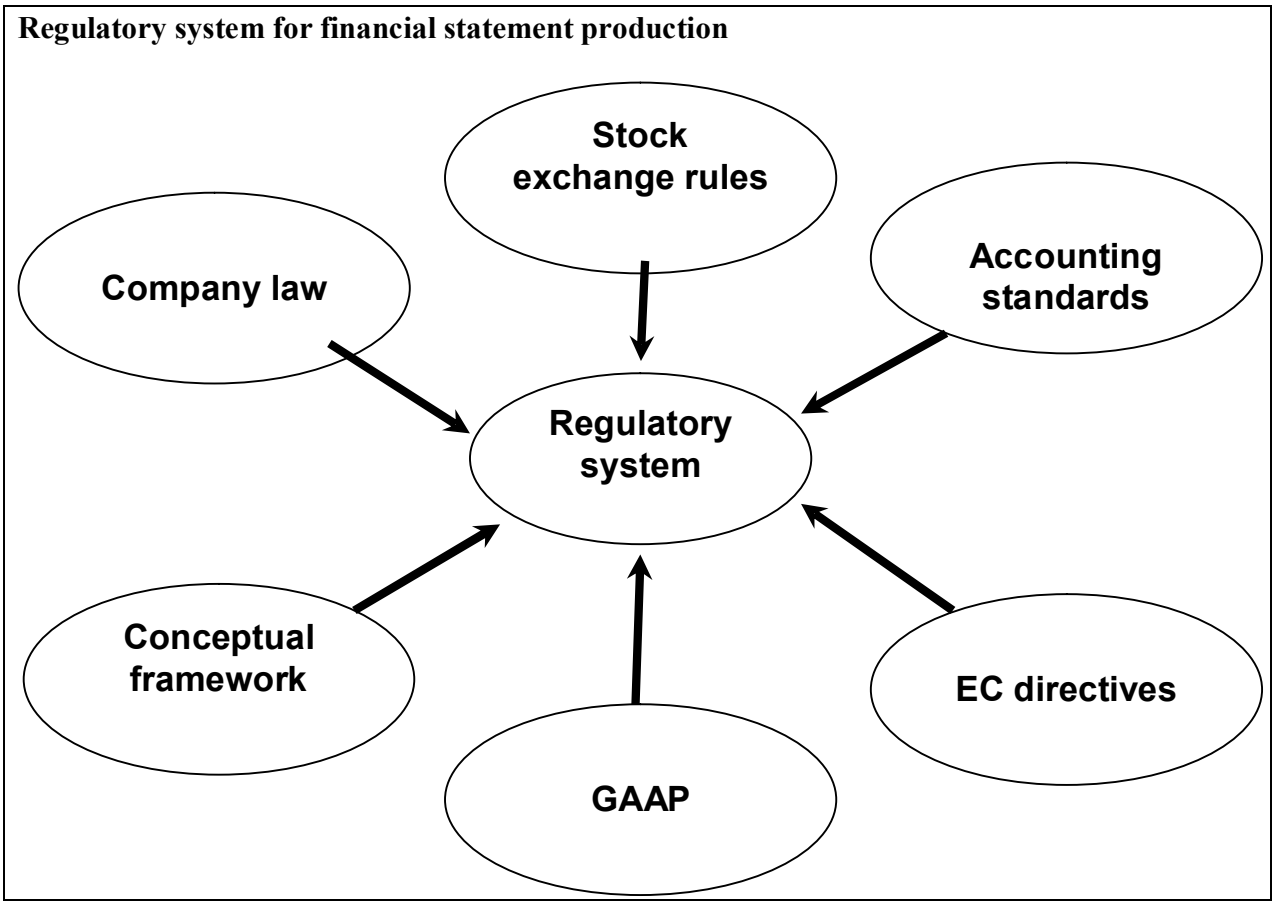
CIMA
Managerial Level – Paper F2
FINANCIAL MANAGEMENT
(REVISION SUMMARIES)

Chapter

1

The Regulatory Framework

Key summary of chapter "the regulatory framework"



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.

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

2

What is a Group?

Key summary of chapter "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 (power) - 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 - Separate Financial Statements (2011)

IAS 27 which was amended in 2011 outlines the accounting and disclosure requirements for 'separate financial statements', which are financial statements prepared by a parent, or an investor in a joint venture or associate, where those investments are accounted for either at cost or in accordance with IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments. The standard also outlines the accounting requirements for dividends and contains numerous disclosure requirements.

IAS 27 supersedes the 2008 accounting a standard which has now been revised. The consolidation requirements are now in IFRS 10 consolidated financial statements.

When a parent company has to produce separate financial statements, it is required by IAS 27 to show its investments in subsidiaries, associates and joint ventures at either cost or as a financial instrument under IAS 39 / IFRS 9.

IFRS 10 - Consolidated Financial Statements (2011)

This accounting standard details the preparation and presentation of consolidated financial statements. It requires the parent company (investor) to consolidate organisations that it **controls** (investee).

Control requires exposure or rights to variable returns and the ability to affect those returns through power over an investee.

IFRS 10 was issued in May 2011 and applies to annual periods beginning on or after 1 January 2013.
The objective of IFRS 10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

IFRS 10

- requires a parent entity (an entity that controls one or more other entities) to present consolidated financial statements
- defines the principle of control, and establishes control as the basis for consolidation
- set out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee
- sets out the accounting requirements for the preparation of consolidated financial statements
- defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.

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

General provisions of IFRS 10 for consolidation

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

Chapter

3

Group Accounts: Consolidated Statement of Financial Position

Key summary of chapter "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 companyôs 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 **inter-company dividends payable and receivable will be cancelled upon consolidation**. 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 purchase method). 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 **obtains control** 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).

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

Negative purchased goodwill 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 ôbig bathô 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 parentôs 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 companyôs 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 doesnôt 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

4

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 added back 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 subsidiaryôs assets were subjected to fair value adjustments upon acquisition and if the subsidiary hasnôt 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 not 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) Profit for the year (subsidiaryôs profit for year adjusted for consolidated adjustments x NCI %)

	(ii) Other comprehensive income (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 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

5

Associates and Joint Ventures

Key summary of chapter "Associates and joint venture"

IAS 28 investments in associates and joint ventures (as amended in 2011) outlines how to apply, the equity method to investments in associates and joint ventures.

Associates

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.

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

Joint venture

Joint venture is where two or more companies jointly control another company. Interest is held on a long-term basis under a contractual agreement.

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

Equity method

Equity method of accounting includes the following

Consolidated income statement:

The groupôs share of the associates and joint ventures profit for the period is shown in the consolidated income statement. This will be shown after consolidated operating profit but before consolidated finance cost.

Associates / joint ventures profit for the period x %

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

The parent share of other comprehensive income for associates and joint ventures is also shown in the consolidated statement of comprehensive income under other comprehensive income

Associates / joint ventures other comprehensive income x %

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

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 parentôs (investor's) share of the net profit or loss of the associate

The investment (interest) in associate undertaking and joint ventures 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 / joint venture	X
Method 2	
Cost of investment / fair value	X
Plus group share of post-acquisition retained reserves	X
Less impairment of goodwill	(X)
Investment in associate undertaking / joint venture	X

Dividends paid by the associate and joint venture

When the associate / joint venture 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 not 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 / joint venture 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 / joint ventures goodwill

The goodwill 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 / joint venture in the consolidated statement of financial position and also reduces the share of associates / joint ventures profit in the consolidated income statement.

Journal for impairment loss on goodwill in associate

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

Inter company transactions between group companies and associates / joint ventures

Just with subsidiaries, inter company transactions between associates / joint ventures 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)

IFRS 11 Joint Arrangements (2011)

IFRS 11 details the accounting by organisations of joint control arrangements.

Joint control involves the contractual agreed sharing of control and arrangements subject to joint control are classified as either a joint venture (representing a share of net assets and equity accounted) or a joint operation (representing rights to assets and obligations for liabilities, accounted for accordingly).

IFRS 11 states that a party to a joint arrangement determines the type of joint arrangement in which it is involved by assessing its rights and obligations and accounts for those rights and obligations in accordance with that type of joint arrangement.

Classifying joint arrangements – joint operation or joint venture?

The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

The structure and form of the arrangement, is determined, the terms agreed by the parties in the contractual arrangement and other facts and circumstances. The classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement.

Structure vehicle (separate entity)

A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle (entity) can be **either a joint venture or a joint operation**.

Not structure vehicle (no separate entity)

A joint arrangement that is not structured through a separate vehicle is a **joint operation.** In such cases, the contractual arrangement establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement, and the parties' rights to the corresponding revenues and obligations for the corresponding expenses.

Financial statements of parties to a joint arrangement

Joint operations - recognising the assets controlled and liabilities owed, recognising the expenses and share of profits from the joint operation

Joint Venture - Equity method of accounting using IAS 28 investment in associates and joint ventures (2011).

Chapter

6

Complex Groups

Key summary of chapter "complex groups"

A complex group structure exists where a subsidiary of a parent company owns all or part of the shareholding that makes another a company also a subsidiary or associate of the parent company. The structure can be either vertical or D shaped (mixed) group.

The most important point when dealing with complex group structures is in establishing direct and indirect holdings and establishing the date on which control was gained. Control and ownership need to be distinguished carefully.

The establishment of the group structure is very important. The following steps ensure the complex group is correctly identified:

Step 1	Establish the absolute voting rights which determine the relationship and date of control
Step 2	From the relationship determine the accounting treatment
Step 3	Calculate effective holdings

1 Vertical group

The parent company (A) has a subsidiary (B) and the subsidiary also has a subsidiary (C) (sub subsidiary).

- A controls B, B controls C, therefore A controls C.
- Therefore B is a subsidiary of A and C is also a subsidiary of A (known as a sub-subsidiary).
- Establish date of effective control
- All 3 companies are consolidated as normal.
- Establish effective holdings

Calculation of the 3 usual suspects in a vertical group structure

Goodwill	There are 2 lots goodwill calculated. 1 A in B 2 B in C. BUT adjusted to make it from point of view of A ï the parent company (goodwill x Aõs share in B).
Non controlling interest (NCI	There are 2 lots of NCI. 1 B x NCI% - BUT with investment of C removed from net assets. 2 C x Effective NCI %
Consolidated reserves	This includes the post acquisition retained reserves (PARR) for both B and C. With C it is the effective holding and date of acquisition (DOA) is when it came under the control of A.

2 D shaped (mixed) groups

The parent company (A) has a subsidiary (B) and the subsidiary also has a subsidiary (C) (sub subsidiary). The parent company also has a direct investment in the sub subsidiary (C).

- B is a subsidiary of A and C is also a subsidiary of A
- Establish date of effective control
- All 3 companies are consolidated as normal.
- Establish effective holdings

Calculation of the 3 usual suspects in a mixed group structure

Goodwill	There are 3 lots goodwill calculations. 1 A in B 2 B in C. BUT adjusted to make it from point of view of A ï the parent company (goodwill x Aõs share in B). 3 A in C for the direct holding
Non controlling interest (NCI)	There are 2 lots of NCI. 1 B x NCI% - BUT with investment of C removed from net assets. 2 C x Effective NCI %
Consolidated reserves	This includes the PARR for both B and C. With C it is done in 2 parts for direct and indirect. This is because of different acquisition dates and hence different reserves figures at DOA.

3 Indirect investment in associates

If a subsidiary has an associate then the parent company will have an indirect investment in the associate. The parent company (A) has a subsidiary (B) and the subsidiary has an associate (C) (sub associate).

A controls B, therefore B is a Sub. B has an associate C. Therefore C is an associate of A as well.

Calculation of the 3 usual suspects in a mixed group structure

Goodwill	There are 2 lots goodwill calculations. 1 A in B 2 B in C. BUT adjusted to make it from point of view of A ï the parent company (goodwill x Aôs share in B).
Non controlling interest (NCI)	One NCI calculation Net assets of B (*with any normal adjustments*) Less investment of C (associate) Plus share (40%) of net assets of C at year end date= X x NCI % of B In the consolidated income statement, the NCI also includes subsidiaries share of profit after tax of associate (30% x 40%)
Consolidated reserves	This includes the PARR for both B and C. With C the associate it is the effective holding = 70% x 40% = 28%

Step acquisitions (piecemeal acquisitions)

It is quite common for parent companies to make investments in other companies at different dates. The parent company may acquire shares, which change the status of its investment. The acquisition of equity shares over time, changes the investment from a simple investment to associate and then finally subsidiary when greater than 50% of shares are acquired, giving ultimate control.

IFRS 3 business combinations (revised 2008) gives details on how to account for step acquisitions (piecemeal acquisitions) in the consolidated financial statements. The revised IFRS 3 alongside the IFRS 10 now state that acquisition accounting is only applied when **control** is achieved.

All investments before control is achieved are treated in accordance with their relevant accounting standards:

(i) Less than significant equity investments (i.e. 5%) treat under IAS 39
(ii) Significant investments treat as associate under IAS 28
(iii) Joint control investments treat as joint venture under IAS 28

When the parent company acquires further equity shares and it changes the status of the investment to subsidiary, that is control has been achieved, then acquisition accounting is used but the following must also be done:

- **Re-measure** the previously held investment (any of the 3 above) to **fair value** on the date control is achieved.
- Recognise any resulting **gain or loss** in the consolidated income statement
- Calculate **goodwill**.

Pro-forma for calculating goodwill - step acquisition - control is achieved – investment/associate becomes a subsidiary

Goodwill calculation under the fair value (new) method. Full goodwill.		
	£'000	£'000
Purchase consideration (new investment) at fair value		X
Fair value of previously held equity interest		X
		X
Less share of net identifiable assets acquired at fair value at date of acquisition		(X)
Goodwill at date of acquisition – 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's share + NCI's share)		**X**

Pro-forma for calculating gain or loss on re-measurement of investment once control obtained

Fair value of previously held investment at date control obtained	X
Value before control is obtained (IAS39, IAS 28)	(X)
Gain / (loss) on re-measurement (goes to the income statement)	X / (X)

Step acquisition – subsidiary to subsidiary

The parent company may acquire additional equity shares in itôs existing subsidiary (i.e. 60% equity stake to 80% equity stake). The revised IFRS 3 states that this is a transaction between owners and the ownership has been re-allocated between parent and non controlling shareholders.

Here the parentôs equity is adjusted. The parentôs share has increased and the non controlling interest has decreased. Gain or loss is not recognised and goodwill is not re-measured. The difference between the change in the non controlling interest and fair value of consideration paid is recognised directly in equity and attributed to the parent.

The pro-forma for the adjustment in parentôs equity is:

Fair value of consideration paid	(X)
Decrease in non controlling interest at date of transaction	X
Decrease in non controlling interest in goodwill at date of transaction (if full goodwill method used only)	X
Adjustment to parentôs equity (reduce)	(X)

Chapter

7

Group Disposals

Summary of chapter "group disposals"

Group disposals

Disposals means the parent company selling (i.e. disposing) of some or all of its equity shares in its investment company which it consolidates. Disposals where **control is lost** and disposals where **control is retained** are treated completely differently under IFRS 3 and IAS 27 (revised 2008).

Where **control is retained**, the event is treated as a **transaction between owners** (the non controlling interest has increased and parentôs share has decreased). Itôs shown as a **reallocation of ownership between parent and non controlling interes**t. The revised IFRS 3 (2008) states, that the group is one **economic entity** and views all providers of equity (parent and non controlling interest) as owners of the group. The revised IFRS 3 views the non controlling shareholders as owners of the group and not outsiders.

Where control is lost, acquisition method of accounting ceases and the remaining equity investment is treating accordingly.

Control is retained	**Control is lost**
Subsidiary to subsidiary (i.e. 75% to 60%)	Full disposal (i.e. 75% to zero)
	Partial disposal (i.e. 75% to 40%) ï subsidiary to associate
	Part disposal (i.e. 75% to 10%) ï subsidiary to trade investment
Accounting treatment	**Accounting treatment**
Parentôs individual financial statements - calculate gain or loss plus tax charge (pro-forma working)	Parentôs individual financial statements - calculate gain or loss plus tax charge (pro-forma working)
Group accounts ï consolidate as normal, show disposal of shares as adjustment to parentôs equity (pro-forma working)	Group accounts ï do not consolidate and treat as per status after the disposal (i.e. associate, trade investment or nothing). Calculate group gain or loss on disposal (pro-forma)

Calculation of gain or loss on disposal of shares (full or partial) in parent company's individual financial statements

Sales proceeds	X
Less cost of investment x % sold	(X)
Gain on disposal / (loss)	X / (X)
Tax at % (if gain)	(X)
Net gain	**X**

The journal entries in the **parent's individual financial statements**

Banking sales proceeds, de-recognise investment and recognise gain

Debit	Bank ï with sales proceeds (statement of financial position)
Credit	Investment ï with cost of investment x % sold (statement of financial position)
Credit	Gain on disposal (statement of comprehensive income) ï debit for loss

Accrue for taxation

Debit	Income tax expense (statement of comprehensive income)
Credit	Income tax payable (statement of financial position)

Disposals – control is lost

When control is lost either though full disposal or partial disposal of equity shares, the consolidated accounts must be prepared in accordance with the status of the remaining investment if any.

(i) The consideration received is recognised
(ii) Any remaining investment is recognised at fair value on the date of disposal
(ii) The former subsidiary will no longer be consolidated line by line as control is lost.

1 Full disposal - Sell entire shareholding and be left with nothing

Consolidated statement of financial position (treat as per the status at the year end)

- No subsidiary therefore no consolidation or NCI

Consolidated income statement

- Consolidate results to date of disposal (pro-rata)
- Show group gain or loss on disposal

2 Partial disposal – subsidiary to associate

Consolidated statement of financial position (treat as per the status at the year end)

- No subsidiary therefore no consolidation or NCI.
- The fair value of the remaining investment is used as the cost of investment for associate carrying value using IAS 28 equity method.

Consolidated income statement

- Consolidate results to date of disposal (pro-rata). Treat as associate thereafter (IAS 28).
- Show group gain or loss on disposal

3 Partial disposal – subsidiary to trade investment

Consolidated statement of financial position (treat as per the status at the year end)

- No subsidiary therefore no consolidation or NCI
- The fair value of the remaining investment is used as the cost of investment and IAS 39 treatment of financial assets used thereafter.

Consolidated income statement

- Consolidate results to date of disposal (pro-rata).
- Show group gain or loss on disposal.
- Show investment income thereafter.

Group gain or loss on disposal of shares – control lost	$	$
Fair value of proceeds / consideration received		X
Plus fair value of any investment retained		X
		X
Less		
Net assets x share % at date of disposal	X	
Remaining goodwill	X	
Less remaining goodwill of NCI share (if full method used)	(X)	
		(X)
Gain / (loss) on disposal of shares		X / (X)
Less tax (as per holding company)		(X)
Net gain / (loss)		X / (X)

Disposal – control is retained (subsidiary to subsidiary disposal)

Where there is a partial disposal resulting in the status of the investment remaining a subsidiary after the disposal, IFRS 3 states that **no group gain or loss is calculated**, instead the disposal transaction requires an adjustment to the parentôs equity which affects group retained earnings. When control is retained, the disposal is just a transaction between the owners (parent shareholders and non controlling shareholders).

Partial disposal – subsidiary to subsidiary

Consolidated statement of financial position (treat as per the status at the year end)

- Consolidate as normal
- The NCI is based on the NCI % as at the year end.
- The goodwill remains the same and is not adjusted by the partial disposal.
- The increase in the NCI is shown as an adjustment in the parentôs equity (calculated as the difference between the proceeds received and the change in the NCI).

Consolidated income statement

- Consolidate as normal, as the status of the subsidiary has not changed during the accounting period
- No group gain or loss is calculated.
- The NCI is pro-rated as the NCI % would increase with the partial disposal.

The pro-forma for the adjustment in parentôs equity is:

Fair value of consideration received	X
Increase in non controlling interest in net assets at disposal	(X)
Increase in non controlling interest in goodwill at date of disposal (if full goodwill method used only)	(X)
Adjustment to parentôs equity (increase)	X

IFRS 5 – subsidiaries acquired exclusively for sale

Subsidiary held for resale

There is no exemption for a subsidiary that had previously been consolidated and is now being held for sale. The parent company must continue to consolidate such a subsidiary until it is actually disposed of.

Under IFRS 10 and IFRS 5 there is an exemption for a subsidiary for which **control is intended to be temporary** because the **subsidiary was acquired and is held exclusively with a view to its subsequent disposal in the near future**. For such a subsidiary, if it is highly probable that the sale will be completed within 12 months then the parent should account for its investment in the subsidiary under IFRS 5 as an asset held for sale, rather than consolidate it under IFRS 10. The parent company will show this type of subsidiary as a **single item** on the face of the consolidated statement of financial position, rather than consolidating line by line.

Dividends paid in the year of disposal

When a dividend is paid by the subsidiary on or before the disposal date and in the year of the disposal, the calculations for the disposal need to be adjusted. The post acquisition retained reserves (PARR) need the dividends to be deducted from them.

Chapter

8

Overseas Subsidiaries & Foreign Currency Transactions

Key summary of chapter "overseas subsidiaries and foreign currency transactions"

IAS 21- The effects of changes in foreign exchange rates deals with foreign currency translation.

Functional currency	This is the main currency that the organisation deals with (determined by the currency in which sales prices and costs are determined and settled).
Presentation currency	This is the currency that the financial statements are produced in and may be different from the functional currency (i.e. a UK company may have £ as its functional currency but produce its financial statements in $ due to having a US parent company.
Foreign currency	This is the currency other than the functional currency of the organisation.

IAS 21 has the following rules for individual company foreign currency transactions.

Translate each transaction at exchange rate on date of transaction, which is the spot rate. At each subsequent year end date the following rules apply to monetary and non monetary items:
1 Monetary assets and liabilities at the year end date must be **restated** by using the closing rate of exchange at the year end (e.g. trade receivables, trade payables, bank balances and loans).
2 Non – monetary items like non current assets, inventory and investments that are measured at historical cost are **not restated** at the year end date and remain at their initial translated value.
3 Non monetary items that are measured at fair value are translated using the exchange rate when the fair valuation was done. Exchange differences go to other comprehensive income in the statement of comprehensive income.
4 Exchange differences that arise on re-translation of monetary assets and liabilities are taken to the income statement as exchange gains or losses.

Consolidating financial statements

Before the consolidation process can begin, the overseas subsidiaries financial statements have to be translated into the presentation currency of the parent company. The same applies to associates and joint ventures.

The relationship with the overseas subsidiaries, will determine the translation method. There are 2 relationships and 2 translation methods given by IAS 21. Once the relationship is established, the correct translation method must be used. The method used depends on whether the foreign operation has the same functional currency as the parent.

If the overseas subsidiary is fairly independent of the parent company, it will be likely that the functional currency will be different from the parentôs functional currency. Where the overseas subsidiary is relatively independent from the parent, its transactions do not impinge directly on the parent companyôs cash flows, and the subsidiary can operate fairly autonomously.

Independent subsidiaries - closing rate / presentation currency method
Statement of financial position All assets and liabilities are translated using the **closing rate** at the year end. Share capital and pre-acquisition reserves at historic rate. Post acquisition reserves as balancing item.
Income statement All income and expenses are translated using the rate of exchange ruling at the date of transactions. However this may not be practical and an average rate is used if the exchange rates do not fluctuate a great deal. Dividends proposed are translated at the closing rate.
Exchange differences The exchange differences arising on the re-translation of the statement of financial position are taken to other comprehensive income in the consolidated statement of comprehensive income and accumulated in other components of equity or as part of a translation reserve. The total exchange differences will be split between parent share and non controlling interest share.
Goodwill Goodwill is calculated in exactly the same way, on the translated items. The net assets at acquisition are determined by translating the share capital and pre-acquisition profits at the **rate of exchange at the date of acquisition.** At the year end date, IAS 21 requires that goodwill be treated like any other non monetary asset and be translated at closing rate. Any exchange differences are taken to other comprehensive income in the consolidated statement of comprehensive income. The full 100% of the exchange differences belong to the parent and are **not split between NCI**.

Calculation of exchange differences on re-translation of net assets relating to subsidiary or associate – Method 1	£
Closing net assets at closing rate	X
Less opening net assets** at opening rate	(X)
Movement in net assets	X
Less retained profit per translated income statement	(X)
Exchange differences	X
Group share (%)	X

Calculation of exchange differences on re-translation of net assets relating to subsidiary or associate – Method 2		£
Opening net assets at closing rate		X
Less opening net assets at opening rate		(X)
		X/ (X)
Profit for the year at closing rate	X	
Profit for the year at average rate	(X)	
		X/ (X)
Total exchange difference		X
Group share (%)		X

Exchange differences on re-translation of goodwill	£
Translated goodwill at date of acquisition	X
Translated goodwill as at last year end	(X)
Exchange gain / (loss) as at last year end	X / (X)
Translated goodwill at year end	X
Exchange gain / (loss) this year end	X / (X)
Total exchange gain / (loss) on re-translation of goodwill	

In the consolidated statement of comprehensive income, under other comprehensive income, the exchange difference will consist of:

1 Exchange difference on re-translation of net assets
2 Exchange difference for the year upon re-translation of goodwill.

Dependent overseas subsidiaries

Where the overseas subsidiary is very dependent on the parent, and is in affect an extension of the parent companyôs operations, the functional currency will be the same for both companies. An example of this type of overseas subsidiaries is a manufacturing company, which only manufactures goods for its parent company; another example is where it only sells goods imported from its parent company.

The method for translating this type of subsidiary is to translate the items in the financial statements in the same way as individual company stage. This is because in affect itôs just an extension of the parent company, so the translation is done as if the parent company had undertaken them. This method is knows as the temporal method (also referred to as functional currency method or historical method). Note that there is no choice in the method of translation. Once the relationship has been established, the correct translation method must be used.

Temporal method / functional currency method / historical method
Statement of financial position Non monetary items Translated at their historical rate (non current assets, inventories etc). This is either the exchange rate when subsidiary was acquired or exchange rate when assets were acquired if this date is later than the acquisition date. Monetary items Translate at the closing rate (trade receivables, payables, bank balances etc) Share capital and pre-acquisition reserves at historic rate. Post acquisition reserves as balancing item.
Income statement All income and expenses are translated using the rate of exchange ruling at the date of transactions. However this may not be practical and an average rate is used if the exchange rates do not fluctuate a great deal. Depreciation, opening inventory and closing inventory however are all translated at their historical rates to match them with the items in statement of financial position. Sales, purchases and other expenses are translated at the average / actual rate. Dividends proposed are translated at the actual / closing rate.
Exchange differences The exchange differences arising are taken to the consolidated income statement as exchange gain or loss as part of the profit for the year.
Goodwill The goodwill remains at the historical exchange rate as itôs a non monetary item and isnôt re-translated at the closing rate.

Calculation of profit for the period for foreign subsidiary under temporal / functional method

	£
Closing net assets as per translated balance sheet	X
Less opening translated net assets (at given rates)	(X)
Translated profit or loss in the income statement	X

The exchange gain/loss is the balancing figure in the translated income statement

Hedge accounting

Hedging relationships are regulated by IAS 39 financial instruments, recognition and measurement.

IAS 39 allows the investment which is a non monetary asset to be re-translated at the balance sheet date along side the loan which is a monetary item. The exchange differences can then be offset against each other with only the difference going to the income statement. The offset must be in the region of 80% to 125% (i.e. a highly effective hedge).

IAS 29 hyperinflation

In countries where inflation is high, under historical accounting, the assets in the statement of financial position will be understated and the profits will be overstated (new revenue is matched with old inventory). In hyperinflationary economies, money loses its purchasing power very quickly. This makes comparisons of transaction misleading over time.

IAS 29 is based on current purchasing power principles and requires that financial statements prepared in the currency of a hyperinflationary economy be stated in terms of the **value of money (current measuring unit)** at the reporting year end date.

An overseas subsidiary operating in a hyperinflationary economy will have to re-state its financial statements in a stable currency, before the consolidation can commence by the parent company. This stable currency is usually the parentôs reporting currency.

IAS 21 states that the foreign entity must restate its local currency IAS financial statements in accordance with IAS 29 before translation into the parentôs reporting currency.

Chapter

9

Consolidated Statement of Cash flow

Key summary of chapter "statement of cash flows"

Statement of cash flows are primary financial statements and are required along side the income statement and statement of financial position. Cash is the fuel of a business, without which business will suffer financial stress.

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

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 statement of cash flows, the history can be established, which will highlight any problems to the user of the accounts.

Format of statement of cash flows

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.

Method 2 – Indirect method

With the indirect method, the profit before taxation (or profit before interest and tax) is taken from the income statement 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 years balance sheets.

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.

Using ñTò accounts helps establishing cash flows.

Step by step approach to completing a statement of cash flows	
Step 1	Set out pro forma, using a whole side of paper leaving lots of spaces between the 3 main headings of operating, investing and financing activities.
Step 2	Set up a workings page and read through all the additional information. Also make notes to see how they affect the statement of cash flows.
Step 3	Complete the operating activities section (using the method instructed by the question either direct or indirect). Incorporating interest and taxation cash flows if necessary.
Step 4	Complete the investing activities section by looking at the non current assets. Make sure you take account of both tangible and intangible non current assets.
Step 5	Complete the financing section by looking at share capital, long term debt and capital element of finance leases.
Step 6	Finally review the income statement and statement of financial position to ensure all items have been dealt with. Complete the remaining statement of cash flows, and double check that the increase or decrease in cash and cash equivalents during the period, corresponds to the movement in cash and cash equivalent balances in the 2 statement of financial position.

Consolidated statement of cash flows

The consolidated statement of cash flows has the same major headings as a single company. The consolidated statement of cash flows only deals with the flows of cash external to the group**;** intra group cash flows are eliminated.

- **Non controlling interest**. Dividends paid to any minority interests are reported under ñcash flow from operating activitiesò
- **Associate undertakings**. The only cash flow that is relevant for the equity accounted investment is the dividends received. Dividends received from associates are reported under ñcash flow from investing activitiesò.
- **Acquisition or disposal of a subsidiary during the year** Cash paid or received as consideration should be shown net of any cash transferred as part of the purchase or sale. The net cash flow is reported under ñcash flow from investing activitiesò.

Adjustments are also required for the net assets acquired at the date of acquisition (for newly acquired subsidiaries), and the net assets disposed off at the date of disposal (for disposed subsidiaries during the year).

For **acquisition** of subsidiary during the year the general rule is to **DEDUCT**. For ñTò accounts, remove the figure from the carrying forward balance.

For **disposed** subsidiary during the year the general rule is to **ADD**. For ñTò accounts, add the figure to the carrying forward balance.

Foreign subsidiaries

The exchange differences on translating a foreign subsidiary have to be adjusted for when preparing the consolidated statement of cash flows, as exchange difference are not cash flows. The net assets have the exchange differences removed from the carry forward balances.

Chapter

10

Financial Instruments

Key summary of chapter "financial instruments"

Financial instrument
A financial instrument gives rise to both a financial asset of one company and a financial liability or equity instrument of another entity.

Financial asset
A financial asset can be cash, equity or contractual right to receive cash or exchange financial instrument in the companyôs favour. This also includes derivatives.

Financial liability
A contractual obligation to make payments in the future. This could be cash or exchange financial instrument which are not in the companyôs favour

Equity instrument
Any contract that gives entitlement to the residual interest in a company after all the liabilities have been settled

Derivatives
These are financial instruments that derive their value from the underlying asset. They are used mainly for hedging against adverse movements in prices, exchange rates and interest rates. Examples include future contracts, forward contracts, options and swaps. There is usually very little outlay on investment initially and are settled at a future date.

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

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 - disclosures

IAS 32 financial instruments: presentation

IAS 32 achieves its objectives by:
- Clarifying the **classification** of a financial instrument as either a liability or equity
- Gives the treatment for **treasury shares** (a company's own repurchased shares).
- Gives strict conditions under which assets and liabilities may be **offset** in the balance sheet.
- Additional **disclosure** requirements about financial instruments, including information as to their fair values. However there is a new disclosure accounting standard IFRS 7 which is applicable in addition to IAS 32 from January 2007.

Equity instruments
Ordinary shares
Share warrants
Some type of preference shares

Financial liabilities
Trade payables
Bonds
Loan stock
Debentures
Bank loans
Some type of preference shares

The **substance** of the instrument is looked when assessing what the classification is. If there is an obligation to transfer economic benefit, then this meets the definition of a liability and therefore must be classified as such.

Compound (hybrid) financial instruments
Some financial instruments have both equity and liability elements. IAS 32 requires the liability component be calculated. This amount is then deducted from the whole value (or fair value) of the instrument, which leaves the equity element.

Interest, dividends, losses and gains
IAS 32 states that:
1 Interest, dividends, gains and losses relating to financial instruments that are classified as financial liabilities must be recognised as income or expense in the income statement.
2 Distributions made to equity instrument holders, must be debited to equity (i.e. reduce retained profits).
3 Transaction costs on equity instruments are also debited to equity

IAS 39 financial instruments: recognition and measurement

IAS 39 deals with recognition and de-recognition, the measurement of financial instruments and hedge accounting.

Financial assets
IAS 39 requires financial assets to be classified in one of the following categories:
- Financial assets at fair value through profit or loss.
- Loans and receivables.
- Held-to-maturity investments
- Available-for-sale financial assets

Initial recognition
The financial asset or financial liability must initially be recognised at FAIR VALUE less direct transaction costs.Fair value can be derived from:
(i) Quoted prices
(ii) Where there is no active market, then use valuation techniques with references to market conditions, e.g. discounted cash flows using market discount factor.
(iii) If none of the above 2 is possible, then fair value is cost less any impairment.

Subsequent measurement
Financial assets at fair value through profit or loss
- Subsequent measurement - fair value
- Gains and losses taken to the income statement at each re-measurement

Loans and receivables

- Subsequent measurement - Amortised cost, using the effective interest rate method, or fair value.
- Gains and losses taken to the income statement at each re-measurement

Held to maturity investments

- Subsequent measurement - Amortised cost, using the effective interest rate method, or fair value
- Gains and losses taken to the income statement at each re-measurement

Available for sale financial assets

- Subsequent measurement - fair value
- Gains and losses taken to the other comprehensive income (reserves). Only when the item is sold, can the gains or losses be recognised in the income statement

Impairment - Loans & receivables and held to maturity assets

Compare the carrying value with the value in use (the present value of future cash flows discounted at the original effective interest rate). Any impairment loss will go to the income statement.

Impairment – Available for sale financial assets

Impairment losses on available for sale financial assets they must be recognised in the income statement and the previous losses removed from the equity. For financial assets at fair value through profit or loss, the fair value measurements go through the income statement anyway so any impairment losses would also go to the income statement.

Impairment calculations

The impairment loss is the difference between the carrying amount of the financial asset and the present value of the future cash flows discounted at the original effective interest rate.

Reversal of impairment losses

Impairment losses can be reversed if the situation changes in subsequent periods for:

- Financial assets carried at amortised cost (loans and receivables, held to maturity)
- Debt instrument carried as available-for-sale

Impairments relating to **investments in available-for-sale equity instruments** are not reversed.

Derivative financial instruments

IAS 39 also requires derivate financial instruments to be incorporated into the financial statements at fair value.

A derivative is a financial instrument:

- Whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price or index.
- That requires very little initial investment.
- That is settled at a future date.

Embedded Derivatives
Some contracts that themselves are not financial instruments may have financial instruments embedded in them. (E.g. a contract to purchase a commodity at a fixed price for delivery at a future date has embedded in it a derivative that is indexed to the price of the commodity). An embedded derivative is a feature within a contract, such that the cash flows associated with that feature behave in a similar fashion to a stand-alone derivative.

IAS 39 requires the same treatment of these embedded derivates. They must be accounted for at fair value in the statement of financial position with changes recognised in the income statement.

Hedging
Hedge accounting offsets the profit on one item against the loss of another item, where they are used together. Remember offsetting is not normally allowed.

IAS 39 permits hedge accounting on two conditions.

a) The hedging relationship must be formally documented and designated. This means that there is a proper strategic policy in place for the hedging.
b) The hedge must be highly effective. This means that most (80% to 125%) of the losses will be recovered by the profits and vice versa.

Fair value hedge
This is where the fair value of the hedged item changes as the market prices change. At the end of the year the items are re-measured to fair value. The changes in the fair value of financial derivative and the hedged item (i.e. variable debt and interest rate future) are offset against each other in the income statement. If the hedge is highly effective it will have little impact on profit as the gain and losses will be roughly equal.

Cash flow hedges
This is where the cash flows of the item being hedged change as the market prices change. The change in the fair value of the hedging financial instrument is taken to equity initially, and when the actual transaction occurs, the change is then moved to the income statement.

IFRS 7 financial instruments – disclosures (effective January 2007)

IFRS 7 requires disclosure of information about the significance of financial instruments for an organisationôs financial position and performance.

The aim of these disclosures is to make it easier for analysts and investors to see the impact of risk on a companyôs financial health and position. The enhanced disclosures should reflect the way senior management perceives measures and manages the companyôs risks.

IFRS 7 requires 2 main categories of disclosures as follows:

(i) Information about the significance of financial instruments.
(ii) Information about the nature and extent of risks arising from financial instruments

The types of risk have been identified by the standard for financial instruments which require disclosure:

Market risk
The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. These include currency risk, interest rate risk and price risk (inflation).

Credit risk
The risk that one party to a financial instrument will cause a financial loss for the other party by failing to pay. This is the risk of non payment by third parties

Liquidity risk
This is the risk of not being able to meet the obligations associated with the financial liabilities

Interest rate risk
This is the risk that the interest rates in the future will affect the financial instrument. An example is the increase interest payments of variable rate debt, without a corresponding increase in the fair value.

Other price risk
The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Chapter

11

Reporting Substance Over form

Key summary of chapter "reporting substance over legal form"

Substance over form requires that transactions must be accounted for in accordance with their economic substance, rather than its true legal form.

Most accounting transactions are straight forward to account for. Where there is a complex transaction, the legal form may not represent the actual economic substance.

Complex transactions and off statement of financial position finance

An organisation may undertake complex transactions in order to keep assets and liabilities off the statement of financial position, as there is no legal requirement to include them in the statement of financial position. This is known as creative accounting. Off statement of financial position finance means financing which under legal requirements may not be shown inn the statement of financial position. The main reasons for dong these are:

- Not including liabilities means lower gearing ratio, which may have stock market advantages.
- Keep a company within loan covenants.
- Lower liabilities mean a greater capacity to borrow more.
- Lower borrowing costs will increase profits and therefore increase bonuses and performance related pay. So the management will want to encourage off statement of financial position finance.

The risk and rewards are a good indication as to whom the asset and liability belongs to. Risk is the uncertainty of the expected outcome. In this case it is the uncertainty of future economic benefits and potential exposure to loss.

Recognition in the statement of financial position will occur once the assets and liabilities have been identified (by looking at risk and rewards) and can be measured with sufficient reliability

Process of enquiry

- Has the transaction taken place?
- Has the transaction led to access to future benefits and is the entity exposed to the risks in those benefits?
- Is the asset controlled by the entity?
- Is there sufficient evidence of the existence of the item?
- Can the item be measure as a monetary amount with reasonable reliability?

Common forms include consignment stock, sale and purchase, sale and leaseback and factoring.

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.

IFRS 13 Fair value measurement

IFRS 13 applies to IFRSs that require or permit fair value measurements or disclosures and provides a single IFRS framework for measuring fair value and requires disclosures about fair value measurement. IFRS 13 seeks to increase consistency and comparability in fair value measurements and related disclosures through a 'fair value hierarchy'. The hierarchy categorises the inputs used in valuation techniques into three levels.

Chapter

12

Retirement Benefits

Key summary of chapter "retirement benefits"

IAS 19 deals with 2 areas of employee benefits

1 Short term employee benefits

These include wages and salaries, sick pay, bonuses and other remunerations. IAS 19 states that these are straightforward to account for, usually the cost falls in the period that the benefit arises.

2 Post employment benefits

These are mainly in the form of pensions, and it is this that causes accounting problems.

Defined contribution scheme	Defined benefit schemes
Regular contributions are paid into this scheme. The benefits are directly determined by the value of contributions paid and the performance of the scheme assets. This scheme does not present a problem for the company.	Under these schemes employeesô pension benefits are specified, normally as a percentage of final salary. An actuary will calculate the size of the fund required on retirement to provide the specified pensions and hence the contributions. The rules define the benefits of independently of the contribution payable, and the benefits are not directly related to the investments of the scheme. The scheme may be funded or un-funded.
Accounting treatment is to charge the contributions to the income statement in the period occurred. In the statement of financial position an accrual or prepayment might arise if too much or too little has been paid.	The problems with this scheme are ▪ Valuing the scheme assets ▪ Estimating the scheme liabilities ▪ Measuring and recognising the cost to the employing company

Accounting for defined benefit schemes is complex and the following steps need to be taken:

- Establish the present value of future obligations and the current service cost
- Establish the fair value of the pension scheme assets
- Establish the actuarial gain or loss and recognised immediately in full under other comprehensive income.

IFRS 2 share based payments

IFRS 2 share based payments was introduced by the IASB, which states that when the company offers share options or warrants, it must treat this as a **financial instrument** and recognise them in the financial statements at fair value, the charge going to the income statement and the credit going either to equity or liabilities.

There were a number of arguments for not accounting for share based payments, all of which were rejected by the IASB. The arguments were that as there is no cost, no amounts can be charged to the income statement. However it makes it impossible to compare the results of the companies who offer different remuneration packages to their staff.

There are two types of transactions:

1 Equity –settled share based payment transactions (share options)

Debit	Expense in the income statement
Credit	Equity in the statement of financial position

2 Cash – settled share based payment transactions (share appreciation rights – SARS)

Debit	Expense in the income statement
Credit	Liability in the statement of financial position

Chapter

13

Profit Measurement

Key summary of chapter "profit measurement"

Historical cost accounting (HCA)

Accounts prepared using historical cost principles are not that relevant during periods of high inflation or other price changes. In the statement of financial position the historical cost assets do not represent any measure of the current value of such assets. In the income statement out of date historical costs are deducted from current revenues, which gives a profit, which is not that useful. This makes information obtained from the financial statements less useful for decision making.

Accounting for changing price levels

In times of changing price levels, the historical cost accounting method is less useful. The capital of the company may diminish in real terms. Real term is the value of money with the effect of inflation removed. Money value is the value of money including the effect of inflation.

Concepts of capital and capital maintenance

Capital maintenance means that during any accounting period the profits earned cover the maintenance of the enterprises capital. Inflows of assets in excess of amounts needed to maintain capital are regarded as profit and therefore as a return on capital. Therefore profit is the residual amount that remains after expenses (including capital maintenance adjustments) have been deducted from income. If expenses exceed income the residual amount is a loss.

Concept of current cost accounting (CCA)

Valuation of assets in current cost accounting is based on the **deprival method / value to business.** This is the method of valuing assets at the **lower of replacement cost and recoverable amount**.

The preparation of financial statements based on current cost accounting would involve identifying the deprival values or value to business for inventory and non current assets. This would involve revaluations of non current assets.

The charge to the income statement would also be affected by using CCA. The historical cost profit figure will require adjustments to:

- Cost of sales adjustment
- Depreciation adjustment
- Monetary working capital adjustment
- Gearing adjustment

Current purchasing power accounting (CPP)
The items in the accounts are adjusted using the general price index. This will show the change in the general purchasing power of money. This will maintain the financial capital maintenance.

IAS 29 is based on current purchasing power principles and requires that financial statements prepared in the currency of a hyperinflationary economy be stated in terms of the **value of money (current measuring unit)** at the reporting year end date.

Chapter

14

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 doesnôt 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 doesnôt 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 companyôs own purposes and any rental income is at an armôs 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 ï the investment property is treated like any other property and is carried at cost less accumulated depreciation and accumulated impairment loss.

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

Chapter

15

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

16

Various Standards

Key summary of chapter "various accounting standards"

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 doesnôt 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.

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 f**inance 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 lesseeôs 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

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 donôt affect the financial statements they are known as non-adjusting events.

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

Where is a **long term provision**, then to incorporate into the financial statements now, the **present value** (discounting) of the provision needs to be established.

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

17

Earnings per Share

Key summary of chapter "earnings per share"

IAS 33 covers EPS. Stock exchange requires all listed companies to show EPS figure on the face of the income statement. EPS is a stock market indicator and is used to calculate the price earnings (PE) ratio.

Basic calculation

$$\frac{\text{Net profit/loss attributable to ordinary shareholders (earnings for the year)}}{\text{Weighted average no. of shares (WANS)}}$$

Change in capital structure	Earnings	WANS
Issue at full market price New capital is introduced therefore earnings would be expected to rise from date of new Issue.	Remain the same as basic	The numbers of shares are time apportioned. There is no affect to prior years EPS as the issue is a full price.
Bonus issue Free shares are issued to existing shareholders. The earnings of the company will not rise as there are no extra funds generated.	Remain the same as basic	No time apportioning. The bonus shares are treated as if they were already in issue at the beginning of the year and for prior years. The reciprocal (1/x) of the bonus fraction is applied to prior years EPS. Bonus fraction is calculated as : New share holding / old share holding (i.e. one bonus share for every four = 5/4)
Rights issue Shares are issued to existing shareholders at reduced price. Therefore there is a bonus element involved as shares are issued at reduced price	Remain the same as basic	▪ Firstly calculated the **theoretical ex-rights price TERPS.** ▪ Calculate the **bonus element** = market price (cum rights)/ TERPS. ▪ Calculate **WANS**, by time apportioning shares. All time apportioned shares before rights issue multiply by bonus element. All time apportioned shares after rights issue do not apply bonus element. ▪ **Restate** prior years EPS by multiplying with reciprocal of bonus element.

IAS 33 requires the diluted earnings per share (DEPS) to be disclosed along with the basic EPS where the company has such issues.

Convertible loan stock or preference shares

Earnings

Net basis earnings	X
Add back interest or dividends saved	X
Less taxation lost on interest saved	(X)
Diluted earnings	X

No of shares

Basic weighted average	X
Add additional shares on conversion (use terms giving max dilution available)	X
Diluted number	X

Chapter

18 Financial Analysis

Key summary of chapter "financial analysis"

Financial analysis

The objective of financial statements is to provide information to all the users of these accounts to help them in their decision-making. Note that most users will only have access to published financial statements.

Interpretation and analysis of financial statements involves identifying the users of the accounts, examining the information, analysing and reporting in a format which will give information for economic decision making.

Ratios can be grouped into 3 main areas:

1	Performance	-	how well the business has done (profitability)
2	Position	-	short term standing of the business (liquidity)
3	Potential	-	what the future holds for the business

Exam technique for analysing performance

The following steps should be adopted when answering an exam question on analysing performance:

Step 1 Review figures as they are and comment on them.
Step 2 Calculate relevant ratios according to performance, position and potential (if possible)

1 Performance (profitability) – how well has the business done

Return on capital employed (ROCE)	Profit before interest & tax (PBIT) / Capital employed (CE) X 100%
Operating profit margin	PBIT / Turnover X 100%
Asset turnover	Turnover / Total assets (number of times)
(Operating profit margin x asset turnover = ROCE)	
Return on equity (ROE)	Profit after tax / Shareholder funds (capital + reserves) x 100%

2 Position (liquidity)– short term standing of the business	
Current ratio	Current assets (number of times) Current liabilities
Quick ratio	Current assets ï inventory (number of times) Current liabilities
Gearing - equity	Debt capital X 100% Equity (shareholders funds)
Gearing – total	Debt capital X 100% Debt + equity (total capital)
Interest cover	Profit before interest & tax (PBIT (number of times) Interest paid
Trade payable days	Trade payables x 365 days Cost of sales (or purchases)
Inventory days	Inventory x 365 days Cost of sales
Trade receivable days	Trade receivable x 365 days Sales
Working capital cycle	Trade receivable days + inventory days ï trade payable days
3 Potential (investor) – what investors are looking at	
Earnings per share (EPS)	Profit after tax Number of shares
P/E ratio	Share price Earnings per share
Dividend yield	Dividend per share X 100% Share price
Dividend cover	Earnings per share Dividend per share

Step 3 Add value to the ratios by:

Interacting with other ratios and giving reasons

a) State the **significant fact or change** (i.e. increase or decrease)

b) **Explain the change** or how it may have occurred by looking at the business activities and other information.

c) Explain the significance of the ratio in terms of **implications for the future** and how it fits in with the userôs needs.

d) **Limitations** of the ratio analysis. Look at the 2 figures used to compute the ratio and criticise them. Also look at other factors which may distort the information (creative accounting, seasonal fluctuations etc.)

Limitations of ratio analysis

A ratio on its own is meaningless. Accounting ratios must always be interpreted in relation to other information.

Ratios based on historic cost accounts do not give a true picture of trends, because of the effects of inflation and different accounting policies. Investorsô ratios particularly have a disadvantage, because investment means looking into the future and the past may not always be indicative of the future.

Comparing the financial statements of similar businesses can be misleading.

Different accounting policies that can be adopted will have an impact on the ratios calculated and therefore make comparisons more difficult. The different accounting policies affect the income statement and the statement of financial position and these impacts on all the major ratios like ROCE and gearing.

Creative accounting (also known as aggressive accounting or earnings management) distorts financial analysis of company accounts. Creative accounting is done by organisations to perhaps enhance the balance sheet or performance by either exploiting loopholes in the accounting standards or deliberately not showing certain items. Listed companies especially have added pressures for the maintenance and increase of share prices; this obviously has an impact on the valuation of the company. As share prices are stipulated by the market, the information fed to the market can be manipulated to ensure this.

Interpretation of financial obligations included in the accounts

Financial obligations reported in the accounts need to be understood properly. These include redeemable debt, contingent liabilities and earn out arrangements.

IFRS 8 operating segments

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.

Chapter

19

Developments in External Reporting

Key summary of chapter "developments in external reporting"

Corporate collapses and accounting scandals have resulted in pressure for more information from the companies.

Financial statements are prepared on a mainly historic basis and show transactions that have already occurred. Users of the accounts need additional information to make informed economic decisions.

The ways in which this can be achieved are as follows:

Forecast information	Annual financial statements can include forecast data. But this is difficult as estimates have to be made, and if the organisation does not achieve those targets it will reflect badly on them.
Environment and social reporting	Details of the way the organisation is dealing with its environmental responsibilities as this affects the public. Human resource issues like redundancies and the type of labour being used.
Non financial information	More information on non financial aspects of the organisation can be given, like future product development, local community information and how the organisation interacts with it. Information of the organisationôs ethical policies.

Operating and financial review (OFR)

The OFR gives details of the organisations past results and future plans, and is prepared by the senior management. The OFR is not mandatory but most listed companies produce it as part of their annual accounts. In the UK the government is intending to make the OFR mandatory for all listed companies and wants them to produce and publish it as part of their annual accounts.

Global reporting

The global reporting initiative (GRI) was set up by the US and environmental bodies including the UN environment programme. The guidelines set out in the GRI apply to all entities that produce financial information, and its intention is to develop sustainable reporting practices to make all entities more comparable and to provide important non financial information.

Environmental reporting

Organisations have a huge impact on the environment, ranging from industrial pollution, gas emissions and mining. Therefore they must be accountable for how they deal with environmental issues, and in some cases are required by law to do so.

Social and ethical reporting

Social and ethical reporting can be both financial and non financial and covers a broad range of issues.

The sociological environment is the environment that the organisation deals with. It employs human resources and has an impact on the society with its decisions. It can bring wealth to the community but it could also bring pollution and destruction.

Ethical reporting is increasingly becoming important, as a large number of investors will only invest in organisations adhering to ethical rules. For example unethical companies may exploit child labour, or sell arms to worn torn countries. The ethical investors group reports on unethical organisations.

Human resource accounting

Human resource accounting involves measuring and disclosing the value of employees or human resources to the organisation. The basic principle of human resource accounting is that, employees are assets, and competitive advantage is gained by effective use of people

International issues

With greater corporate globalisation, companies are increasingly operating on a global scale. Investors are investing in companies outside their own countries. This requires financial information to be consistence and comparable globally. The harmonisation of financial accounting and reporting is well under way. In the UK all listed companies have to prepare consolidated accounts under International accounting standards by 2005. This convergence program is being adopted by many other countries.