Identify the related parties
2 Disclose any transactions undertaken with the related parties, being at arms length or not
3 Disclose any outstanding amounts

Examples of related party
Companies in same group
Associates and joint ventures
Directors
Pension funds
Key management
Someone owning more than 20% of voting rights
Companies managed under a management contract
Partnerships, companies, trusts, other entities
Accounting treatment for related party transactions
Names of the transacting related parties
The relationship
Description of transactions
The amounts involved
The amounts due to and from at the year end date
The amounts written off in respect of debts from related parties

Chapter

15

Share Capital Transactions and Financial Instrument (IAS 32 & IAS 39)

Summary of chapter "share capital transaction"

A limited company issues shares, which investors buy and then these investors become owners of the company. These shares may be issued privately (ltd) or to the public (plc). Ownership in the company is through the issue of shares. The shareholders have an equity stake in the business and have voting rights.

Usually for large organisations the shareholders do not run the business. The directors do this. The shareholders are entitled to dividends declared by the directors. The dividends are declared at the discretion of the directors and depend on how much profit the company has made.

Authorised share capital	This is the number of shares that the company is allowed to issue and is stipulated in its memorandum or articles of association.
Issued share capital	This is the number of shares that the company actually issues. This cannot exceed the authorised share capital
Called up share capital	This is the issued share capital for which the shareholders are required to pay to the company.
Paid up share capital	This is the amount of share capital paid up by the shareholders
Nominal value	This is the value of the each share which the company will originally issue the shares at, (also known as face or par value)
Market value	This is the trading value of the shares, and is the price an individual pays for the shares
Share premium	This is the increase from nominal value to market value of the share

Procedures for new issue of equity shares
Issue and forfeiture

Application	Potential shareholders apply for shares in the company and send cash to cover the amount applied for.
Allotment	The company allocates shares to the successful applicants and returns cash to unsuccessful applicants.
Call	Where purchase price is payable in instalments, the company will ócallô for instalments on their due dates of payment
Forfeiture	If shareholders fail to pay a call, their shares may be forfeited without the need to return the money they have paid; the forfeited shares may then be reissued to other shareholders

Rights issue of ordinary shares
If a company issues ordinary shares for cash it must first offer them to its existing ordinary shareholders in proportion to their shareholdings. This is called a **rights issue** because members may obtain new shares in right of their existing holdings.

Bonus issue of ordinary shares
A bonus issue is when new shares are issued to existing shareholders but no money is received. Instead the company capitalises its reserves, this is only permitted to the extent that the articles permit it and the correct procedure must be observed.

Preference shares
Preference shares are issued by companies to raise finance. These shares are different from ordinary shares. Preference shares do not give voting rights and therefore holders of preference shares do not have a stake in the business.

Revenue reserves arise when a company makes profits and does not pay out all the profits to the shareholders. There is no statutory requirement for a company to have any amounts in its revenue reserve. These non-statutory reserves take various names like ñretained profitsò, ñprofit and loss reservesò, ñun-appropriated profitsò etc.. A company can make dividend payments out of revenue reserves i.e. they are distributable to the shareholders

Capital reserves must be established in certain circumstances by law. These statutory reserves include share premium account (set up when ordinary shares issued) and revaluation reserve (set up when fixed assets revalued). A company cannot make dividend payments out of capital reserves, i.e. they are un-distributable

Redemption of shares
A company may decide to buy back some of its issued ordinary shares and then cancel them. For this to happen, their must be authorisation from articles of association, special resolutions and sometimes from the court.

Redemption of shares from capital
The accounting treatment for the redemption of shares is strict. A company must set up a ñcapital redemption reserveò to protect the creditors. This is done by utilising the accumulated realised profits (distributable reserves). The amount taken to the capital redemption reserve is the nominal value of the shares redeemed.

Redemption of shares out of new issue of shares
If the redemption of share is financed **entirely** by a new issue of shares, then no capital redemption reserve is set up as the capital is maintained.

Redemption of share out of partial new issue
If the redemption of shares is financed partly by a new issue of shares, then the amount of offset against the new issue is also partial. A capital redemption reserve needs to be created but only to the extent that the nominal value of shares redeemed exceed the total proceeds from the new issue (nominal plus premium).

IAS 32 and IAS 39 – financial instruments

Financial instruments

Financial instruments are all instruments that are issued by companies as a means of raising finance (capital) including shares, debentures, loans, debt instruments, options and warrants that give the holder the right to subscribe for or obtain capital instruments. It also includes derivative instruments such as options and futures.

The accounting standards that deal with financial instruments are:

(i) IAS 32 financial instruments - presentation
(ii) IAS 39 financial instruments - recognition and measurement
(iii) IFRS 7 financial instruments ï disclosures

Chapter

16 External Audits

Summary of chapter "external audits"

An audit is an independent examination of the financial statements by experts (known as auditors) to express an opinion on whether they are true and fair. It is another legal requirement for incorporated entities.

True - information is factual and conforms to reality, not false and correctly extracted from books and records.

Fair - information is free from discrimination and bias and is in compliance with required standards and law. Reflects underlying transactions.

Division of responsibilities

Directors

- Preparation and presentation of financial statements
- Stewardship role

Auditors

- Forming and expressing an opinion on financial statements
- Audit does not alleviate directors of their responsibilities

Rights and duties of external auditors

Rights

- Access to records
- Right to necessary information and explanations
- Attendance at, and notice of, general meetings
- Right to speak at general meeting
- Right to receive written resolutions
- Right to require laying of accounts

Duties

- Report to members on annual financial statements
- Give audit opinion on truth and fairness of financial statements
- Adequate returns received from branches not visited
- Accounts agree with records
- All necessary information and explanations received
- Proper disclosure of directorsô emoluments
- Appropriate disclosure of directorsô loans and other transactions
- Directorôs report information consistent with the accounts

Forming an opinion

The auditors can give:

Unqualified report - states that they are in agreement with the financial statements.

Qualified report - States that they do not agree with the financial statements due to disagreements or uncertainties.

Except for (limitation of scope)
Auditors disclaim an opinion on a particular aspect of the accounts, which is not considered fundamental.

Disclaimer of opinion ï (pervasive limitation of scope)
Auditors state they are unable to form an opinion on truth and fairness.

Except for (disagreement)
Auditors express an adverse opinion on a particular aspect of the accounts, which is not considered fundamental.

Adverse opinion ï (pervasive disagreement)
Auditors state the accounts do not give a true and fair view.

Chapter

17

Concepts, sources & systems in taxation

Summary of chapter "Concepts, sources & systems in taxation"

Direct tax ï this is a tax directly levied on the person or organisation that is expected to pay it.

Indirect tax ï this a tax which is not directly levied at the person or organisation who pays the tax. It is a final consumer of goods or services tax, levied on transactions.

Taxable persons ï liable to pay direct taxes, this maybe a person, a company or other types of organisations.

Competent jurisdiction ï this is the authority responsible for collecting and administering the taxes in a tax jurisdiction.

Progressive tax systems ï this a tax system which increases its rate of tax as the income of the taxable person increases.

Regressive tax systems ï this is the opposite of a progressive tax system as the rate of tax increases as the income of the taxable person reduces.

Proportional tax systems ï this is a tax system where the rate of tax is the same regardless of the amount it is applied to.

The tax gap ï this is the difference between taxes that would have been received by the tax authorities if all that was due was collected and taxes actually received.

Hypothecation ï this is the formalisation of devoting particular taxes for only certain causes.

Adam Smith's "canons of taxation"

- Equality
- Certainty
- Convenience of payment
- Economy of collection

The three major principles in a modern tax system are:

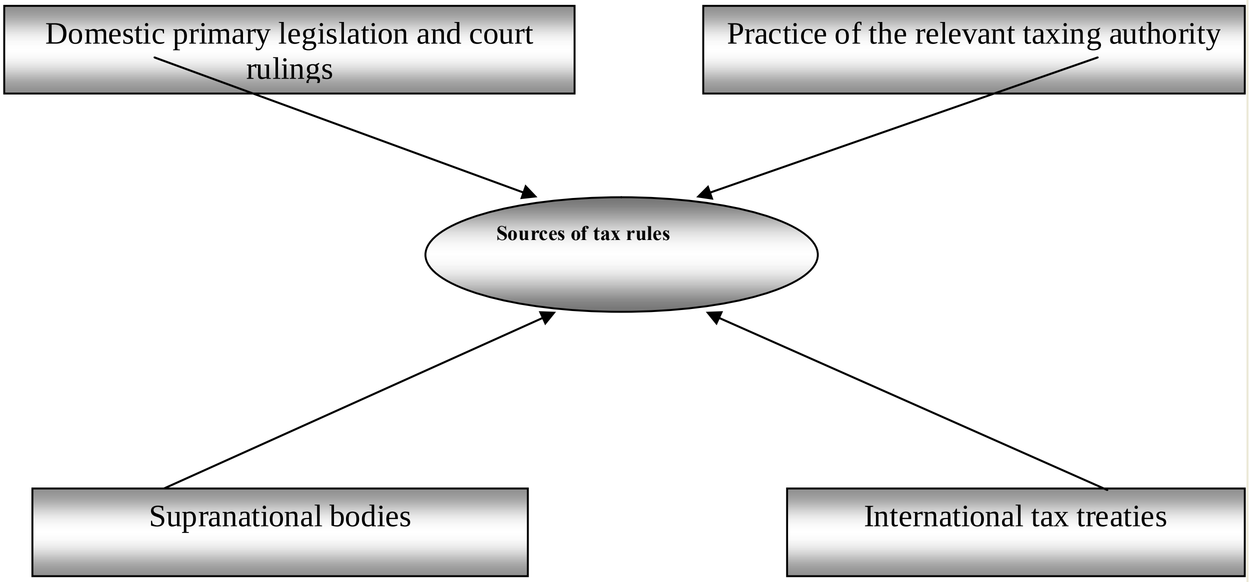
- Efficiency
- Equity
- Economic effects must be considered

Tax bases

A tax base is the assessed value of something that is liable to tax, for example assets, investments or income streams. Anything that can be taxed has a tax base. The main tax bases are:

- Income
- Capital or wealth
- Consumption

Sources of tax rules



- Dividends are never included in a tax calculation as a deduction on profits or gain.

- <u>Disallowed expenditure</u> must be added back in arriving at the adjusted taxable profit.

- <u>Disallowed income</u> must be deducted in arriving at the adjusted taxable profit.

Systems of taxation

- Classical system
- Full imputation system
- Partial imputation system

Disallowed expenditure

Each country has its own list of items that are disallowed and allowed, but generally speaking the following tend be the items of consequence.

- Tangible non-current assets
- Intangible non-current assets
- General provisions
- Formation expenses
- Acquisition costs
- Entertainment
- Gifts
- Donations
- Legal expenses

Recharacterising interest payments as dividends

Interest payments are recharaterised as dividends and therefore are an appropriation of profit and not a legitimate trading expense.

Chapter

18

Tax depreciation, losses and groups

Summary of chapter "Tax depreciation, losses and groups"

Tax depreciation - tax authorityֳs version of depreciation which is allowed as a deduction for tax purposes.

Tax base ï initial cost of the non-current asset minus tax depreciation to date.

First year allowances ï A higher tax depreciation rate which is allowed to be claimed only in the first year that the non-current asset was purchased. Only given for particular non-current assets.

Trading losses ï these are losses made on the main activity of the business which can be used as tax relief against trading profits.

Capital losses - these are losses made on non-current assets which can be used as tax relief against capital gains made on assets.

Tax consolidation

Group companies have special rules for the use of trading losses and capital losses between group members.

Marginal rates of tax and tax planning

Give priority to those members that have the highest marginal rates of tax (MRT), when relieving group losses. Saving tax at the highest MRT is the primary factor when surrendering group losses.

Chapter

19

Other areas of taxation and the power of tax authorities

Summary of chapter "Other areas of taxation and the power of tax authorities"

The effective incidence of tax ï is the taxable person who ultimately bears the tax.

The formal incidence of tax - the entity that has direct contact with the tax authorities and who is responsible for collecting the tax revenues and passing them on to the tax authorities has the formal incidence of tax.

Unit tax ï is based on physical measure being perhaps the number of units sold or produced. Examples of a unit tax are excise duties; quantity of petrol sold and amount of oil extracted.

Ad valorem tax ï is based on the value of sales. The most common example of this is a sales tax or value added tax (VAT).

VAT is charged on the taxable supply of goods and services, other than an exempt supply.

Output VAT (output sales tax) accounted for on sales on most goods and services.

Input VAT (input sales tax) accounted for expenses and purchases made by the business.

Standard rated goods and services ï sales are taxable at standard rate.

Zero rated goods and services ï sales are taxable at 0%

In both types of supply input VAT incurred for business expenditure can be recovered.

Standard rated and zero rated sales together are called taxable supplies.

Exempt supplies ï sales are exempt and outside the scope of sales tax.

Single stage sales tax system - sales tax is applied to a single point in the production or sales, for example at the point of sale to the consumer.

Multi stage sales tax system - sales tax is applied at all stages of production and sales where a transfer of the product has occurred.

Tax point - basic tax point is the date goods or services are delivered or made available to the customer.

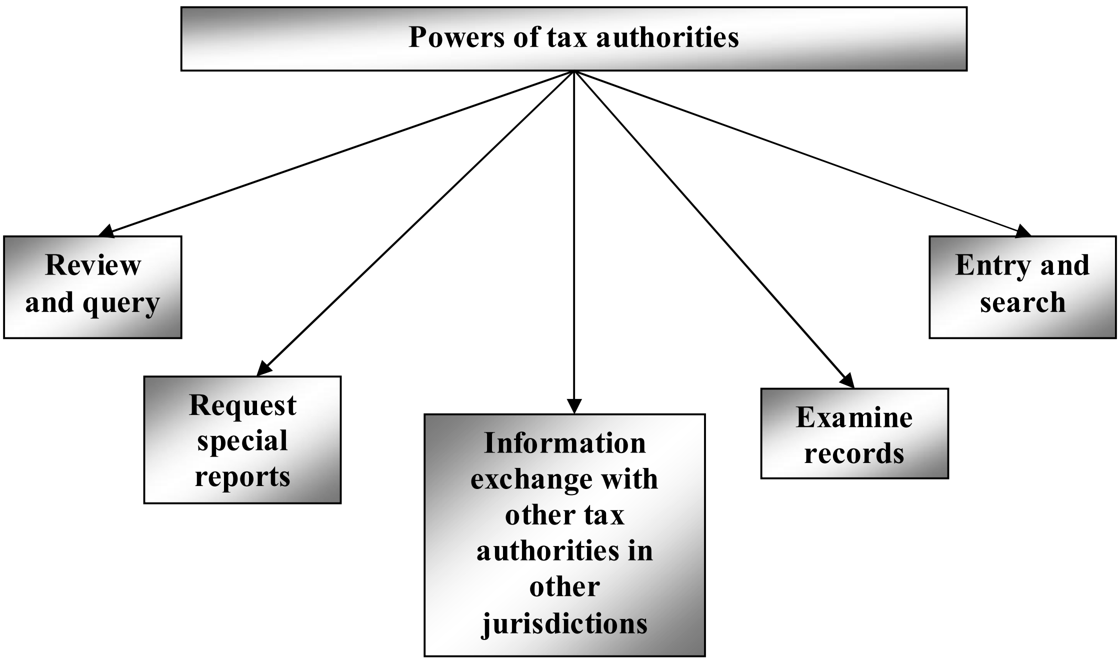
Employment income - income arising from an employment under a contract of service (both employees and directors) where each employee is assessed how much tax he should pay as a separate taxable person by the authorities.

Tax collection, assistance and compliance
Employers are responsible for collecting the taxes which employees have to pay. They only pay the net amount after all deductions to the employee. The deductions are sent to the tax authorities. This is known as a ñwithholding tax systemò.

Record keeping and record retention
Taxable person are expected to keep records which would be needed to support tax returns) sent to the authorities. Records relating to tax issues should be retained for as long as reasonable amount of time to allow the tax authorities to carry out there inspections and investigation as necessary.

Filing returns and tax payments
Once submitted the tax authorities can inspect and if necessary challenge the return with regards to any aspect. Deadlines for submission of returns vary but the basic principle is set a reasonable deadline for submission allowing the authorities to investigate if necessary and then a final payment or repayment by a certain date as well.

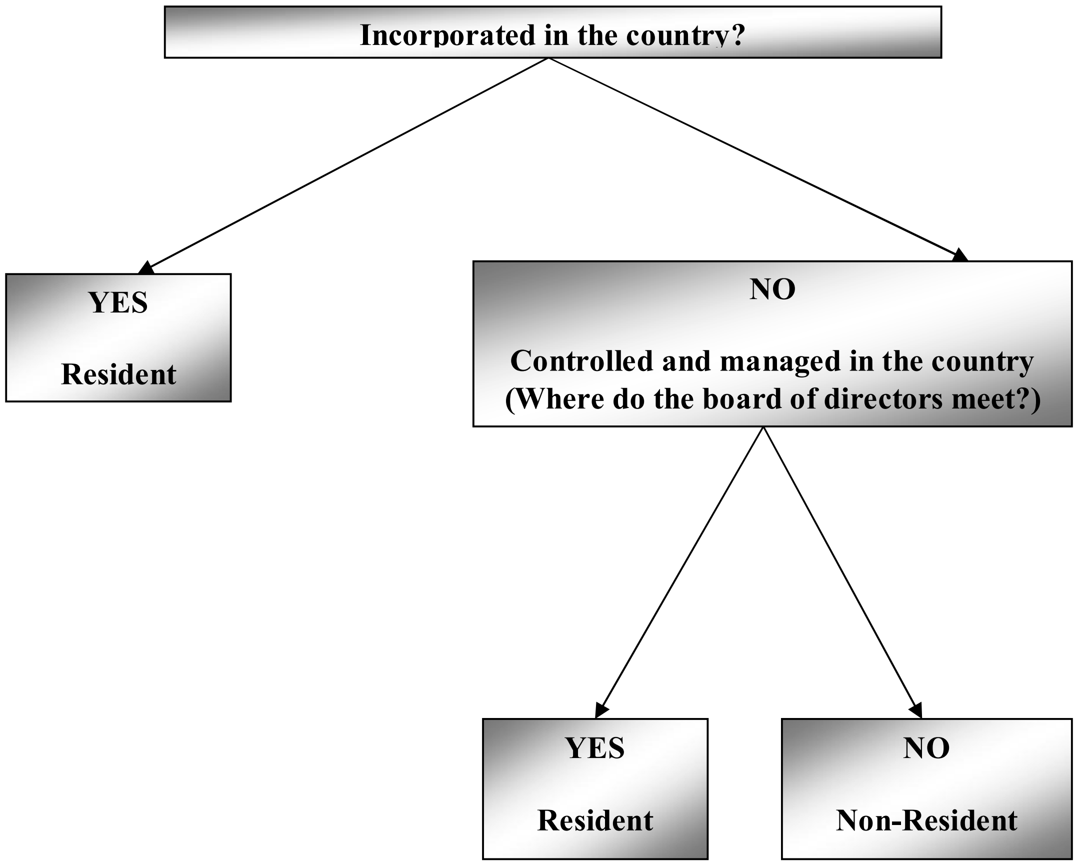
Powers of tax authorities



Chapter

20

International & deferred taxation



A foreign branch is just an extension of your domestic operations.

A **foreign company** is a separate company incorporated abroad.

Withholding tax (WHT) and double taxation relief (DTR)

If a company remits income abroad to another country then there maybe some tax that has to be paid before it leaves the country. This is known as withholding tax (WHT).

However the foreign income received from the overseas company would have to be subject to tax again in this country. Double taxation relief (DTR) is used to mitigate taxing overseas income twice. There is normally a bilateral agreement between countries to address this.

Double taxation treaties based on the OECD Model Convention

The main points are as follows:

- Specify which taxes should be included.
- Residency
- Permanent
- Income from immovable property
- Business profits
- Dividends
- Interest
- Royalties
- Capital gains

Methods of double taxation relief

- Credit method
- Exemption method
- Deduction method

Underlying tax (ULT)

$$\text{ULT} = \frac{\text{(Dividend actually received + WHT)}}{\text{Financial profit after tax of the foreign company}} \times \text{tax paid on profits}$$

Tax avoidance is the legal arranging of tax affairs to deliberately take full advantage of tax reliefôs.

Tax evasion is minimising or not paying any tax at all to the authorities by deliberately breaking the tax rules.

General anti-avoidance rules (GAAR) are rules that can be applied to specific situations and make it difficult to avoid tax through schemes.

IAS 12 Current tax

Current tax deals with the actual tax payable to the authorities on taxable profits for companies. The double entry to record the tax charge is:

Dr	Tax charge in the income statement	X	
Cr	Tax creditor in the balance sheet		X

IAS 12 Deferred tax

The differences between **accounting profits and taxable profits**, so that tax inequalities arising from timing differences are ironed out over time.

Permanent differences

Items which are taken into the financial statements but which are disallowed for tax purposes.

Timing differences

Items that are recognised in different periods for financial and taxable purposes.

Deferred taxation is not concerned with permanent differences, only timing differences.

Timing differences - Main categories

- Accelerated capital allowances (ACA)
- Interest charges and development costs
- Intra group profits in stock
- Accruals for pension costs that will be deductible for tax purposes only when paid.
- Revaluations of fixed assets.
- Unrelieved tax losses Un-remitted earnings of subsidiaries