ADVANCED FINANCIAL REPORTING

STUDY TEXT

Copyright

ISBN NO: 9966-760-27-X

First Published 2009

SUP

P.O. Box 59857, 00200,

Nairobi, Kenya.

Tel: +254 (0) 20 606155 Fax: +254 (0) 20 607498

Acknowledgment

We gratefully acknowledge permission to quote from past examination papers of the **Kenya Accounts and Secretaries National Examination Board (KASNEB).**

Table of Contents

- Acknowledgment iii
- Table of Contents v

PART A vii

- CHAPTER ONE 1
- ACCOUNTING FOR GROUPS 3
- CHAPTER TWO 75
- ACCOUNTING FOR ASSETS AND LIABILITIES (PART A) 77
- CHAPTER THREE 141
- ASSETS AND LIABILITIES (PART B) 143

PART B 199

- CHAPTER FOUR 201
- PRESENTATION AND ANALYSIS OF FINANCIAL STATEMENTS (PART A) 203
- CHAPTER FIVE 291
- EFFECTS OF INFLATION 293
- CHAPTER SIX 329
- PRESENTATION AND ANALYSIS OF FINANCIAL STATEMENTS (PART B) 331

PART C 371

- CHAPTER SEVEN 373
- PUBLIC SECTOR ACCOUNTING 375
- CHAPTER EIGHT 443
- CURRENT ISSUES 445
- CHAPTER NINE 483

SUMMARIES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs), INTERNATIONAL ACCOUNTING STANDARDS (IASs) AND IFRIC/SIC INTERPRETATIONS AS OF 31st DECEMBER 2005 485

- **ANSWERS TO EXAM QUESTIONS** 523
- **REFERENCES** 559
- **GLOSSARY** 563
- **INDEX** 575

PART A

STUDY TEXT

CHAPTER ONE

ACCOUNTING FOR GROUPS

CHAPTER ONE

ACCOUNTING FOR GROUPS

OBJECTIVES

After this chapter the student will be able to:

- Understand the basic principles of acquisition and merger accounting.
- Explain the principles of measurement relating to the fair value of the consideration and the net assets acquired.
- Discuss the nature of step-by-step acquisitions.
- Prepare consolidated financial statements where including Associate companies, jointly controlled entities and foreign of subsidiaries.
- Prepare consolidated financial statements on disposal of subsidiaries.

INTRODUCTION

This chapter begins with the on basic principles of group accounts professional requirements as set out in IAS 27 Accounting for subsidiary undertakings. It then looks at the requirements of IFRS 3 business combinations.

Thereafter, we look at the preparation of consolidated accounts where there has been a step-by-step acquisition. As the name suggests, step-by-step acquisitions involve acquiring control of a company in stages. A discussion on mergers, associates and joint ventures is provided.

DEFINITION OF KEY TERMS

Subsidiary: An entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

Parent: An entity that has one or more subsidiaries.

Group structure: The relationship between the holding company and the subsidiaries.

Associate: An enterprise in which an investor has significant influence but not control or joint control.

Joint venture: A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Foreign operation: A subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

▶ EXAM CONTEXT

In past examinations, the examiner has tested the students' knowledge on the following topics:

- Group structures
- Foreign subsidiaries
- Merger Vs Acquisition
- Disposal of subsidiaries

Students should, therefore, understand these topics.

▶ INDUSTRY CONTEXT

This chapter enables firms to know what kind of investment they have made in another firm. That is, whether it is a subsidiary, joint venture, merger, foreign subsidiary and so on.

Consolidation assists firms to know how to prepare consolidated financial statements if they have acquired subsidiaries, joint ventures, mergers and so on.

The topic on foreign subsidiaries assists firms that have acquired foreign subsidiaries to know how to translate the foreign subsidiary's financial statements into the reporting currency of the holding company.

It also assists the holding company to know how to prepare consolidated financial statements with the foreign subsidiary.

1.1 BASIC CONSOLIDATION (IAS 27)

FAST FORWARD: A parent is required to present consolidated financial statements in which it consolidates its investments in subsidiaries.

IAS 27 has the objectives of setting standards to be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent; and in accounting for investments in subsidiaries, jointly controlled entities, and associates when an entity elects, or is required by local regulations, to present separate (non-consolidated) financial statements.

The following are important definitions in IAS 27:

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

Subsidiary: An entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

Parent: An entity that has one or more subsidiaries.

Control: The power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

Control is presumed when the parent acquires more than half of the voting rights of the enterprise. Even when more than one half of the voting rights are not acquired, control may be evidenced by power:

(i) Over more than one half of the voting rights by virtue of an agreement with other investors; or

(ii) To govern the financial and operating policies of the other enterprise under a statute or an agreement; or

(iii) To appoint or remove the majority of the members of the board of directors; or

(iv) To cast the majority of votes at a meeting of the board of directors.

The parent company need not present consolidated financial statements in the following circumstances:

- The parent is itself a wholly-owned subsidiary, or is a partially owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

- The parent's debt or equity instruments are not traded in a public market;

- The parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

- The ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

The consolidated accounts should include all of the parent's subsidiaries, both domestic and foreign.] There is no exception for a subsidiary whose business is of a different nature from the parent's (This is a requirement by the companies Act but it is now not allowed on the grounds that the firm can present segmental report). Also, as a result of an amendment of IAS 27 by IFRS 5 in March 2004, there is no exception for a subsidiary for which control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future.

Special purpose entities (SPEs) should be consolidated where the substance of the relationship indicates that the SPE is controlled by the reporting enterprise. This may arise even where the activities of the SPE are predetermined or where the majority of voting or equity are not held by the reporting enterprise. Once an investment ceases to fall within the definition of a subsidiary, it should be accounted for as an associate under IAS 28, as a joint venture under IAS 31 or as an investment under IAS 39, as appropriate.

1.1.1 The consolidation process

Intra-group balances, transactions, income, and expenses should be eliminated in full. Intra-group losses may indicate that an impairment loss on the related asset should be recognized. Some of the adjustments requires during consolidation include:

(i) Elimination of unrealized profit on inventory and Property, plant and equipment that has been sold within the group.

(ii) Elimination of inter-company indebtness as a result of inter-company transactions for example receivables and payments and proposed dividends in subsidiary companies.

The financial statements of the parent and its subsidiaries used in preparing the consolidated financial statements should all be prepared as of the same reporting date, unless it is impracticable to do so. If it is impracticable a particular subsidiary to prepare its financial statements as of the same date as its parent, adjustments must be made for the effects of significant transactions or events that occur between the dates of the subsidiary's and the parent's financial statements. And in no case may the difference be more than three months.

Consolidated financial statements must be prepared using uniform accounting policies for transactions and other events in similar circumstances.

Minority interests should be presented in the consolidated balance sheet within equity, but separate from the parent's shareholders' equity. Minority interests in the profit or loss of the group should also be separately presented.

Where losses applicable to the minority exceed the minority interest in the equity of the relevant subsidiary, the excess, and any further losses attributable to the minority, are charged to the group unless the minority has a binding obligation to, and is able to, make good the losses. Where excess losses have been taken up by the group, if the subsidiary in question subsequently reports profits, all such profits are attributed to the group until the minority's share of losses previously absorbed by the group has been recovered.

1.1.2 Requirements of IFRS 3 'Business combination

Cost of a Business Combination

Fair value of consideration given plus costs

The holding company measures the cost of a business combination at the sum of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the subsidiary; plus any costs directly attributable to the combination. If equity instruments are issued as consideration for the acquisition, the market price of those equity instruments at the date of exchange is considered to provide the best evidence of fair value. If a market price does not exist, or is not considered reliable, other valuation techniques are used to measure fair value.

Measurement of acquired assets and liabilities

The acquired identifiable assets, liabilities, and contingent liabilities are measured initially by the acquirer at their fair value at the acquisition date, irrespective of the extent of any minority interest. In other words, the identifiable assets acquired, and liabilities and contingent liabilities incurred or assumed, must be initially measured at full fair value, including any minority interest's share of the acquired item.

Step acquisitions

If a business combination involves more than one exchange transaction, each exchange transaction shall be treated separately by the acquirer, using the cost of the transaction and fair value information at the date of each exchange transaction, to determine the amount of any goodwill associated with that transaction.

Goodwill

Recognition and measurement of goodwill

Goodwill is recognised by the acquirer parent as an asset from the acquisition date and is initially measured as the excess of the cost of the business combination over the acquirer's share of the net fair value of the subsidiary identifiable assets, liabilities and contingent liabilities.

No amortisation of goodwill

IFRS 3 prohibits the amortisation of goodwill; instead goodwill must be tested for impairment at least annually in accordance with IAS 36 Impairment of Assets. If the acquirer's interest in the net fair value of the acquired identifiable net assets exceeds the cost of the business combination, that excess (sometimes referred to as negative goodwill) must be recognised immediately in the income statement as a gain. Before concluding that "negative goodwill" has arisen, however, IFRS 3 requires that the acquirer reassess the identification and measurement of the subsidiaries' identifiable assets, liabilities, and contingent liabilities and the measurement of the cost of the combination.

>>> Example 1

Mtito Limited purchased 80% of the ordinary shares of Andei Limited on 1 May 2005. On 30 September 2005, the trial balances of the two companies were as follows:

	Mtito Ltd.	Andei Ltd.
	Sh.'000'	Sh.'000'
Cash at bank	-	11,500
Receivables	62,300	51,600
Dividend: Interim paid	4,500	3,000
Expenses (including depreciation of fixed assets)	184,700	123,600
Freehold land and buildings (net book value)	25,500	18,900
Investment in Andei Limited	94,260	
Motor vehicles (net book value)	6,700	4,900
Purchases	375,400	335,200
Plant and machinery (net book value)	28,900	21,600
Inventory	22,100	17,600
Taxation: installment tax paid	9,100	6,380
	813,460	594,280
Bank overdraft (secured on land and buildings)	6,700	
Payables	38,200	17,100
Sales	586,600	480,000
Share capital: Authorised, issued and fully paid Ordinary shares of Sh.10	60,000	20,000
Retained Profits	121,960	77,180
	813,460	594,280

Additional information:

(i) Closing inventory was Sh.24, 200,000 in Mtito and Sh.19,200,000 in Andei.

(ii) The turnover and expenses in Andei accrued evenly over the year; the rate of gross profit was constant throughout the year.

(iii) Mtito paid its interim dividend on 15th May 2005; Andei paid its interim dividend on 31 March 2005. Mtito has not yet accounted for any dividend receivable from Andei.

(iv) Between 1 May 2005 and 30 September 2005, Mtito sold goods to Andei. These goods had cost Mtito Sh.30 million. Mtito earned a gross profit of 37.5% on the selling price of these goods. On 30 September 2005, one sixth of these goods were included in the stock of Andei. Included in the debtors figure for Mtito was Sh. 7,200,000 from Andei: Mtito's account in Andei's books agreed with this figure.

(v) The self assessment tax returns of Mtito and Andei show the corporation tax charge for the year at **Sh.**10,020,000 and **Sh.**7,980,000 respectively; both companies have paid installment tax on the preceding year basis.

(vi) The directors have proposed that Mtito should pay a final dividend of **Sh.**6 million and Andei **Sh.**3 million.

(vii) Goodwill arising on the acquisition of Andei is considered to be impaired at sh.1million.

Required:

A consolidated income statement for the year ended 30 September 2005 (including reconciliations of the retained profit for the year and carried forward) and a consolidated balance sheet as at 30 September 2005.

Solution:

Please note that the examiner has not given us the respective final accounts of the holding company and the subsidiary. It will be important therefore to prepare the three sets of accounts on and present them in columnar form for the purpose of presentation. However if possible, only present the group final accounts and the individual accounts can be presented as a working.

Mtito Ltd and Andei Ltd

Income statement for year to 30 September 2005

	Mtito	Andei	Group
	Sh. '000'	Sh. '000'	Sh. '000'
Sales	586,600	480,000	738,600
Cost of sales:			
Opening inventory	22,100	17,600	
Purchases	375,400	335,200	
	397,500	352,800	
Less closing inventory	(24,200) 373,300	(19,200) 333,600	
Gross profit	213,300	146,400	467,300
Expenses	(184,700)	(123,600)	(236,200)
Goodwill impairment		-	(1000)
Operating profit	28,600	22,800	34,100
Dividend income	2,000	-	-
Profit before tax	30,600	22,800	34,100
Income tax expense	(10,020)	(7,980)	(13,345)
Profit after tax	20,580	14,820	20,755
Less MI	-	-	(1,235)
Profit attributable to Shareholders of Mtito	20,580	14,820	19,520
Dividends: Paid	(4,500)	(3,000)	(4,500)
Dividends: Proposed	(6,000)	(3,000)	(6,000)
	132,040	86,000	130,980

Retained profits:	Yr	c/f
Holding Co Mtito)	6,080	128,040
Subsidiary Andei)	2,940	2,940
	9,020	130,980

Workings for intergroup sales

Sales = (30m X 0.6) +30000 = 48m

Group sales = (586,600 + (5/12 X 480,000)) – 48,000 = 738600

Group cost of sales = 373300 + (5/12 X 333600) – 48,000 + VP = 467300;

where VP = (1/6 X (48,000 – 30,000) = 3,000

Group expenses = 184700 + (5/12 X 123,600) = 236,200

Dividend income

	7 months	5 months

Total dividend payable by Andei = 6,000

Total dividend accountable for by Mtito = 80% X 6,000 = 4,800

	Pre acq	post acq
	7/12 X 4,800	= 5/12 X 4,800
	= 2,800	= 2,000

Dividend receivable = 2,400

Post acq P&L) = (2,000)

Pre acq COC) = 400

Minority interest:

Profit after tax in Andei	14,820
Less pre acq	(8,645)
Amount in Group P & L	6,175
MI 20%)	1,235

Statement of retained profits:

Retained profits:	**b/f**	**Yr**	**c/f**
	Sh. '000'	Sh. '000'	Sh. '000'
Holding co: Mtito)	121,960	10,080	132,040
UPCS	-	(3,000)	(3,000)
Goodwill impaired	-	(1,000)	(1,000)
	121,960	6,080	128,040
Subsidiary: Andei)	77,180	(5,145)	(82,325)
Less pre-acq profits	(77,180)	(5,145)	(82,325)
		3,675	3,675
Group share 80%)	-	2,940	2,940

Mtito Ltd and Andei Ltd

Balance Sheet as at 30 September 1996

	Mtito	Andei	Group
	Sh.'000'	**Sh.'000'**	**Sh.'000'**
Non-Current Assets			
Property Plant and Equipment			
Land and Buildings	25,500	18,900	44,400
Plant and Machinery	28,900	21,600	50,500
Motor vehicles	6,700	4,900	11,600
	61,100	45,400	106,500
Goodwill	-	-	11,000
Investments: In subsidiary	93,860	-	-
	154,960	45,400	117,500
Current assets			
Inventory	24,200	19,200	40,400
Receivables	62,300	51,600	106,700
Dividends rec'able	2,400	-	-
Cash at bank	-	11,500	11,500
	88,900	82,300	158,600
Total Assets	243,860	127,700	276,100
Capital and Reserves			
Ordinary shares @ Sh.10	60,000	20,000	60,000
Profit and Loss	132,040	86,000	130,980
	192,040	106,000	190,980
MI	-	-	21,200
	192,040	106,000	212,180
Current liabilities			
Payables	38,200	17,100	48,100
Tax payable	920	1,600	2,520
Proposed dividends	6,000	3,000	6,000
Div to M1	-	-	600
Bank o/d	6,700	-	6,700
	51,820	21,700	63,920
Total Equity and Liabilities	243,860	127,700	276,100

1.2 GROUP STRUCTURES

The relationship between the holding company and the subsidiaries is referred to as the group structure. Apart from a situation where the holding company has only one subsidiary, the following are examples of different types of structures and their accounting approach:

(i) Holding company with more than one subsidiary: This type of situation is straight forward as the procedure involves consolidating the results of the holding with its subsidiaries the normal way. However separate computation of goodwill for each subsidiary is required.

(ii) Holding company with a subsidiary company and a sub-subsidiary: In these type of structure, the holding company owns a subsidiary company which owns another subsidiary company called a sub-subsidiary company: The consolidation process is also the same as before only that for the purpose of consolidating the sub-subsidiary, we need to determine the effective shareholding and minority interest for the group.

The following example will help illustrate the accounting approach.

>>> Example 2 – Sub-subsidiary

Ademo Limited is a company quoted on the Nairobi Stock Exchange. It distributes a wide variety of household machinery including sewing machines. On 1 October 1997 it purchased shares in Afro clothing Limited. The group purchased shares in Piki Limited, a nation wide chain of retail shops dealing in casual wear on 1 April 1998. All the companies make up their accounts to 31 March each year.

The draft final accounts for the three companies for the year ended 31 March 2000 are as follows overleaf:

Income statements for the year ended 31 March 2000.

	Ademo Ltd	Afro Ltd	Piki Ltd
	Sh.m	Sh.m	Sh.m
Revenue	1,368	774	685
Cost of sales	(810)	(407)	(355)
Gross profit	558	367	330
Distribution costs	(196)	(64)	(78)
Administration expenses	(112)	(73)	(72)
Finance cost	(50)	(20)	0
Profit before tax	200	210	180
Income tax expense	(60)	(60)	(50)
Profit after tax	140	150	130
Proposed dividends	(150)	(100)	(100)
Retained profits for the year	(10)	50	30
Retained profits brought forward	713	610	420
Retained profit carried forward	703	660	450

Balance sheet as at 31 March 2000	Ademo Ltd	Afro Ltd	Piki Ltd
Non current assets	Sh.m	Sh.m	Sh.m
Property, plant and equipment	853	415	495
Investment in Afro	702		
Investment in Piki		405	
	1555	820	495
Current assets			
Inventory	368	200	190
Trade receivables	380	230	240
Cash at bank	120	115	91
Total assets	2,423	1,365	1,016
Ordinary share capital	900	200	100
Retained profits	703	660	450
Shareholders’ funds	1,603	860	550
Noncurrent liabilities			
10% loan stock	500	200	0
Current liabilities			
Trade and other payables	140	175	346
Current tax	30	30	20
Proposed Dividends	150	100	100
Total equity and liabilities	2,423	1,365	1,016

The following additional information is available:

(i) On 1 October 1997 Ademo Ltd acquired 16 million sh.10 ordinary shares in Afro Clothing Ltd. For Kshs 602 million when the retained profits of Afro Ltd was Kshs 490 million. Ademo also acquired half of the loan stock in Afro on 1 April 1999.

(ii) On 1 April 1998 Afro Ltd acquired 7.5 million **Sh.**10 ordinary shares in Piki Ltd for **Sh.**405 million when the retained profits of Piki Ltd amounted to sh. 300 million. On this date the a leasehold property had a fair value of **Sh.**40 million in excess of the book value and 10 years remaining on the lease. Depreciation charge on the book value of the lease is included as part of administration expenses.

(iii) In the year ended 31 March 2000 Piki Ltd sold goods at a price of **Sh.**80 million. Piki Ltd had marked up these goods by 100% on cost. Afro Ltd held 50% of these goods in stock on 31 March 2000.

(iv) In the year ended 31 March 2000 Afro Ltd sold Ademo Ltd goods at a price of sh.90 million. Afro Ltd had marked up these goods by 80% on cost. Ademo Ltd held 25% of these goods in stock on 31 March 2000.

(v) On 1 April 1999 Ademo Ltd sold sewing machines to Afro Ltd for sh.150 million. Afro Ltd included these machines in its PPE and charges depreciation of 20% on cost. Ademo Ltd had marked up these items at 50% on cost. Afro Ltd includes the depreciation of these machines in its cost of sales.

(vi) On 31 March 200 all the inter company balances are in agreement with Afro Ltd owing Piki Ltd **Sh.** million and Ademo Ltd owing Afro Ltd sh.18 million. Meanwhile the group had not yet paid the interest due on the respective loan stocks, the balances included in the trade and other payables.

(vii) In the current year the management feels that half of the goodwill has been impaired. This impairment loss is to be charged as a separate item in the income statement.

Required

The consolidated income statement for the year ended 31 March 2000 and a consolidated balance sheet as at the same date. (25 marks)

Solution:

Ademo and Its subsidiaries

Consolidated Income statement for the year ended 31 March 2000

	Sh.	**Sh.**
Revenue		2,507.00
Cost of Sales		(1,322.00)
Gross Profit		1,185.00
Expenses		
Distribution Costs	338.00	
Administration Expenses	261.00	
Goodwill impaired	55.00	
Finance costs	60.00	(714.00)
Profit before tax		471.00
Income tax expense		(170.00)
Profit for the period		301.00
Profit attributable to: Holding Company		228.60
Minority interest		72.40
		301.00

Consolidated statement of changes in equity (Extract)

		Retained Profits
	Sh.	Sh
Balance as at 1 April 1999		878.60
Profit for the period		228.60
		1,107.20
Less proposed dividends		(150.00)
Balance as at 31 March 2000	-	957.20

Ademo and Its subsidiaries

Consolidated Balance sheet as at 31 March 2000

	Sh.	Sh.
Non Current Assets		
Property, plant and equipment		1,755.00
Goodwill		55.00
		1,810.00
Current assets		
Inventory	728.00	
Trade Receivables	808.00	
Cash at bank	326.00	1,862.00
TOTAL ASSETS		3,672.00
Ordinary Share Capital		900.00
Retained Profits		957.20
		1,857.20
Minority Interest		330.80
Shareholders' funds		2,188.00
Non-Current Liabilities		
10% Loanstock		600.00
Current Liabilities		
Trade & Other payables	609.00	
Current tax	80.00	
Proposed dividends	195.00	884.00
TOTAL EQUITY & LIABILITIES		3,672.00

Statement of retained profits	b/f	Yr	C/f
Ademo	713.00	(25.00)	688.00
Share in Afro	96.00	100.00	196.00
Share in Piki	69.60	3.60	73.20
	878.60	78.60	957.20

Workings			
Ademo			
As per the accounts	713.00	(10.00)	703.00
Add Divs receivable		80.00	80.00
Interest receivable		10.00	10.00
Less UPPPE		(50.00)	(50.00)
Less Goodwill Impaired		(55.00)	(55.00)
	713.00	(25.00)	688.00
Share in Afro			
As per the accounts	610.00	50.00	660.00
Less preacquisition	(490.00)	-	(490.00)
	120.00	50.00	170.00
Less UPCS	-	(10.00)	(10.00)
Add excess depreciation		10.00	10.00
Add Divs Receivable	-	75.00	75.00
	120.00	125.00	245.00
Share of Ademo (80%)	96.00	100.00	196.00

Share in Piki

As per the accounts	420.00	30.00	450.00
Less Preacquisition	(300.00)	-	(300.00)
	120.00	30.00	150.00
Less UPCS		(20.00)	(20.00)
Less depn on FV adjustment	(4.00)	(4.00)	(8.00)
	116.00	6.00	122.00
Share of Ademo at 60%	69.60	3.60	73.20

Workings

P & L Items

	Revenue	COS	DIST	ADM	FIN	TAX
Ademo	1,368.00	810.00	196.00	112.00	50.00	60.00
Afrol	774.00	407.00	64.00	73.00	20.00	60.00
Piki	685.00	355.00	78.00	72.00	-	50.00
	2,827.00	1,572.00	338.00	257.00	70.00	170.00
Less:						
Sales by Pi to Af	(80.00)	(80.00)				
Sales by Af to Ad	(90.00)	(90.00)				
Sales by Ad to Af	(150.00)	(100.00)				
Excess depn (20% x 50)		(10.00)				
Interco. Interest					(10.00)	
Add:						
UPCS: Pi to Af		20.00				
UPCS: Af to Ad		10.00				
Depreciation due to FV				4.00		
	2,507.00	1,322.00	338.00	261.00	60.00	170.00

2. Goodwill impaired (separate goodwill figures for Afro and Piki)

		Afro		Piki
Cost of investment		602.00		324.00
Less:				
OSC	160.00		60.00	
P & L	392.00		180.00	
FV adjustment	-	(552.00)	24.00	(264.00)
		50.00		60.00
Impairment		25.00		30.00

3. Profit attributable to Minority Interest in the P & L

		Afro		Piki
PAT		150.00		130.00
Less:				
UPCS: Pi to Af	-		(20.00)	
UPCS: Af to Ad	(10.00)		-	
Depreciation due to FV	-	(10.00)	(4.00)	(24.00)
		140.00		106.00
Less:				
Excess depreciation		10.00		0
Adjusted PAT		150.00		106.00
MI's share at 20% and 40%		150.00		106.00
MI's share at 20% and 40%		30.00		42.40

STUDY TEXT

4. Retained Profit b/f

			Sh.
Ademo	Afro	Piki	
	Sh.	Sh.	
Balance b/f	610.00	420.00	
Less pre acquisition	(490.00)	(300.00)	
	120.00	120.00	
Less depreciation on FV adjustment b/f	______	(4.00)	
	120.00	116.00	
Share of Ad @ 80% & 60%	96.00	69.60	165.60
			878.60

	Afro	Piki	
	Shm	Sh.	
Shareholders' funds	860.00	550.00	
ADD: FV adjustment	-	40.00	
Excess depreciation	10.00	-	
	870.00	590.00	
Dividends in Piki (0.75 x 100)	75.00		
LESS: UPCS	(10.00)	(20.00)	
Depreciation on FV Adju. (2 yrs)		(8.00)	
Adjusted shareholders funds	935.00	562.00	
MI's share at 20% and 40%	187.00	224.80	411.80
Less share of Investment in Piki (0.2 x 405)			(81.00)
			330.80

5. Minority interest in the balance sheet

(i) The holding company and subsidiary company both have a direct shareholding in sub-subsidiary company: he accounting treatment is similar to that discussed in (ii) above and care should be taken when computing the effective shareholding of the group in the sub-subsidiary company. The following example illustrates this position:

STUDY TEXT

>>> Example 3

Rain Ltd., Storm Ltd. and Thunder Ltd. are in the business of manufacturing tents. Their balance sheets as at 30 September 2003 were as below:

	Rain Ltd.		Storm Ltd.		Thunder Ltd.	
	Sh.	Sh.	Sh.	Sh.	Sh.	Sh.
	"000"	"000"	"000"	"000"	"000"	"000"
Non-current assets:						
Non-current assets (net of depreciation)		14,000		6,300		1,700
Shares in subsidiaries		5,000		1,900		-
		19,000		8,200		1,700
Current assets:						
Inventory	2,000		1,200		1,600	
Trade payables	4,800		2,000		800	
Cash	2,700		1,400		1,100	
	9,500		4,600		3,500	
Current liabilities:						
Trade payables	4,800		2,000		800	
Cash	2,700		1,400		1,100	
	9,500		4,600		3,500	
Current liabilities:						
Trade payables	(5,000)		(2,600)		(1,800)	
Net current assets		4,500		2,000		1,700
		23,500		10,200		3,400
Financed by:						
Authorised and issued						
Share capital:						
Ordinary shares of Sh.100						
Each fully paid		15,000		5,000		2,000
10% preference shares of Sh. 100 each fully paid		-		3,000		1,000
Retained Profits		2,500		(800)		400
		23,500		10,200		3,400

Additional information:

1. Rain Ltd. purchased 30,000 ordinary shares in Storm Ltd. on 1 October 2001 for Sh. 3,400,000 and 5,000 preference shares on 1 October 2002 for Sh. 600,000. On 1 October 2002, Rain Ltd. purchased 5,000 ordinary shares in Thunder Ltd. for Sh. 1,000,000. Storm Ltd. purchased 11,000 ordinary shares in Thunder Ltd. for Sh. 1,900,000 on the same date.

STUDY TEXT

2. Balances are as given below:

Profit and loss account

Storm Ltd.	1 October 2001	Sh. 500,000 (debit).
	1 October 2002	Sh. 600,000 (debit).
Thunder Ltd.	1 October 2002	Sh. 300,000 (debit).

General reserve

Storm Ltd.	1 October 2001	Sh. 1,000,000
	1 October 2002	Sh. 2,000,000
Thunder Ltd.	1 October 2002	-

3. The following inter-company balance are included in the balances of trade debtors and trade creditors:

Receivables	Rain Ltd.	Sh. 600,000 due from Thunder Ltd.
	Thunder Ltd.	Sh. 300,000 due from Rain Ltd.
		Sh. 200,000 due from Thunder Ltd.

4. On 30 September 2003, thunder Ltd. remitted Sh.200,000 to Rain Ltd. which was not received until 3 October. There were no other inter-company balances.

5. Rain Ltd. sold goods to Storm Ltd. for Sh.800,000. The goods had originally cost Rain Ltd. Sh.600,000. Storm Ltd. still had Sh.200,000 worth of these goods (at invoiced price) in stock as at 30 September, 2003.

Required:

Prepare the consolidated balance sheet of Rain Ltd. and its subsidiaries as at 30 September 2003.

Solution:

Rain Ltd and its subsidiaries

Consolidated Balance sheet as at 30 September 2003

	Sh.'000'	**Sh.'000'**
Non Current Assets		
PPE		22,000
Goodwill (W2)		1,006
		23,006
Current Assets		
Inventory (2 + 1.2 + 1.6 – 0.05) Receivables (W6)		
Cash (2.7 + 1.4 + 1.14 + 0.2)		
		16650
	4,750	39656
EQUITY AND LIABILITIES	6,500	
Share capital	5,400	
Sh.100 ordinary shares fully paid		15,000
General reserve (W5)		7,780
Retained Profits (W4) (300 + 2,028)		2,328
		25,108
Minority interest (W3)		6,048
		31,156
Current liabilities:		
	–	
Payables		8500
TOTAL EQUITY AND LIABILITIES		39,656

Workings

1. Determination of group ownership structure

	Storm Ltd			**Thunder Ltd**
	Ordinary	Preference		Ordinary
Rain Ltd:				25%
Direct				33%
Indirect	60%	1/6	(60% x 55%)	58%
Minority Interest	40%	5/6		42%

2. **Cost of Control**

	Sh.'000'		Sh.'000'
		Share of Storm equity	
Investment in Storm:		Ordinary share capital (60% x 5000)	3,000
Ordinary	3,400	General reserves (60% x 1000)	600
Preference	600		
Share of retained losses		Preference share capital (1/6 x 3,000)	
(60% x 500)	300	Goodwill I	500
	4,300		200
Investment in Thunder		Share of Thunder equity	4,300
(60% x 1,900) by	1,140	Ordinary share capital (58% x 2,000)	
Storm	1,000	Profit b/f (58% x 300)	1,160
Rain spent in Thunder	——	Goodwill II	174
			806
	6,440		6,440

Total goodwill on consolidation = 806 + 200 = 1,006

3. **Minority Interest**

	Sh.'000'		Sh.'000'
Cost of shares in Thunder	760	Storm Ltd: Equity	2,000
(40% x 1900)		Ordinary share capital (40% x 5000)	2,500
		Preference share capital (5/6 x 3000)	1,200
Storm Ltd Profit & Loss	320	General reserve (40% x 3000)	
40% x 800)		Thunder Ltd: Equity	840
Consolidated balance		Ordinary share capital (42% x 2000)	-
sheet		Preference share capital	420
	6,048	General reserve (42% x 1000)	
		Thunder Ltd Profit & Loss	168
		(42% x 400)	
	7,128		7,128

4. **Group retained Earnings A/c**

		Sh.'000'		Sh.'000'
Rain Ltd			Bal b/d: Rain	2,500
UPCs (200/800 x 200)		50	Cost of control a/c	
Bal b/f		800	(60% x 500)	300
Thunder ltd:			Minority Interest A/c	
Cost of control a/c			(40% x 800)	320
25% x 300	75		Bal b/d: Thunder	400
33% x 300	99	174		
Minority interest				
(42% x 400)		168		
Consolidated balance sheet		2,328		——
		3,520		3,520

5.

Consolidated General reserve

	Sh.'000'		Sh.'000'
Storm Ltd: COC (60% x 1000)	600	Bal b/f	6,000
MI (40% x 3000)	1,200	Rain	3,000
Thunder: MI (42% x 1,000)	420	Storm	1,000
Consolidated balance sheet	7,780	Thunder	
	10,000		10,000

6. **Group Receivables A/c**

	Sh.'000'		Sh.'000'
Rain Ltd	4,800	Cash in transit (Thunder)	200
Storm Ltd	2,000	Group creditors: T – R	400
Thunder Ltd	800	R – S	300
		T – S	200
		To consolidated balance sheet	6,500
	7,600		7,600

7. **Group Payables A/c**

	Sh.'000'		Sh.'000'
Group debtors	900	Rain Ltd	5,000
To consolidated balance sheet	8,500	Storm Ltd	2,600
		Thunder Ltd	1,800
	9,400		9,400

(ii)

Multiple group structure: In this type of Structure the holding company has several subsidiaries that also have sub-subsidiaries. It is not examinable within this scope and applies only in practice.

1.3 ASSOCIATES COMPANIES (IAS 28)

FAST FORWARD: A holding of 20% or more of the voting power (directly or through subsidiaries) will indicate significant influence unless it can be clearly demonstrated otherwise.

IAS 28 applies to all investments in which an investor has significant influence but not control or joint control except for investments held by a venture capital organization, mutual fund, unit trust, and similar entity that (by election or requirement) are accounted for as held for trading under IAS 39. Under IAS 39, those investments are measured at fair value with fair value changes recognised in profit or loss.

The following are important definitions in IAS 28:

Associate: An enterprise in which an investor has significant influence but not control or joint control.

Significant influence: Power to participate in the financial and operating policy decisions but not control them.

Equity method: A method of accounting by which an equity investment is initially recorded at cost and subsequently adjusted to reflect the investor's share of the net profit or loss of the associate (investee).

Identification of Associates

If the holding is less than 20%, the investor will be presumed not to have significant influence unless such influence can be clearly demonstrated. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(i) Representation on the board of directors or equivalent governing body of the investee; participation in the policy-making process;

(ii) Material transactions between the investor and the investee; interchange of managerial personnel; or

(iii) Provision of essential technical information.

(iv) Potential voting rights are a factor to be considered in deciding whether significant influence exists.

1.3.1 ACCOUNTING FOR ASSOCIATES (IAS 28)

In its consolidated financial statements, an investor should use the equity method of accounting for investments in associates, other than in the following three exceptional circumstances:

(i) An investment in an associate that is acquired and held exclusively with a view to its disposal within 12 months from acquisition should be accounted for as held for trading under IAS 39. Under IAS 39, those investments are measured at fair value with fair value changes recognised in profit or loss.

(ii) A parent that is exempted from preparing consolidated financial statements by paragraph 10 of IAS 27 may prepare separate financial statements as its primary financial statements. In those separate statements, the investment in the associate may be accounted for by the cost method or under IAS 39.

(iii) An investor need not use the equity method if all of the following four conditions are met:

a. the investor is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;

b. the investor's debt or equity instruments are not traded in a public market;

c. the investor did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

d. the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

Applying the Equity Method of Accounting

Basic principle: Under the equity method of accounting, an equity investment is initially recorded at cost and is subsequently adjusted to reflect the investor's share of the net profit or loss of the associate.

Distributions and other adjustments to carrying amount:

Distributions received from the investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be required arising from changes in the investee's equity that have not been included in the income statement (for example, revaluations).

Potential voting rights:

Although potential voting rights are considered in deciding whether significant influence exists, the investor's share of profit or loss of the investee and of changes in the investee's equity is determined on the basis of present ownership interests. It should not reflect the possible exercise or conversion of potential voting rights.

Implicit goodwill and fair value adjustments:

On acquisition of the investment in an associate, any difference (whether positive or negative) between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the associate is accounted for like goodwill in accordance with IFRS 3, Business Combinations. Appropriate adjustments to the investor's share of the profits or losses after acquisition are made to account for additional depreciation or amortisation of the associate's depreciable or amortisable assets based on the excess of their fair values over their carrying amounts at the time the investment was acquired. Any goodwill shown as part of the carrying amount of the investment in the associate is no longer amortised but instead tested annually for impairment in accordance with IFRS 3.

Discontinuing the equity method:

Use of the equity method should cease from the date that significant influence ceases. The carrying amount of the investment at that date should be regarded as a new cost basis.

Transactions with associates:

If an associate is accounted for using the equity method, unrealised profits and losses resulting from upstream (associate to investor) and downstream (investor to associate) transactions should be eliminated to the extent of the investor's interest in the associate. However, unrealised losses should not be eliminated to the extent that the transaction provides evidence of an impairment of the asset transferred.

Date of associate's financial statements:

In applying the equity method, the investor should use the financial statements of the associate as of the same date as the financial statements of the investor unless it is impracticable to do so. If it is impracticable, the most recent available financial statements of the associate should be used, with adjustments made for the effects of any significant transactions or events occurring between the accounting period ends. However, the difference between the reporting date of the associate and that of the investor cannot be longer than three months.

Associate's accounting policies:

If the associate uses accounting policies that differ from those of the investor, the associate's financial statements should be adjusted to reflect the investor's accounting policies for the purpose of applying the equity method.

Losses in excess of investment:

If an investor's share of losses of an associate equals or exceeds its "interest in the associate", the investor discontinues recognising its share of further losses. The "interest in an associate" is the carrying amount of the investment in the associate under the equity method together with any long-term interests that, in substance, form part of the investor's net investment in the associate. After the investor's interest is reduced to zero, additional losses are recognised by a provision (liability) only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

Impairment:

The impairment indicators in IAS 39, Financial Instruments: Recognition and Measurement, apply to investments in associates. If impairment is indicated, the amount is calculated by reference to IAS 36, Impairment of Assets. The recoverable amount of an investment in an associate is assessed for each individual associate, unless the associate does not generate cash flows independently.

>>> Example 4 Associate Companies

Amua Limited purchased 80% of the ordinary share capital of Sawana Limited on 31 January 1999 for Sh.496 million and 20% of the ordinary share capital of Ukwala Limited on 31 July 1998 for Sh.56 million. Profits in all companies are deemed to accrue evenly over the year.

The draft accounts for the three companies are shown below:

Additional information:

Amua Limited has not yet accounted for dividends receivable from either its subsidiary or its associated company.

Goodwill arising in the acquisition of the holding company and associate company is considered to have been impaired at the rate of 20% per annum on cost.

Required:

The consolidated income statement (which should be in accordance with the International Accounting Standard No. 1, showing expenses by function) for the year ended 30 April 1999, and the Consolidated balance sheet as at that date.

Balance Sheet as at 30 April 1999

	Amua Ltd Sh. million	Sawana Ltd Sh .million	Ukwala Ltd Sh. million
PPE (NBV)	414	280	220
Investments	552	-	-
	966	280	220
Current assets			
Inventory	180	210	70
Receivables	240	140	56
Bank	28	12	21
	448	362	147
Current Liabilities			
Payables	189	109	45
Tax	7	3	2
Proposed Divs	63	40	40
	259	152	87
	189	210	60
Net current assets	1,155	490	280
OSC of Sh.10 each	700	200	200
Retained earnings	175	290	80
		490	280
S/holders Funds	875		
15% Debentures	280		
	1,155		

Profit and loss accounts for the year ended 30 April 1999

	Amua Ltd Sh .million	Sawana Ltd Sh .million	Ukwala Ltd Sh. Million
Sales	2,346	2,400	1,400
Cost of sales	(1,564)	(1,620)	(840)
Gross profit	782	780	560
Distribution costs	(310)	(400)	(200)
Admin expenses	(240)	(200)	(180)
Profit from operations	232	180	180
Interest on debentures		-	-
Profit before tax	(42)		
Taxation			
Profit after tax			
Dividends proposed	190	180	180
Retained profits	(72)	(40)	(20)
For the year	118	140	160
Brought forward	63	40	40
Carried forward			
	55	100	120
	120	190	(40)
	175	290	80

Solution:

Amua Ltd and its subsidiary co.

Consolidated income statement for the year ended 30 April 1999.

	Sh.M	**Sh.M**
Sales		2,946
Cost of sales		(1,969)
Gross profit		977
Share of profit after tax in associate co		
		24
Distribution costs	410	1,001
Administration costs	297.4	
Finance cost	42	
Profit before tax		(749.4)
Income tax expense		251.6
Profit for the period		(82)
Profit attributable to : ordinary shareholders		169.6
: Minority Interest		162.6
		7
		169.6

Statement of changes in equity extract

	Retained Profits
	Sh.'000'
Bal as at 30.4..98	120
Transfer to reserve	162.6
Profit for year	
	63
Dividends:	
Final	(63)
Bal as at 30.4..99	219.6

Amua Ltd and its subsidiary co.

Balance sheet as at 30 April 1999

	Sh.M	Sh.M
Non-current assts		
Plant, property and Equipment		694
Goodwill		95
Investment In associate		69.6
		858.6
Current assets		
Inventory	390	
Receivables	380	
Dividend receivable from Ukwala	8	
Bank	40	
		818
		1676.6
Capital and Reserves	-	
Ordinary share @ sh.10		700
Capital Reserve		2
Retained profit		217.6
		319.6
Minority interest		
Noncurrent liabilities		98
15% debentures		
		280
		1,297.6.
Current liabilities	298	
Payables	10	
Tax payable	63	
Proposed dividends Group	8	
Dividend to MI		379
		1676.6

TOTAL EQUITY AND LIABILITIES

Minority Interest

	Sh.M		Sh.M
Bal C/d	98	OSC	40
		P& L	58
	98		98

Retained Profits

	Sh. M		Sh.M
Capital Reserve	2	Pre-acquisition dividend	175
Goodwill written off: S	5	OSC	20
U	2.4	P& L	18
Balance c/d	217.6	Goodwill: Written off	8
		C/d	6
	227		227

STUDY TEXT

Goodwill (Premium) in Associate

	Sh.M.	Sh.M
Investment (56m less pre acquisition dividend of Sh. 2m)		54
OSC	200	
P& L	(10)	
	190	
Group share (20%)		38
Full goodwill		16
Goodwill impaired (for only 9 months)		2.4

Investment in associate

	Sh.M.	Sh.M
Investment		54
Group share of past acquisition profit	18	
Goodwill impaired	(2.4)	15.6
		69.6

Cost of Control

	Sh.M			Sh.M
Investment in S	496	Pre-acquisition dividend		24
		OSC		160
		P& L		212
		Goodwill:Written off	5	
		C/d	95	100
	496			496

1.4 JOINTLY CONTROLLED ENTITIES (IAS 31)

IAS 31 applies to accounting for all interests in joint ventures and the reporting of joint venture assets, liabilities, income, and expenses in the financial statements of ventures and investors, regardless of the structures or forms under which the joint venture activities take place, except for investments held by a venture capital organisation, mutual fund, unit trust, and similar entity that (by election or requirement) are accounted for as held for trading under IAS 39.

Important definitions in IAS 31

Joint venture:

A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Venturer:

A party to a joint venture and has joint control over that joint venture.

Investor in a joint venture:

A party to a joint venture and does not have joint control over that joint venture.

Control:

Refers to the power to govern the financial and operating policies of an activity so as to obtain benefits from it.

Joint control:

The contractually agreed sharing of control over an economic activity such that no individual contracting party has control.

IAS 31 deals with three types of joint Ventures

(i) Jointly Controlled operations,

(ii) Jointly Controlled assets,

(iii) Jointly Controlled Assets

(i) Jointly Controlled Operations

Jointly controlled operations involve the use of assets and other resources of the venturers rather than the establishment of a separate entity. Each venturer uses its own assets, incurs its own expenses and liabilities, and raises its own finance. IAS 31 requires that the venturer should recognise in its financial statements the assets that it controls, the liabilities that it incurs, the expenses that it incurs, and its share of the income from the sale of goods or services by the joint venture. [IAS 31.15]

(ii) Jointly Controlled Assets

Jointly controlled assets involve the joint control, and often the joint ownership, of assets dedicated to the joint venture. Each venturer may take a share of the output from the assets and each bears a share of the expenses incurred. IAS 31 requires that the venturer should recognise in its financial statements its share of the joint assets, any liabilities that it has incurred directly and its share of any liabilities incurred jointly with the other venturers, income from the sale or use of its share of the output of the joint venture, its share of expenses incurred by the joint venture and expenses incurred directly in respect of its interest in the joint venture.

(iii) Jointly Controlled Entities

A jointly controlled entity is a corporation, partnership, or other entity in which two or more venturers have an interest, under a contractual arrangement that establishes joint control over the entity. Each venturer usually contributes cash or other resources to the jointly controlled entity. Those contributions are included in the accounting records of the venturer and recognised in the venturer's financial statements as an investment in the jointly controlled entity.

IAS 31 allows two treatments of accounting for an investment in jointly controlled entities – except as noted below:

(i) Proportionate consolidation.
(ii) Equity method of accounting.

Proportionate consolidation or equity method is not required in the following exceptional circumstances:

(i) An investment in a jointly controlled entity that is acquired and held exclusively with a view to its disposal within 12 months from acquisition should be accounted for as held for trading under IAS 39. Under IAS 39, those investments are measured at fair value with fair value changes recognised in profit or loss.

(ii) A parent that is exempted from preparing consolidated financial statements by paragraph 10 of IAS 27 may prepare separate financial statements as its primary financial statements. In those separate statements, the investment in the jointly controlled entity may be accounted for by the cost method or under IAS 39.

An investor in a jointly controlled entity need not use proportionate consolidation or the equity method if all of the following four conditions are met:

1. the investor is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying proportionate consolidation or the equity method;

2. the investor's debt or equity instruments are not traded in a public market;

3. the investor did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

4. the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

i) Proportionate Consolidation

Under proportionate consolidation, the balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The income statement of the venturer includes its share of the income and expenses of the jointly controlled entity.

IAS 31 allows for the use of two different reporting formats for presenting proportionate consolidation:]

The venturer may combine its share of each of the assets, liabilities, income and expenses of the jointly controlled entity with the similar items, line by line, in its financial statements; or

The venturer may include separate line items for its share of the assets, liabilities, income and expenses of the jointly controlled entity in its financial statements.

(ii) Equity Method

Procedures for applying the equity method are the same as those described in IAS 28 Investments in Associates.

1.5 MERGER VS ACQUISITION (IFRS 3)

Definition of business combination/Merger

A business combination is the bringing together of separate entities or businesses into one reporting entity.

Scope exclusions

IFRS 3 applies to all business combinations except combinations of entities under common control, combinations of mutual entities, combinations by contract without exchange of ownership interest, and formations of joint ventures.

Method of Accounting for Business Combinations

Purchase method

All business combinations within the scope of IFRS 3 must be accounted for using the purchase method. The pooling of interests method is prohibited.

Acquirer must be identified

The old IAS 22 had required the pooling method if an acquirer could not be identified. Under the pooling of interest method/merger accounting no goodwill arose on consolidation, there was no distinction between the post acquisition and pre acquisition profits and consolidation was carried out as if the companies have been one entity despite acquisition partway during the year. The main form of acquisition was by way of share for share exchange in addition to cash payment. However, the investment in the 'acquiring' company was valued at the par value of shares issued. The difference between Par value of shares issued plus cash paid and the par value of shares received was referred to as difference on consolidation or merger reserve. Difference on consolidation is a debit balance that was written off against the group reserves while a merger reserve is a credit balance that is shown in the consolidated balance sheet together with the other group reserves.

The following two examples are comprehensive and include all the companies that have been covered so far (Subsidiaries, Associates and jointly controlled entities.) he merger method of accounting has been used for illustrative purpose only and is not to be used. IFRS 3 requires all mergers to be accounted for using the acquisition or purchase method. Under IFRS 3, an acquirer must be identified for all business combinations.

>> Example 6

Embamba Ltd., a company quoted on the Nairobi Stock Exchange, with 200 million shares in issue on 1 April 1996, has owned 75% of the ordinary share capital and 60% of the preference share capital of Fanya Limited since 1 April 1990 when the balance on the profit and loss account of Fanya Ltd. was Sh. 120 million.

On 1 July 1996, Fanya Ltd. purchased 40% of the ordinary share capital of Guvu Ltd. as a long-term investment and appointed two directors to its board.

On 1 October 1996, Embamba Ltd. purchased 50% of the ordinary share capital of Hadithi Ltd.; the other 50% was purchased by ABC Inc. a multi-national. Embamba and ABC both have joint control of Hadithi.

On 2 January 1997, Embamba Ltd., issued 138 million of its ordinary shares of Sh.10 to the owners of 92 million shares (in exchange for these shares) in Imani Ltd., which has 100 million ordinary shares u. Sh.10 in issue and which are quoted on the Nairobi Stock Exchange. The Registrar of Companies has approved the use of the merger method of accounting for this union. The market values of the shares in Embamba and Imani were Sh.40 and Sh.60 respectively as at the time. Neither Embamba nor Imani have any reserves other than their balances on the profit and loss accounts.

	E Ltd **Sh.m**	**F Ltd** **Sh. m**	**G Ltd** **Sh. M**	**H Ltd** **Sh. M**	**I Lttd** **Sh. m**
Revenue	6 000	1.440	960	820	7,200
Profit for the year	1,320	280	290	220	1,600
Dividends received	74	**20**			
	1394	**300**			
Taxation	**(460)**	**(100)**	**(90)**	(60)	(600)
Profit after tax	934	200	200	160	1,000
Preference divs paid	-	(40)	-	-	-
Ordinary dividends:					
Interim paid	(200)	(40)	(50)	(40)	(300)
Final proposed	(1,014)	(60)	(70)	(60)	(300)
	(1,214)	(100)	(120)	(100)	(600)
Retained profit for year	(280)	60	80	60	400

Statement of retained earnings

At 1 April 1996	2,480	580	360	210	1,200
Retained profit for year	(280)	60	80	60	400
At 31 March 1997	2,200	640	440	270	1,600

STUDY TEXT

All companies paid their interim dividends in the month of December 1996. Embamba Ltd. Considers that all goodwill is impaired at the rate of 20% per annum from the date of acqusition. The goodwill that had arisen on the purchase of Fanya Ltd. was Sh.80 million. The goodwill paid by Embamba Ltd. on the purchase of its shares in Hadithi Ltd. was Sh.50 million. The premium paid by Fanya on the purchase of its shares in Guvu Ltd. was Nil. Embamba Ltd. wishes to account for the results of Hadithi Ltd. in the same way as ABC Inc. does i.e. proportionate consolidation combining items on a line-by-line basis.

Required:

A consolidated income statement for the group in accordance with the relevant International Financial Reporting Standards; include a Statement of Retained Earnings, disclosing how much of the retained profit for the year and carried forward is included in the holding company, the subsidiary companies, the joint venture and the associated company. **(20 marks)**

Solutions:

NB: This is a June 1997 Question four. The format given was that used before ICPAK adopted International Accounting Standards. The solution is therefore K limited to the format but a few modifications have been made. Pay attention to the workings.

Embamba Ltd & its subsidiaries
Consolidated profit & loss a/c
For the year ended 31 March 1997

	Sh.	**Sh.**
Turnover		14845
Profit for the year: Group Loss		3250
Share of associate co.		62.25
		3,315.25
Taxation: Group Co.	1175	
Share of associate co.	20.25	(1195.25)
Profit after tax		2120
Minority interest		(131)
Profit attributable to Embamba		1989
Dividends: Interim paid	476	
Final proposed	1290	(1766)
Retained profits: For year		223
B/f		3389
C/f		3612

Retained Profit

	B/f	Yr	C/f
	Sh.	Sh.	Sh.
Embamba	1940	(235)	1705
Imani (Merger)	1104	368	1472
	3044	133	3175
Fanya (subsidiary)	345	57	402
Goro (Associate)	-	18	18
Hadithi (J.V.)	-	15	15
Group Co.	3389	223	3612

Workings

i)

Turnover:	Sh.	Profit for year
Embamba	6000	1320
F Ltd	1440	280
H Ltd (50 x $\frac{6}{12}$)	205	55
G Ltd	7200	1600
	14845	3255
Less: Goodwill amortised H Ltd	50% x 20% X 50	(5)
		3250

ii) Share of Associate Co. Profit for year and Tax

		Profit for Year	Tax
As per a/c	290		90
Prorated for nine months		217.5	67.5
Share (75% x 40%)		65.25	20.25

iii) Minority Interest

	Sh.		Sh.
MI in I Ltd	8% x 1000		80
MI in F Ltd:			
PAT	200		
Less inter company	(20)		
	180		
Preference	(40)	40%x40	16
PAOS	140 x 25%		35
			131

iv) Retained Profits

	b/f Sh.	yr Sh.	c/f Sh.
E Ltd	2480	(280)	2200
Div Receivable F	-	45	45
H	-	30	30
Re-acquisition div H Ltd (50% x 100 x $\frac{6}{12}$)	-	(25)	(25)
Goodwill amortisee F	(80)	-	(80)
H		(5)	(5)
Difference on Consolidation	(460)	-	(460)
	1940	(235)	1705
I Ltd	1200	400	1600
Share of E 92%	1104	368	1472

	b/f Sh.	yr Sh.	c/f Sh.
F Ltd	580	60	640
Div Receivable (40% X 70)	-	28	28
Re-acquisition div 40% x 120 x $\frac{3}{12}$	-	(12)	(12)
Re-acquisition profits	(120)	-	(120)
	460	76	536
Share of E 75%	345	57	402
H Ltd 60 x 50% x $\frac{6}{12}$	-	15	15
G Ltd 80 x $\frac{9}{12}$ x 40% x 75%	-	18	18

Difference on Consolidation

	Sh.
Par value of shares issued (138 x 10)	1380
Less Par value of share received (92 x 10)	920
	460

1.6 FOREIGN SUBSIDIARIES (IAS 21)

FAST FORWARD: The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

The objective of IAS 21 is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

Important definitions in IAS 21

Functional currency: The currency of the primary economic environment in which the entity operates. The term 'functional currency' is used in the 2003 revision of IAS 21 in place of 'measurement currency' but with essentially the same meaning. Presentation currency: The currency in which financial statements are presented.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Foreign operation: A subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

1.6.1 Foreign Currency Transactions

A foreign currency transaction should be recorded initially at the rate of exchange at the date of the transaction (use of averages is permitted if they are a reasonable approximation of actual). At each subsequent balance sheet dates:

Foreign currency monetary (Receivable and Payables) amounts should be reported using the closing rate.

Non-monetary (like property, plant and equipment) items carried at historical cost should be reported using the exchange rate at the date of the transaction.

Non-monetary items carried at fair value should be reported at the rate that existed when the fair values were determined.

Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognized or in previous financial statements are reported in profit or loss in the period, with one exception. The exception is that exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised, in the consolidated financial statements that include the foreign operation, in a separate component of equity; they will be recognised in profit or loss on disposal of the net investment. If a gain or loss on a non-monetary item is recognised directly in equity (for example, a property revaluation under IAS 16), any foreign exchange component of that gain or loss is also recognised directly in equity. Prior to the 2003 revision of IAS 21, an exchange loss on foreign currency debt used to finance the acquisition of an asset could be added to the carrying amount of the asset if the loss resulted from a severe devaluation of a currency against which there was no practical means of hedging. That option was eliminated in the 2003 revision.

>>> Examples

A number of examples are worked below to illustrate the accounting requirements for foreign currency transactions.

(a) Purchase of property, plant and equipment:

Joki Ltd agreed to purchase a piece of plant and machinery from a Dutch company for Guilders 2450 on 31 March 2001 to be paid for on 31 August 2001 at a contract rate of KSh 30.5. The Exchange rates on 31 March 2001 was G1 = KSh 30.

The plant and machinery will be recorded in the accounts at historic cost. This cost can be ascertained by reference to the effective fixed shilling price of KShs 74,725. Thus, the transaction would have been recorded as:

		KShs	KShs
DR	Plant and Machinery (30.5 x 2,450)	74,725	
CR	Notes payable A/c		74,725

This is the true liability for such a purchase and should therefore be used to value the creditor for the period that the debt is outstanding. No adjustment to this cost should be made in future period. Similar arguments would apply Joki Ltd had entered into a forward contract to purchase G2450 at KSh. 30.5 for every G1 on 31 August 2001.

If no contract rate had been agreed the asset would have to be recorded as costing KSh 73,500 (G2450 @ KSh 30) and as before no subsequent translations would be necessary. It is likely that an exchange difference would have risen on settlement.

(b) Payables

A Kenyan company purchases goods from a UK company in July 2001 for Ksh.550. The company paid off Kshs.200 in August 2001 and the balance was outstanding at the end of the year: i.e. 30 Sept. 2002.

Exchange rates were:

July 2001	Kshs.1 =	KSh 70
August 2001	Kshs.1 =	KSh 80.1
30 Sept. 2001	Kshs.1 =	KSh 82.7

The creditors account would appear as follows:

Payables Account

	KShs		KShs
Aug. 2001 Cash A/c (200 x 80.1)	16,020	July 2001 Purchase A/c (550 x 70)	38,500
Sept. 2001 Bal. c/d (350 x 82.7)	28,945	P & L (Bal figure)	6,465
	44,965		44,965

(c) Receivables

A Kenyan company sells goods to a German company for DM 3000. Payment is received in August 2001. Exchange rates were:

May 2001	1 DM = KShs 27.3
August 2001	1 DM = KShs 26.7

The Kenyan company would make the following entries in the ledger account:

Debtors Account

	Kshs		Kshs
May 2001 Sales A/c (27.3 x 3,000)	81,900	Aug. 2001 Cash A/c (3,000 x 26.7)	80,100
		P & L (Year End) Exchange loss	1,800
	81,900		81,900

Note:

The above example assumes that the Kenyan company invoices the German company in DM. If the invoicing were in Kenya Shillings, accounting problems would be far simpler.

(d) Long term Loans

Amabera Ltd, a Kenyan company acquired a loan from a Canadian bank on 1 January 2001 of Kshs.10, 000. The proceeds were converted into shillings and remitted to Kenya. The year-end for the Amabera Ltd is on 31 December 2001.

The Exchange rates were as follows:

1 Jan 2001	1 Kshs. = KSh 35.3
31 December 2001	1 Kshs. = KSh 33.4
31 December 2001	1 Kshs. = KSh 34.9

The loan account in the books of Amabera Ltd would appear as follows:

Loan Account

	Kshs		**Kshs**
31 Dec. 2001		1 Jan 2001	
Bal c/d (33.4 x 10,000)	334,000	Cash A/c (35.3 x 10,000)	353,000
P & L A/c (Exchange gain)	19,000		
	353,000		353,000
31.12.02 Bal c/d (34.9 x 10,000)	349,000	1.1.02 Bal b/d	334,000
		P & L A/c (Exchange loss)	15,000
	349,000		349,000

Notes:

i. The amounts outstanding at each year end (Kshs.10, 000) should be translated into Kenyan shillings at the exchange rate each year end.

ii. Exchange differences (2001 gain of 19,000/-, 2002 loss of 15,000/-) should according to the requirements of IAS 21 be reported in the profit and loss account as part of the profit from ordinary operations, but must be disclosed in the notes as an unrealised holding gain/loss.

1.6.2 The consolidated Financial Statements

This section deals with the second problem which a company may have in foreign currency translation namely the translation of complete financial statements of foreign entities (subsidiary, branches, associate companies).

The major problem is to determine which Currency to be used (determining the functional currency)

A holding company with a foreign operation must translate the financial statements of those operations into its own reporting currency before they can be consolidated into group accounts.

There are two methods normally used and each method depends on whether the foreign operation has the same functional currency as the parent. IAS 21 requires the firm to consider the following factors in determining its functional currency:

(i) The currency that influences the sales price for goods,

(ii) The currency of the country, whose competitive forces and regulations mainly determine the sales price of its goods and services,

(iii) The currency that influences labor, material and other costs.

Translation Methods

According to IAS 21, the method to be used is determined by the relationship between the holding company and the foreign entity concerned.

Two methods commonly used are:

(a) The Presentation Currency Method (Formerly called Net investment or Closing rate method)

This approach is normally used if the operations of the operations of the subsidiary company are different from those of the parent company and therefore the subsidiary is considered to be semi autonomous from the holding company.

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

(i) Assets and liabilities for each balance sheet presented (i.e. including comparatives) shall be translated at the closing rate at the date of that balance sheet;

(ii) Income and expenses for each income statement (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions, and

(iii) All resulting exchange differences shall be recognized as a separate component of equity.

For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example an average rate for the period, is often used to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

Under such circumstances, it is assumed that changes in the exchange rate has little or no direct effect on the activities or present and future cash flows from operations of either the parents or the foreign entity and because the foreign operation is not an integral part of the operations of the parent.

Translation Procedure

Balance sheet of a foreign entity

All balance sheet items should be translated into the reporting currency of the investing company using the rate of exchange ruling at the balance sheet date.

Profit and loss account of the foreign entity

Items should be translated at either an average rate for the period, or at the closing rate.

Exchange differences:

These may arise for three reasons:

- The rate of exchange ruling at the balance sheet date is different from that ruling at the previous balance sheet date. For example, land and buildings translated last year at one rate will be included in the consolidated balance sheet this year at a different rate.

- The average rate used to translate the profit and loss account differs from the closing rate.

The exchange differences may also arise out of measurements of cash flow differences (occurring immediately or in the future).

(b)The functional method (formerly referred to as temporal method)

IAS 21 states that where the operations of the foreign entity is an integral part of the operations of the parent company i.e. the affairs of a foreign subsidiary company are so closely interlinked with those of the holding company that the business of the foreign entity is regarded as a direct extension of the business of the investing company rather than as a separate and quasi independent business - the functional currency method should be used instead of the closing rate method.

IAS 21 gives the following as examples of situations where the temporal method should be used, where:

i. The foreign entity acts as a selling agency receiving stocks of goods from the investing company and remitting the proceeds back to the company.
ii. The foreign entity produces a raw material or manufactures parts or sub-assemblies which are then shipped to the investing company for inclusion in its own products.
iii. The foreign entity is located overseas for tax, exchange control or similar reasons to act as a means of raising finance for other companies in the group.

Note

Each subsidiary company must be considered separately. The relationship between each subsidiary and the holding company must be established so that the appropriate translation method can be determined. The method should then be used consistently from period to period unless the financial and other operational relationships which exist between the investing company and the subsidiary changes.

Translation Procedure

(a) Exchange differences out of translation should be reported either as part of the profit and loss for the year from ordinary operations or as an extraordinary item as the case may be.

(b) **Profit and loss items**

Item	**Rate**
Sales, cost of sales	Average
Depreciation charge	Historical
Expenses	Average
Tax charge	Average
Dividend paid	Actual (at date of payment)
Dividend proposed	Year end (closing)

(c) **Balance sheet items**

Fixed assets

(1) if acquired before subsidiary became part of the group, use exchange rate of date of acquisition of subsidiary

(2) If acquired post acquisition, use Historical cost.
Stock Rate on date of acquisition of stock (Year end is usually reasonable, practical approximation)

NOTE: The most commonly used method of translation is the Presentation method, and this should be used unless the examiner states otherwise.

Goodwill arising on consolidation is considered to be an asset of the subsidiary company and should therefore be translated using the closing rate method. Fair value adjustments are also translated at the closing rate.

>>> Example

Kenya Curios (KC) Limited purchased 80% of the ordinary share capital of Tanzan Artefacts (TA) Limited, a company incorporated in Tanzania; on 1 October 1995 when there was a credit balance on the profit and Loss Account of Tanzania (T) shillings 630 million. Both companies sell a range of products to tourists and to the tourist industry.

Draft income statements for the year ended 30 September 1998

	KC Ksh. Million	TA Tsh. Million
Revenue	930	2,211
Opening inventory	52	537
purchases	780	1,353
	832	1,890
Closing inventory	(57)	(702)
Cost of sales	775	1,188
Gross profit	155	1,023
Operating expenses	(29)	(99)
Depreciation	(18)	(76)
	(47)	(175)
Operating profit	108	848
Dividend from subsidiary	8	
Profit before tax	116	
Taxation	(33)	(242)
Profit after tax	83	606
Dividends: Interim paid	(20)	(112)
Final proposed	(40)	(420)
	(60)	(532)
	23	74
Retained profit:		
For the year	23	74
Brought forward	161	1,112
Carried forward	184	1,186

Draft Balance Sheets as at 30 September 1998

	KC Ksh. Million	TA Tsh. Million
PPE (Net book value)		
Land and buildings	90	1,764
Equipment	60	84
Motor vehicles	12	60
	162	1,908
Investment in subsidiary	312	
Current Assets:		
Inventory	57	702
Receivables	160	660
Bank	31	264
	248	1,626
Current liabilities:		
Payables	91	396
Taxation	7	132
Proposed dividend	40	420
	138	948
	110	678
	584	2,586
Financed by:		
Ordinary shares Sh. 10	400	1,400
Retained Profits	184	1,186
	584	2,586

Additional information:

1. In the year ended 30 September 1998, KC Limited sold goods worth Ksh. 98 million to TA Limited. These goods had cost KC Limited Ksh. 82 million. In the group accounts, the unrealised profit at the commencement of the year was Ksh. 6 million and Ksh. 8 million at the end of the year. Group policy is to recover the whole of the unrealised profit from group stock and from the company which made the profit, the minority interest bearing its share if appropriate. Dividends payable to minority interests are shown as current liabilities.

2. Both companies were established on 1 October 1993. The land, buildings and equipment of both companies were purchased on this date. All the motor vehicles in both companies were replaced on 29 September 1997 – No depreciation had been charged on these motor vehicles in the year ended 30 September 1997.

Both companies charge depreciation on the straight line basis at the following rates:

Land and buildings	:	2% per annum on cost (the land is leasehold and had 50 years remaining at 1 October 1993
Equipment	:	10% per annum
Motor vehicles	:	25% per annum

3. The fair values of TA's assets and liabilities on 1 October 1995 were the same as book values.

4. Sales, purchases and expenses occur evenly over the year. In TA, debtors represent 4 months' sales; creditors represent 3 months' purchases; stock represents 6 months' purchases. At 30 September 1998, TA owed KC Tsh.288 million, whilst KC's books showed that TA owed Ksh.24 million.

5. KC has not yet accounted for the dividend receivable from TA. The interim dividend was paid when the exchange rate was Ksh. 1 = Tsh. 11.2.

6. Relevant rates of exchange are:

1 October 1993	Ksh.1 = Tsh.6	30 September 1997	Ksh.2 = Tsh.10
1 October 1995	Ksh.1 = Tsh.7	31 March 1998	Ksh.1 = Tsh.11
31 March 1997	Ksh.1 = Tsh.9.3	30 June 1998	Ksh.1 = Tsh.11.7
30 June 1997	Ksh.1 = Tsh.9.6	30 September 1998	Ksh.1 = Tsh.12

Average for the year to 30 September 1998 Ksh.1 = Tsh.11.

The directors of KC Limited have directed you to prepare the consolidated income statement for the year ended

Required:

The directors of KC Limited have directed you to prepare the consolidated income statement for the year ended 30 September 1998 and the consolidated balance sheet as at 30 September 1998.

Using the following methods:

(i) Presentation method (assuming goodwill was not impaired and it is an asset of the subsidiary)

(ii) Functional currency method (goodwill is impaired at the rate of 20% per annum and it is an asset of the holding company).

1. Presentation Method

Consolidated income statement	**Ksh**
Revenue	1,033.00
Cost of sales	(783.00)
Gross profit	250.00
Operating expenses	(63.00)
Profit before tax	187.00
Income tax expense	(55.00)
Profit for the period	132.00
Attributable to Holding company	121.00
Attributable to Minority interest	11.00
	132.00

Statement of changes in equity extract

		Ksh
Retained profit b/f	KC(less UPOI)	155.00
Share in TA		(31.04)
		123.96
Profit for the period		121.00
		244.96
Less dividends	Interim paid	(20.00)
	Final proposed	(40.00)
Retained profit c/f		184.96

Share of retained profits b/f in TA	Ksh
Opening net assets in TA (Ksh)	251.20
Net assets on acquisition (ksh)	290.00
Reduction in net assets (Loss)	(38.80)
Share of the holding Co@80%	(31.04)

Consolidated balance sheet		Ksh
Non Current assets		
Property plant and equipment		321.00
Goodwill		137.00
		458.00
Current assets		
Inventory	107.50	
A/C receivable	191.00	
Cash at bank	53.00	351.50
Total assets		809.50
Ordinary share capital		400.00
Foreign exchange reserve		20.44
Retained profit		184.96
		605.40
Minority interest		43.10
		648.50

Current liabilities			
Accounts payable	100.00		
Current tax	18.00		
Proposed dividends	47.00	165.00	
		813.50	

Balance sheet		TA Tsh	Exchange rate	TA Ksh
PPE		1,908.00	1/12	159.00
Current assets				
Inventory		702.00	1/12	58.50
A/C receivable		660.00	1/12	55.00
Bank		264.00	1/12	22.00
		1,626.00		135.50
Current liabilities				
A/C payables		396.00	1/12	33.00
Current tax		132.00	1/12	11.00
Proposed divs		420.00	1/12	35.00
		948.00		79.00
Net current assets		678.00		56.50
Net assets		2,586.00		215.50
Ordinary shares		1,400.00	1/7	200.00
Retained profits	Pre acquisition	630.00	1/7	90.00
	Post acquisition	556.00	bal fig	(74.50)
		2,586.00		215.50

Income statement				
Sales		2,211.00	1/11	201.00
Opening stock		537.00		
Purchases		1,353.00		
		1,890.00		
Closing stock		(702.00)		
Cost of sales		1,188.00	1/11	108.00
Gross profit		1,023.00		93.00
Expenses		(99.00)	1/11	(9.00)
Depreciation		(76.00)	1/11	(7.00)
		(175.00)		(16.00)
Operating profit		848.00		77.00
Income tax expense		(242.00)	1/11	(22.00)
Profit after tax		606.00		55.00
Dividends:	Interim dividends	(112.00)	1/11.2	(10.00)
	Final proposed	(420.00)	1/12	(35.00)
Retained profit		74.00		10.00

CoC

	Ksh		Ksh
Inv in S	312.00	OSC (80%x200)	160.00
		P&L(80%x90)	72.00
		Goodwill	80.00
	312.00		312.00

Goodwill restated (80X12/7)	137.00
Goodwill based on historical rate	(80.00)
Gain on exchange to Foreign exchange reserve	57.00

Gain/Loss on foreign currency exchange translation

	Ksh
Net closing assets of TA in KSh	215.50
Net opening assets of TA in KSh(2586-74)/10	251.20
	(35.70)
Less increase in retained profits (P&L in KSh)	10.00
Foreign exchange loss	(45.70)

Group P & L

	Ksh		Ksh
Coc	72.00	KC	184.00
MI	12.24	TA	15.50
		Dividends receivable	28.00
UPCI	8.00	Forex Loss	45.70
Balance c/d	180.96		
	273.20		273.20

Foreign Exchange reserve

	Ksh		Ksh
Group P & L	45.70	MI (20%x45.7)	9.14
		Goodwill	57.00
Balance c/d	20.44		
	66.14		66.14

MI balance sheet

Ordinary share capital in TA	40.00
Share of profit	12.24
	52.24
Less share of forex loss	(9.14)
	43.10

2. Functional Method

KC Ltc & Its Subsidiary
Consolidated Income Statement for Year Ended 30.9.95

	KC Ksh.	TA Ksh.	Adjustments	Group Ksh.
Sales	930	201	930 + 201 - 98	1033
Cost of Sales	(775)	(117)	775 + 117 – 98 – 6+ 8	796
Gross Profit	155	84		237
Expenses (Introducing Depreciation) 29 + 18	(47)	(19)	47 + 19	(66)
Goodwill Amortized	-	-	See Cost of Control	(16)
Exchange Loss	-	-	See Step 3 on computation	(3)
Operating Profit	108	65		152
Investment Income - – Dividends	8	-	Ignore Investment Income	-
Profit before tax	116	65		152
Taxation	(33)	22	33 + 22	(55)
Profit after tax	83	43	2	97
Minority Interest	-	-	20% x (43 – 3)	(8)
Profit attributable to KC	83	43		89
Dividends; Interim paid	(20)	(10)	Only for KC (HC)	(20)
Final proposal	(40)	(35)		(40)
Retained Profits for the year	23	(2)		29

Statement of Retained Profits

	B/fwd	Year	C/fwd
KC	123	33	56
TA	37.6	(4)	33.6
Group	160.6	29	189.6

KC and its subsidiary
Consolidated balance sheet as at 30.9.98

Non-Current Assets	Ksh.M	Ksh.M
PPE		432
Intangible Goodwill		32
Current Assets		464
Inventory	113	
Receivables	191	
Bank	53	357
Total Assets		821
Ordinary Share Capital		400
Retained Profits		189.6
Shareholders funds		589.6
Minority interest workings		66.4
Current Liabilities		
Payables	100	
Taxation	18	
Proposed Dividends	47	165
		821

Workings

Step 1 **Translate income statement of subsidiary co. TA**

	TA Ksh.M	Exchange Rate	TA Ksh.M
Sales	2211	Average 1/11	201
Opening Inventory	537	1/9.3 (Date stock was acquired 31/3/98)	58
Purchases	1353	Average 1/11	123
	1890		181
Closing Inventory	(702)	1/11 (Date stock was acquired 31/3/98)	(64)
Cost of Sales	1188		117
Gross Profit	1023		84
Expenses	99	1/11 Average	9
Depreciation: Land & buildings	39.2	1/7 Rate on 1st October 95	5.6
Equipment	16.8	1/7 Rate on 1st October 95	2.4
Motor Vehicles	20	1/10 Rate on 30 September 97	2
Total Expenses	175		19
Operating Profit	848		65
Taxation	(242)	1/11 Average	22
Profits after tax	606		43
Dividends; interim paid	(112)	1/11.2 (Rate on date of payment)	(10)
Final proposed	(420)	1/12 Closing rate (Rate at b/s date)	(35)
Retained profit for the year	74		2

Step 2 Translation of subsidiary's Balance Sheet

	TA	Exchange Rate	TA
	Ksh.		Ksh.
Non-current Assets			
Land and Buildings	1764	1/7 Rate on 1.10.95	252
Equipment	84	1/7 Rate on 1.10.95	12
Motor Vehicles	60	1/7 Rate on 1.10.95	6
	1908		270
Current Assets			
Inventory	702	1/11 Rate stock was acquired	64
Receivables	660	1/12 Rate on b/sheet	55
Bank	264	1/12 Rate on b/sheet	22
	1626		141
Current Liabilities			
Payables	396	1/12 Rate on b/sheet	33
Taxation	132	1/12 Rate on b/sheet	11
Proposed Dividends	420	1/12 Rate on b/sheet	35
	948		79
Net Current Assets	678		62
Net Assets	2586		332
Ordinary Shares	1400	1/7 Rate of acquisition of sub	200
P & L - Pre-acquisition	630	1/7 Rate of acquisition of sub	90
Post acquisition	556	Balancing Figure	42
1186 - 630	2586		332

Cost of Control

	Ksh.		Ksh.
Investment of TA	312	OSC 80% x 200	160
		P & L at acq 80% x 90	72
		Goodwill Amortized b/f	32
		Amortized for year	16
		Bal c/d Amortized – B/ Sheet	32
	312		312

Step 3 Computation of Exchange Difference

	Ksh.
Closing Net assets of subsidiary (translator) as at 30.9.98	332
Opening net assets of subsidiary as at 30.9.97	337.1
Decrease in Net Assets	(5.1)
Less loss as per translated income statement of subsidiary co.	(2)
	3.1

Workings for opening Net assets

Non-Monetary Assets		TA M	Exchange Rate	Kshs.
	Land & Buildings	1803.2	$\frac{1}{7}$	257.6
	Equipment	100.8	$\frac{1}{7}$	14.4
	Motor Vehicles	80	$\frac{1}{10}$	8
	Stock	537	$\frac{1}{9.3}$	58
Net Monetary Items	Balancing figure	(9)		(0.9)
		2512		337.1

Workings for retained profits

KC	B/fwd	Year	C/fwd
As per the accounts	161	23	184
Less Goodwill amortised	(32)	(16)	(48)
UPCS	(6)	6	-
UPCS	-	(8)	(8)
Dividends receivable			
80% x 35	-	28	28
	123	33	156

A – Share of post acquired profits

As per the accounts	47	(2)	45
Less exchange loss	-	(3)	(3)
Adjusted past acq. profits	47	(5)	42
HC – HC's share of 80%	37.6	(4)	33.6

Workings for B/Sheet Continued	KC	TA
PRE; Land and Buildings	90	
Equipment	60	
Motor Vehicle	12	
	162	270

Minority Interest a/c

	Sh.M		Sh.M
		OSC 20% X 200	40
Bal c/d	66.4	P & L 20%(90 +42)	26.4
	66.4		66.4

1.7 DISPOSAL OF SUBSIDIARIES (IFRS 5)

IFRS 5 replaced IAS 35 Discontinuing Operations. The definition of discontinued operations is very much the same as the definition of discontinuing operations in IAS 35. However the timing of the classification now depends on when the discontinued operation satisfies the criteria to be classified as held for sale. The same requirement applies to non-current asset held for sale. Further, IFRS 5 requires the results of discontinued operations to be presented as a single amount on the face of the income statement

1.7.1 Non Current asset held for sale

In general, the following conditions must be met for an asset (or 'disposal group') to be classified as held for sale:

(i) management is committed to a plan to sell

(ii) the asset is available for immediate sale

(iii) an active programme to locate a buyer is initiated

(iv) the sale is highly probable, within 12 months of classification as held for sale (subject to limited exceptions)

(v) the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value

(vi) Actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

The assets need to be disposed of through sale. Therefore, operations that are expected to be wound down or abandoned would not meet the definition (but may be classified as discontinued once abandoned).

The following rules apply in measuring and presenting non current assets held for sale:

(i) At the time of classification as held for sale. Immediately before the initial classification of the asset as held for sale, the carrying amount of the asset will be measured in accordance with applicable IFRSs. Resulting adjustments are also recognised in accordance with applicable IFRSs.

(ii) After classification as held for sale. Non-current assets that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

(iii) **Impairment.** Impairment must be considered both at the time of classification as held for sale and subsequently:

- **At the time of classification as held for sale.** Immediately prior to classifying an asset as held for sale, measure and recognise impairment in accordance with the applicable IFRSs (generally IAS 16, IAS 36, IAS 38, and IAS 39). Any impairment loss is recognised in profit or loss unless the asset had been measured at revalued amount under IAS 16 or IAS 38, in which case the impairment is treated as a revaluation decrease.
- **After classification as held for sale.** Calculate any impairment loss based on the difference between the adjusted carrying amounts of the asset and fair value less costs to sell. Any impairment loss that arises by using the measurement principles in IFRS 5 must be recognised in profit or loss, even for assets previously carried at revalued amounts.

(iv) **Assets carried at fair value prior to initial classification.** For such assets, the requirement to deduct costs to sell from fair value will result in an immediate charge to profit or loss.

(v) **Subsequent increases in fair value.** A gain for any subsequent increase in fair value less costs to sell of an asset can be recognised in the profit or loss to the extent that it is not in excess of the cumulative impairment loss that has been recognised in accordance with IFRS 5 or previously in accordance with IAS 36.

(vi) Non-depreciation**.** Non-current assets that are classified as held for sale shall not be depreciated.

(vii) Balance sheet presentation**.** Assets classified as held for sale, and the assets and liabilities included within a disposal group classified as held for sale, must be presented separately on the face of the balance sheet.

Disclosures:

Non-current assets classified as held for sale must be disclosed separately from other assets in the balance sheet.

There are also several other additional disclosures including a description of the nature of assets held and the facts and circumstances surrounding the sale.

Disposal of a subsidiary

Before we look at the detail requirements of IFRS 5 it is important to remember that the holding company can dispose partly, the investment held in subsidiary company. Therefore we shall look at partial disposals and full disposal (which requires consideration of IFRS 5)

Partial disposals

(i) From subsidiary to subsidiary:

This means that the holding company will reduce the level of control but still at the subsidiary level for example from 80% shareholding to 60% shareholding. The subsidiary will still be consolidated only that in the income statement, care should be taken in computing minority interest. If the disposal takes place partly during the year then the results of the subsidiary should be split into two for the purpose of allocating the minority interest share of the profit after tax in subsidiary company. The respective minority interest percentage share in the subsidiary for each period will apply. In the consolidated balance sheet only the final minority interest percentage share will apply. The group will also report a profit or loss on the sale of the partial investment.

The profit or loss is computed as follows:

(i) Method one

	Sh	Sh
Cash proceeds on disposal		X
Less: Share of net assets on disposal		(X)
Add Unimpaired goodwill to date	X	(X)
Profit/ (loss) on Disposal		X / (X)

(ii) Method two

	Sh	Sh
Profit on disposal reported by the holding company		X
Less: Group share of post acquisition P&L in Sub	X	
Less Goodwill impaired to date	(X)	(X)
Profit/ (loss) on disposal		X

(ii) From subsidiary to a jointly controlled entity:

The holding company reduces its control in the subsidiary to 50% and thus becoming a jointly controlled entity. Care should be taken especially if the disposal takes place during the year. The consolidate income statement requires careful approach because, the subsidiaries results will be split into the respective periods and full consolidation will apply the normal way according to the requirements of IAS 27 for the period before disposal. In the period after disposal we will use the requirements of IAS 31 i.e either the partial consolidation or equity method. In the consolidated balance sheet we shall use the requirements of IAS 31. The group will also report a profit or loss on the sale of the partial investment.

(iii) From subsidiary to Associate companies

The holding company reduces its control in the subsidiary to a percentage that is less than 50% but more than 20%. Care should also be taken especially if the disposal takes place during the year. The consolidate income statement requires careful approach because, the subsidiaries results will be split into the respective periods and full consolidation will apply the normal way according to the requirements of IAS 27 for the period before disposal. In the period after disposal we will use the requirements of IAS 28 i.e. the equity method. In the consolidated balance sheet we shall use the requirements of IAS 28. The group will also report a profit or loss on the sale of the partial investment.

(iv) From subsidiary to an investment

The holding company reduces its control substantially to less than 20%. This means that the remaining shareholding will be accounted for according to the requirements of IAS 32 and 39: Financial instruments which we shall see later.

If the disposal takes place during the financial period then the results of the subsidiary should be split into the two periods and full consolidation will take place in relation to the period before disposal as far the consolidated income statement is concerned. In the remaining period and the balance sheet the requirement of IAS 32 and 39 will apply.

(v) Full disposal (IFRS 5)

We shall now move on to the requirements of IFRS 5 with reference to disposal of subsidiaries or other major components of the business.

A 'disposal group' is a group of assets, possibly with some associated liabilities, which an entity intends to dispose of in a single transaction. The measurement basis required for non-current assets classified as held for sale is applied to the group as a whole, and any resulting impairment loss reduces the carrying amount of the non-current assets in the disposal group in the order of allocation required by IAS 36.

The following rules also apply in measurement and presenting discontinued operations:

(i) <u>After classification as held for sale.</u> Disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. [IFRS 5.15]

(ii) <u>Impairment.</u> Impairment must be considered both at the time of classification as held for sale and subsequently:

- <u>At the time of classification as held for sale.</u> Immediately prior to classifying a disposal group as held for sale, measure and recognise impairment in accordance with the applicable IFRSs (generally IAS 16, IAS 36, IAS 38, and IAS 39). Any impairment loss is recognised in profit or loss unless the asset had been measured at revalued amount under IAS 16 or IAS 38, in which case the impairment is treated as a revaluation decrease.

- After classification as held for sale. Calculate any impairment loss based on the difference between the adjusted carrying amounts of the disposal group and fair value less costs to sell. Any impairment loss that arises by using the measurement principles in IFRS 5 must be recognised in profit or loss, even for assets previously carried at revalued amounts. This is supported by IFRS 5 BC.47 and BC.48, which indicate the inconsistency with IAS 36.

Non-depreciation

Disposal groups that are classified as held for sale shall not be depreciated.

Balance sheet presentation

Assets classified as held for sale, and the assets and liabilities included within a disposal group

Disclosures

The assets of a disposal group classified as held for sale must be disclosed separately from other assets in the balance sheet.

The liabilities of a disposal group classified as held for sale must also be disclosed separately from other liabilities in the balance sheet.

Additional rules and matters regarding disposal of subsidiaries

Definition

A discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale, and:

Represents a separate major line of business or geographical area of operations, is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or is a subsidiary acquired exclusively with a view to resale.

Income statement presentation

The sum of the post-tax profit or loss of the discontinued operation and the post-tax gain or loss recognised on the measurement to fair value less cost to sell or fair value adjustments on the disposal of subsidiary should be presented as a single amount on the face of the income statement. Detailed disclosure of revenue, expenses, pre-tax profit or loss, and related income taxes is required either in the notes or on the face of the income statement in a section distinct from continuing operations. Such detailed disclosures must cover both the current and all prior periods presented in the financial statements.

Cash flow statement presentation

The net cash flows attributable to the operating, investing, and financing activities of a discontinued operation shall be separately presented on the face of the cash flow statement or disclosed in the notes.

No retroactive classification

IFRS 5 prohibits the retroactive classification as a discontinued operation, when the discontinued criteria are met after the balance sheet date.

Disclosures

In addition to the income statement and cash flow statement presentations noted above, the following disclosures are required:

(i) Adjustments made in the current period to amounts disclosed as a discontinued operation in prior periods must be separately disclosed.

(ii) If an entity ceases to classify a component as held for sale, the results of that component previously presented in discontinued operations must be reclassified and included in income from continuing operations for all periods presented.

The formats of the income statements showing the disposal of a group (subsidiaries) is given as follows:

	Continuing Operations	Discontinued Operations	Enterprise as a whole
	Shm	**Shm**	**Shm**
Revenue	X	X	X
Cost of Sales	(X)	(X)	(X)
Gross Profit	X	X	X
Other Incomes	X	X	X
	X	X	X
Distribution Costs	(X)	(X)	(X)
Administration Costs	(X)	(X)	(X)
Other Expense	(X)	(X)	(X)
Finance costs	(X)	(X)	(X)
Profit before tax	X	X	X
Income tax Expense	(X)	(X)	(X)
Profit for the period	X	X	X

Alternatively a firm can present the results as follows and the detail break down given by way of notes to the accounts:

	Shm
Revenue	X
Cost of Sales	(X)
Gross Profit	X
Other Incomes	X
	X
Distribution Costs	(X)
Administration Costs	(X)
Other Expense	(X)
Finance costs	(X)
Profit before tax	X
Income tax Expense	(X)
Profit for the period from continuing operations	X
Profit for the period from discontinued operations	X

>>> Example

Udi Supermarket Limited (USL) is a company quoted on the Nairobi Stock Exchange. In the early 1990's it diversified its operations by purchasing 100% of the shares of United Autos Limited (UAL) on 1 November 1990, 80% of the shares of Utility Chemicals Limited (UCL) on 31 October 1991 and 70% of the shares in Uday Drycleaners Limited (UDL) on 30 April 1992. Each company operates in different business segment. In the year ended 31 October 1999, USL decided to sell its entire 100% shareholding in UAL, and half of its shareholding in UCL. The sale of shares in UAL took place in a single transaction on 30 June 1999 for Sh.162 million and the sale of shares in UCL took place in a single transaction on 31 July 1999 for Sh. 169 million. In both cases proceeds were credited into the account for the investment in the books of USL. The financial statements of the four companies for the year ended 31 October 1999 were as follows.

Profit and loss accounts for the year ended 31 October 1999

	USL Sh. million	UAL Sh. million	UCL Sh. million	UDL Sh. million
Revenue	1,800	840	600	480
Cost of sales	(1,350)	(630)	(400)	(200)
Gross profit	450	210	200	280
Distribution costs	(100)	(120)	(60)	(70)
Administration expense	(150)	(120)	(40)	(50)
	(250)	(240)	(100)	(120)
Profit from operations	200	(30)	100	160
Dividends received	44	-	-	-
Finance costs	(50)	-	-	-
Profit before tax	194	(30)	100	160
Income tax expense	(54)	-	(20)	(50)
Profit/ (loss) after tax	140	(30)	80	110
Dividends:				
Interim paid 31 May	(50)	-	(20)	(40)
Final proposed	(50)	-	(40)	(40)
	(100)	-	(60)	(80)
Retained profit/ (loss)	40	(30)	20	30

Balance sheet as at 31 October 1999

	USL Sh. million	UAL Sh. million	UCL Sh. million	UDL Sh. million
Property, plant and equipment	640	220	180	400
Investments:				
UAL	6			
UCL	39			
UDL	270			
Current assets	300	140	150	130
Current liabilities	(210)	(60)	(70)	(80)
Net current assets	90	80	80	50
	1,045	300	260	450
Ordinary share capital	500	50	100	200
Profit and loss account	545	250	160	250
	1,045	300	260	450

Additional information:

1. USL had purchased its shareholding in UAL, UCL and UDL when the balance on the profit and loss accounts were Sh.38 million.,Sh.110 million and Sh.100 million respectively. On these dates, the fair values of the identifiable net assets of the companies concerned were equal to their fair values.

2. USL impairs goodwill that arises on the acquisition of subsidiary or an associate at the rate of 20% per annum.

3. USL intends to retain its remaining shareholding in UCL; at 31 October 1999, two of UCL's five directors were directors of USL.

4. There is no tax charge or allowance on the profit or loss on the disposal of shares.

Required:

Prepare the consolidated income statement for the year ended 31 October 1999 and the consolidated balance sheet as at 31 October 1999 in accordance with International Financial Reporting Standards.

STUDY TEXT

Solution

USL and its subsidiaries
Consolidated income statement for the year ended 31st Oct 1999

	Continuing	Discontinuing	Enterprise as a whole.
	Sh/Millions	Sh/Millions	Sh. Millions
Sales	2730	560	3290
Cost of sales	(1850)	(420)	(2270)
Gross profit	880	140	1020
Other incomes(profit on disp)	57		57
Share of PBT in Associate	10		10
Distribution costs	(215)	(80)	(295)
Administration costs	(230)	(80)_	(310)
Other expenses (loss on disp)	0	(148)	(91)
Finance cost	(50)	0	(50)
Profit before tax	452	(168)	274
Income tax Expense	_(121)	-__	(121)
Profit for the period	331	(168)	284

=

USL ltd and its subsidiaries

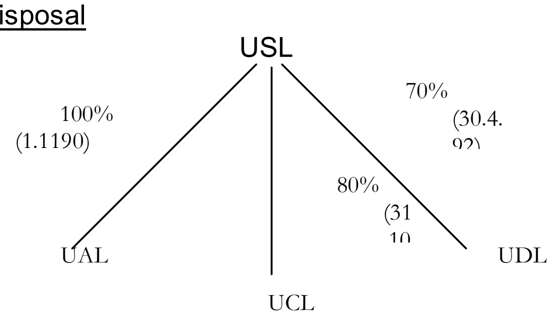
Consolidated balance sheet as at 31st October 1999

Property, plant and equipment	1,040
Investment in associates	104
Current assets	446
	1,590
Financed by	500
Share capital	693
Profit and loss A/C	135
Minority interest	
Share holders' funds	1328
Current liabilities	262
	1590

Workings

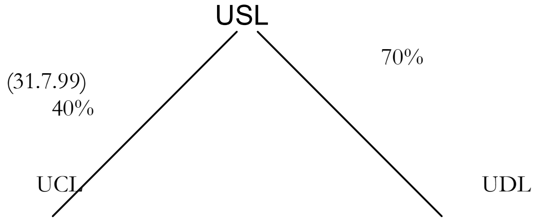
(i) Structures.

(a) Before disposal



STUDY TEXT

(b) <u>After disposal</u>



(ii) <u>Gain / Loss on disposal</u>

(a) Sale of shares either cum-dir or ex-dir.

- Dividends received from UCL
  40% x 20% = 8

- Dividend earned
  60% x 9/12 x 40% = (18)

- <u>Dividend earned but sold</u> 10

(b)

	UAL Sh/Millions	**UCL Sh/Millions**
Proceeds	162	
Dividends foregone	-	169
	162	(10)
Less Net assets sold		
Share capital	50	159
Profit and loss Account B/f	280	
Profit for the period		100
UAL (30 X 8/12)	(20)	140
UCL (20 X 9/12)	-	
		-
	310	15
UAL 100% x 310	(310)	
UCL 40% x 255	-	255
Gain (loss on disposal)	(148)	-
		(102)
		57

OR

Goodwill arising on acquisition

	UAL	Sh/Millions	UCL	Sh/Millions	UDL	Sh. Millions
Cost of investment		168		208		270
Net Assets acquired						
Share capital	50		100		200	
Profit and loss	38		110		100	
Account		88		210		300
		(88)		-		-
UAL 100%		-		(168)		-
UCL 80%		-		-		(210)
UDL 70%		80		40		60
Goodwill						

	UAL Sh/Millions	UCL Sh/Millions
Proceeds	162	169
Dividends sold	-	(10)
	162	159
Cost of investment	(168)	(104)
Gain/loss as per Holding company	(6)	55
Goodwill amortised	80	20
Increase in value of net assets		
UAL (260 – 38)	(222)	
UCL 40% (155 – 110)	-	(18)
	(148)	57

Minority interest			
UCL: 20% x 80 x 9/12			
UDL: 30% x 110			12
Profit attributable to members of		33……………………………..	
group	(45)		
Dividend: - Interim paid		…………………………….. 118	
Proposed		…………………………….. (50)	
Retained earnings for		…………………………….. (50)	
the yr			
		……..………………………. 18	

			Sh. Millions
Retained earnings B/forward (545 – 40)			505
Goodwill amortised	UAL	(80)	
	UCL	(40)	
	UDL	(60)	(180)
			325
UAL = 250 + 30 – 38			242
UCL = 80% (160 – 20 – 110)			24
UDL = 70% (250 – 30 – 100			84
			675
Retained earnings for year			18
			693

STUDY TEXT

Workings:

Consolidated P &L A/C

Loss on sale of shares in UAL	6	USL	545
Premium Amortised	20	Dividend sold	10
COC 70% x 100	70	Gain on sale of shares UCL	55
Minority Interest 30% x 250	75	Dividend receivable:	
Goodwill amortised	60	UCL: 40% x 40	16
CBS	693	UDL: 70% x 40	28
		Investment in:	
		Associates	20
		UDL	250
	924		924

Minority Interest

		Share capital: 30% x 200	60
CBS	135	P& L A/C	75
	135		135

Investment in Associates A/C

Balance B/f	104	Premium Amortised	20
Post – acquisition retained earnings:			
40% (160 – 110)	20	CBS	104
	124		124

Current Assets

USL	300	Intra group trading	28
UDL	130		
Dividend from: UCL	16		
UDL	28	CBS	446
	474		474

Current Liabilities A/C

Intra-group trading	28	USL	210
CBS	262	UDL	80
	290		290

CHAPTER SUMMARY

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

Subsidiary: An entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

Parent: An entity that has one or more subsidiaries.

Group structure: The relationship between the holding company and the subsidiaries.

Associate: An enterprise in which an investor has significant influence but not control or joint control.

Significant influence: Power to participate in the financial and operating policy decisions but not control them.

Equity method: A method of accounting by which an equity investment is initially recorded at cost and subsequently adjusted to reflect the investor's share of the net profit or loss of the associate (investee).

Joint venture: A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Venturer: A party to a joint venture and has joint control over that joint venture.

Investor in a joint venture: A party to a joint venture and does not have joint control over that joint venture.

Control: The power to govern the financial and operating policies of an activity so as to obtain benefits from it.

Joint control: The contractually agreed sharing of control over an economic activity such that no individual contracting party has control.

Functional currency: The currency of the primary economic environment in which the entity operates.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Foreign operation: A subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

CHAPTER QUIZ

1. What is a subsidiary?
2. What is a joint venture?
3. What are the three types of joint ventures dealt with in IAS 31?
4. What is a foreign operation?

ANSWERS TO THE CHAPTER QUIZ

1. Subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).
2. A Joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.
3. IAS 31 deals with three types of joint Ventures
   (i) Jointly Controlled operations,
   (ii) Jointly Controlled assets,
   (iii) Jointly Controlled Assets
4. Foreign operation is a subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

PAST PAPER ANALYSIS

Group structures was tested in the following examinations:

12/'07

06/'07

12/'06

06/'06

06/'05

12/'04

05/'02

12/'00

07/'00

Foreign subsidiaries were tested in the following examinations:

12/'05

06/'04

12/'02

12/'01

06/'01

Disposal of subsidiaries (IFRS 5) was tested in the following examinations:

06/'07

06/'03

Merger Vs Acquisition was tested in: 12/'03

EXAM QUESTIONS

QUESTION ONE

M. Ltd. started operating several years ago. As a strategy to expand its operations, its management has in the recent past purchased shares from other companies, whose trial balances are given below:

Trial balance as at 31 December 2001

	M. Ltd Sh. '000'	**H. Ltd Sh. '000'**	**C. Ltd Sh. '000'**	**A Ltd. Sh. '000'**
Property and equipment	250,000	220,000	200,000	96,000
7,500,000 ordinary shares of Sh. 10 each in H	165,000	-	-	-
Ltd				
6,000,000 7% non-cumulative preference	60,000	-	-	-
shares	5,000	-	-	-
Of Sh. 10 each in H Ltd	26,100	-	-	-
6% debentures in H Ltd	-	102,000	-	-
1,800,000 ordinary shares of Sh. 10 each in A	145,500	143,400	120,000	50,000
Ltd	651,600	465,400	320,000	146,000
6,400,000 equity shares in C Ltd and Sh. 10				
each	300,000	100,000	80,000	60,000
Current assets	-	80,000	-	-
	50,000	40,000	40,000	6,000
	98,500	44,400	100,000	30,000
Ordinary shares of Sh. 10 each	60,000	130,000	40,000	20,000
7% non-cumulative preference shares of Sh. 10	-	20,000	-	-
each	30,000	10,000	-	10,000
General reserve	-	5,600	-	-
Profit and loss account	-	1,200	-	-
Provision for depreciation	113,100	34,200	60,000	20,000
6% debentures	651,600	465,400	320,000	146,000
Proposed dividend: Ordinary				
Preference				
Accrued debenture interest				
Trade payable				

Additional information:

1. The general reserve of all the companies was the same as they were one year ago. The profit and loss account balances of C. Ltd. and A. Ltd were Sh.16 million and Sh.21 million respectively at the time their shares were purchased, one year previous to the preparation of the balance sheets provided.
2. M Ltd. acquired the shares of H Ltd cum-dividend on 1 January 2001. The balance on the profit and loss account of H Ltd. consisted of the following:

	Sh. '000'
Profit and loss account balance on 31 December 20X0	28,000
Net profit for the period ended 31 December 2001	32,000
	60,000
Less proposed dividend	(15,600)
Profit and loss account balance on 31 December 2001	44,400

3. The balances on the profit and loss account of H Ltd. at the acquisition date is after providing for preference dividend of Sh.5.6 million and a proposed ordinary dividend of Sh.5 million, both of which were subsequently paid and credited to the profit and loss account of M Ltd.
4. No entries have been made in the books of M Ltd. in respect of debenture interest due from, or proposed dividends from two of its investments, except that dividends due from A Ltd. were credited to M Ltd.'s profit and loss account and the corresponding entry made in its debtor.
5. The debentures of H Ltd. were purchased at par.
6. The stock in trade of H Ltd. on 31 December 2001 includes Sh.6 million in respect of goods purchased from M Ltd. These goods had been sold by M Ltd. at such a price that M Ltd. earned a profit of 20% on the invoice price.
7. The group policy is to account for any associate company using the equity method. Goodwill arising on consolidation is amortized using the straight-line method over a useful life of five years, (assuming a zero residual value) a proportionate charge being made for any period of control of less than a full year. All unrealised profit on closing stock is removed from the accounts of the company that realized it, giving a proportionate charge to the minority interest is appropriate.
8. Dividends to minority interest shareholders are shown as part of minority interest.
9. H Ltd. sold a fixed asset on 31 December 2001 to M Ltd. for Sh.20 million, making a 20% profit on the invoice price. H Ltd. depreciates its assets at 20% using the straight-line method. H Ltd's accountant erroneously used the selling price for depreciation purposes, however, the cost of assets reflected the correct amounts.

Required:

A consolidated balance sheet of M Ltd. and its subsidiaries as at 31 December 2001. **(25 marks)**

QUESTION TWO

The draft balance sheet of Aberdare Limited, Batian Limited and Elgon Limited as at 31 March 1999 are as follows:

Balance sheet as at 31 March 1999

	A Ltd.	B Ltd.	E Ltd.
	Sh. million	Sh. million	Sh. million
PPE	1,280	920	700
Investments in subsidiaries (cost)	840	750	-
	2,120	1,670	700
Current assets			
Inventories	420	410	210
Trade receivables	680	540	390
Cash	80	90	70
	1,180	1,040	700
Current liabilities			
Trade payables	390	380	210
Taxation	40	20	10
Proposed dividends	300	250	200
	730	650	420
Net current assets	450	390	280
	2,570	2,060	980
Issued share capital			
Ordinary shares of Sh.10	600	500	500
Revaluation reserve	-	260	-
Retained earnings	1,970	1,300	480
	2,570	2,060	980

Additional information:

1. All the shares in all the companies rank equally for voting purposes.
2. A Ltd. purchased 30 million ordinary shares in B Ltd. on 1 April 1990, when the balance of retained earnings in B Ltd. was Sh.800 million. On 1 April 1990, the fair values of the identifiable net assets of B Ltd. were approximately the same as book values. By 31 March 19989, some of the fixed assets of B Ltd. had depreciated significantly in value: the directors commissioned Uptown Estate Agents to revalue the fixed assets, which resulted in the reserve stated in the accounts. The revaluation had been incorporated in the accounts as at 31 March 1998.
3. B Ltd. acquired 30 million shares in E Ltd. on 30 September 1998. On this date, the fair value of the fixed assets in E Ltd. was Sh. 60 million in excess of book value and the fair value of stock was Sh.20 million in excess of book value. In addition, E Ltd. possessed patent rights of fair value Sh.10 million on 30 September 1998: however, these were not carried in the books of E Ltd. E Ltd depreciates fixed assets at 10% per annum and intangible assets at 20% per annum (both figures being reduced proportionately for a period which is less than a year). 80% of the stock in hand on 30 September 1998 in E Ltd. had been sold by 31 March 1999. Between 30 September 1998 and 31 March 1999, E Ltd.'s sales to A Ltd. and B Ltd. were Sh.240 million and Sh.160 million respectively. All these goods had been resold by the two companies but at 31 March 1999, A Ltd. and B Ltd. owed E Ltd. Sh. 36 million and Sh.32 million respectively. E Ltd.'s net profit for the year, after tax but before dividends, was Sh.240 million; this profit accrued evenly over the year.
4. Neither A Ltd. nor B Ltd. Has accounted for dividends receivable.
5. The group accounting policy in relation to goodwill is to recognise it as an intangible asset and impair it a rate of 33.333% per year, with a proportionate charge for a period of less than one year. Minority interest is recorded as its proportion of the fair values of the net assets of the subsidiary: dividends due to minority interest are carried within current liabilities.

Required:

The consolidated balance sheet of Aberdare Limited and its subsidiaries as at 31 March 1999 in accordance with the International Accounting Standard 1 – presentation of financial statements (Revised 2004)

CASE STUDY

In the world of growing economy and globalization, major companies on both domestic and international markets struggle to achieve the optimum market share possible. Every day business people from top to lower management work to achieve a common goal – being the best at what you do, and getting there as fast as possible. As companies work hard to beat their competitors they assume various tactics to do so. Some of their tactics may include competing in the market of their core competence, thus, insuring that they have the optimal knowledge and experience to have a fighting chance against their rivals in the same business; hostile takeovers; or the most popular way to achieve growth and dominance – mergers and acquisitions.

Mergers and acquisitions are the most frequently used methods of growth for companies in the twenty first century.

Mergers and acquisitions present a company with a potentially larger market share and open it up to a more diversified market. At times, a merger or an acquisition simply makes a company larger, expands its staff and production, and gives it more financial and other resources to be a stronger competitor on the market.

Source: www.google.co.ke- case studies on mergers and acquisition

CHAPTER TWO

STUDY TEXT

ACCOUNTING FOR ASSETS AND LIABILITIES (PART A)

CHAPTER TWO

ACCOUNTING FOR ASSETS AND LIABILITIES (PART A)

▶ OBJECTIVES

After this chapter, the student will know how to account for:

- Leases (IAS 17)
- Impairment of assets (IAS 36)
- Assets that are used in exploring Mineral Resources (IFRS 6)
- Financial Instruments (IAS 32, 39 and IFRS 7)

▶ INTRODUCTION

Leasing is a unique form of intermediate term financing. It is also a major form of 'off balance sheet' financing, though disclosure of leased assets and corresponding obligations in financial statements are now increasingly required internationally.

IAS 36 applies to all tangible, intangible and financial assets except inventories, assets arising from construction contracts, deferred tax assets, assets arising under IAS 19, employee benefits and financial assets within the scope of IAS 32, Financial instruments, disclosures and presentation.

▶ DEFINITION OF KEY TERMS

Lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time.

Impairment: a fall in the value of an asset so that its recoverable amount is now less than its carrying value in the balance sheet.

Financial instrument: A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

▶ EXAM CONTEXT

In past examinations, the examiner has tested the students' knowledge on the following topics:

- Leases
- Impairment of Assets

Students should therefore understand these topics.

INDUSTRY CONTEXT

This chapter shows organisations how to classify leases and account for them.

Organizations learn how to account for impairment of assets and to properly account for financial instruments and make adequate disclosures in the financial statements.

2.1 LEASES (IAS 17)

FAST FORWARD: Leasing is a major form of 'off balance sheet' financing, though disclosure of leased assets and corresponding obligations in financial statements are now increasingly required internationally.

Introduction

Leasing is a unique form of intermediate term financing.

Lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time. The lessor remains the owner but lessee has a right to use the equipment for agreed rentals to be paid over a period. Though the lessee has an unrestricted right of use of the lease equipment but does not become the owner. The lease contract will cover lease period, the amount and timing of payments to be made by the lessee, provision of payment of taxes, insurance, maintenance expenses and provision for renewal of the lease or purchase of asset at the expiration of the lease period.

Terms used in leasing

Lessor: This is the person, who under an agreement conveys to another person (the lessee) the right to use in return for rent, an asset for an agreed period of time.

Lessee: this is a person, who under an agreement obtains from another person (the lessor) the right to use, in return for rent, an asset for an agreed period of time.

Non-cancellable lease: A lease that is cancellable only:

- Upon the occurrence of some remote contingency
- With the permission of the lessor
- If the lessee enters into a new lease for the same or any equivalent asset with the same lessor, or
- Upon payment by the lessee of an additional amount such that at inception continuation of lease is reasonably certain

Inception of the lease: the earlier of the date of the lease agreement or of a commitment by the parties to the principal provision of the lease. Thus it is the date that the principal provisions of the lease are committed to in writing by the parties.

Lease term: the non-cancellable period for which the lessee has contracted to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment which option at the inception of the lease it is reasonably certain that the lessee will exercise. Thus, the period, which the lessee is required or expected to make, lease payments include:

- Non-cancellable term of the lease
- Any period for which failure to renew the lease results in a penalty to the lease in an amount, at the inception of the lease
- Any period subject to a bargain renewal option or proceeding the date that a bargain purchase option becomes exercisable and
- Any period during which the lease may be renewed or extended at the option of the lessor

Minimum lease payments*:* the payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with the residual value. Thus, it includes the sum of the payments that the lessee is required or expected to make during the lease term other than amounts representing taxes, insurance maintenance etc together with:

In case of lessee, any amount generated by him or by a party related to him with any penalty that the lessee must pay for failure to renew or extend the lease beyond the lease term

In the case of lessor any guarantee by a third party of the residual value or rental payment beyond the lease terms.

Fair value: the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

Useful life: In the case of an operating lease either the period over which a fixed asset is expected to be used by the enterprise; or the number of production (or similar) units expected to be obtained from the asset by the enterprise. In case of a finance lease, the useful life of the asset is the lease term.

Interest rate implicit in the lease: the discount rate that, at the inception of the lease, cause the aggregate present value of the minimum lease payments, from the standpoint of the lessor, to be equal to the fair value of the leased asset, net of any grants or tax credits received by the lessor. In other words, it is the discount rate that equates the present value of the minimum lease payments plus the unguaranteed residual value to the fair value of the leased property at the inception of the lease less any investment tax credit retained and expected to be realised by the lessor.

Gross investment in the lease: the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor.

Unearned finance income: the difference between the lessor's gross investment in the lease and its present value.

Net investment in the lease: the gross investment in the lease less unearned finance income.

Bargain option: it is an option that can be exercised by lessee to renew the lease or purchase the leased property for an amount which is sufficiently below the expected future market value. Such an option appears at the inception of the lease.

Estimated economic life of the leased property: the expected remaining period during which the property is expected to be economically usable for the purpose for which it was intended at the inception of the lease.

Unguaranteed residual value: The expected fair value of the leasehold property at the end of the term (excluding the amount of nay guarantee) included in the minimum lease payments.

Classification of leases

In general lease means allowing a person to use a property on payment of a certain amount of money in installment as agreed between the lessor and lessee. A contract of lease may be classified into three types:

Operating lease
Finance lease
Leveraged lease

Operating or (cancellable lease)

A lease is classified as an operating lease if it does not secure for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term. Therefore, the asset should be treated by the lessor as a fixed asset and rentals receivable should be included in income over the lease term.

Costs, including depreciation, incurred in earning the rental income should be charged to income. Initial direct costs incurred by lessor in negotiating and arranging the lease should be expensed in the year in which they are incurred.

Lease rentals in the books of the lessee should be accounted for on accrual basis over the lease term so as to recognise an appropriate charge in this respect in the profit and loss account with a separate disclosure thereof. The excess of lease rentals paid over the amounts accrued in respect thereof should be treated as prepaid lease rental and vice versa.

Accounting entries in the books of lessee

When rent is paid on the leased property

Dr: Rent A/c
Cr: Cash A/c

The entry will be repeated in subsequent years till the lease expires.

Accounting entries in the books of lessor

When rent is received under the lease contract

Dr: Cash A/c

Cr: Rental income

When depreciation is to be charged

Dr: Depreciation A/c

Cr: Accumulated depreciation A/c

When insurance/maintenance/taxes are paid

Dr: Insurance/maintenance/taxes A/c

Cr: cash A/c

Finance (or capital) lease

A lease under which the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset. This method of financing the asset is similar to that of borrowing for acquisition of an asset. The asset is acquired immediately without making any payment for it. Contract made under this type of lease is irrevocable or non-cancellable. The lessor will try to recover his original investment of equipment plus a reasonable return on such investment during the lease term.

Accounting entries in the books of the lessor

When the equipment is purchased on lease

Dr: Equipment A/c

Cr: Cash A/c

When the contract is signed and property leased out to the lessee

Dr: Rent receivable A/c
Cr: Equipment a/c

When first installment on lease is received

Dr: Cash A/c
Cr: Rent receivable A/c

At end of first year
When interest becomes receivable

Dr: Interest receivable a/c
Cr: Interest a/c

When the amount is received in respect of interest and rent

Dr: Cash a/c
Cr: Rent receivable a/c
Cr: Interest receivable a/c

These entries are repeated in subsequent years

At the end of last year
When the equipment is sold and lease is terminated

Dr: Cash a/c
Cr: Income on sale of equipment a/c

At the end of last year
When the equipment is purchased and lease is terminated

Dr: Equipment a/c
Cr: Cash a/c

When accumulated depreciation is transferred to equipment a/c at the time of termination of the lease and purchase of the asset

Dr: Accumulated depreciation a/c

Cr: Equipment a/c

Accounting entries in the books of the lessee

When contract is signed and property acquired and the liability is assumed

Dr: Equipment a/c

Cr: Rent obligation a/c

When first installment payment of rental obligation is made

Dr: Rental obligation a/c

Cr: Cash a/c

At the end of first year

When interest becomes payable

Dr: Interest a/c

Cr: Interest payable a/c

When the payment is made for rental and interest

Dr: Rental obligation a/c

Interest payable a/c

Cr Cash a/c

When depreciation at the end of the year is charged

Dr: Depreciation a/c

Cr: Accumulated depreciation a/c

When insurance, maintenance, taxes are paid

Dr: Insurance/maintenance/taxes a/c

Cr: Cash a/c

The above entries are repeated in each of the subsequent years.

Distinction between an operating lease and a finance lease

A lease is classified as a finance lease if it secures for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term. On the other hand a lease is classified as an operating lease if it does not secure for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term.

Operating lease	Finance lease
It is usually for a shorter duration and bears no relation to the useful life of the asset.	It is usually related to the useful life of the asset
It is a non-revocable contract	It is a revocable contract
The cost of maintenance, repairs, taxes and insurance etc. are borne by the lessor	These expenses are borne by the lessee unless there is a contract to the contrary
The lessee is protected against the risk of obsolescence	The risk of obsolescence has to be taken by the lessee
The rentals are not sufficient to fully amortise the cost of the asset	The rentals would cover the lessor's original investment cost plus a reasonable return on investment
There is no option to review or buy the lease	It will provide for an option to review the lease or to buy the asset at a nominal price at the expiration of the lease period.

Leveraged lease

A leveraged lease is a finance lease and has all the following characteristics:

- It involves at least three parties; a lessee, a lessor and one or more long term creditors
- The creditor's recourse to the lessor in the event of default is restricted to the proceeds from the disposal of the leased asset and any unremitted rentals relating thereto; and
- The lessor's investment in the lease declines in the early years of the lease and rises in later years before its final elimination.

This is used in those cases where huge capital outlays are required for acquiring assets. In this type also, the lessee makes contract for periodical payments over the lease period and in turn is entitled to use the asset over the period of time. Legal ownership of the leased asset remains with the lessor who is, therefore, entitled to tax deductions such as depreciation and other allowances.

It is appropriate therefore, that the method of finance income recognition on leveraged lease should take account of the cash flows resulting from the tax benefits. It is proposed to define leveraged leases and require that finance income from such leases should be recognised using the net cash investment method.

Net cash investment method

The net cash investment in the lease is the balance of the cash outflows and inflows in respect of the lease, excluding flows relating to insurance, maintenance and similar costs rechargeable to the lessee. The cash outflow includes payments made to acquire that asset, tax payments, interest and principal on third party financing. Inflows include rentals receipts, receipts from residual values and grants, tax credits and other savings or repayments arising from the lease.

Under the net cash investment, a lessor recognizes finance income based on a pattern reflecting a constant periodic return on its net cash investment outstanding in respect of the finance lease. Lease rentals relating to the accounting period, excluding costs for services, are applied against gross investment in the lease to reduce the principal and the unearned finance income. Hence, this method usually involves using a net-of-tax basis for the allocation of income.

The net cash investment method is often considered to be the most appropriate method of accounting for finance income from lease that have been entered into largely on the basis of the tax benefits that are expected to flow from the lease.

Net investment method

The net investment in the lease is the gross investment in the lease less any unearned finance income. Remaining unearned income is allocated to revenue over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. The use of the net investment method is usually supported on the basis that the lessor earns income for lending money to the lessee, which at any particular time is the amount of the outstanding net investment in a lease.

Sale and leaseback

A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The rentals and the sale price are usually interdependent as they are negotiated as a package and may not represent fair values.

If in the case of leaseback, the rentals and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is normally recognised immediately. If the sale price is below fair value, any profit or loss is recognised immediately, except that, if the loss is compensated by future rentals at below market price, it is deferred and amortised in proportion to the rental payments over the useful life of the asset. If the sale price is above fair value, the excess over fair value is deferred and amortised over the useful life of the asset.

Presentation of financial statements

Financial Accounting Standards Board and International Accounting Standards Committee have issued a number of guidelines in this regard. The following are the factors to be disclosed in the financial statements under operating lease by the lessee:

- Future minimum rental payment required as on date on the presentation of the balance sheet, both as aggregate and year wise for the succeeding 5 years
- The total minimum rental from lease to be received in future on sub-leases and
- Rental expenses for the period to which the income statement relates, classifying the amount into minimum rental, consignment rental and sub lease rentals

For finance lease, the gross amount of assets as on the date of balance sheet distinguishing according to nature and functions disclosed. The amount of accumulated amortisation expenses should be disclosed in full. Again the total amount of future lease payments due in aggregate and for each year for the succeeding five years is to be stated.

Following factors are to be disclosed by the lessor under operating lease in financial statements:

- The cost of property on lease
- The minimum rental receipt from such leases in aggregate and separately for the succeeding five years
- In the income statement, the contingent rentals included in the income for the period
- The total cost of the property on lease must also be shown major category wise together with the depreciation so far accumulated

In the case of finance lease, the financial statements should include:

- The gross investment in the lease depicted by the sum of the minimum lease payments and the estimated residual value
- The difference between the gross investment and its present value as unearned income to be recognised as earned over the life of the lease
- The sale price will be shown at the present value of the minimum lease payments deducting from the same, the cost of sale comprising of the cost of the leased property and other initial direct cost incidental to the same less the present value of the residual.

Disclosures in the financial statements of lessees

Disclosures should be made of the amount of the assets that are subject of finance leases at each balance sheet date. Liabilities, differentiating between the current and long-term portions.

Commitments for minimum lease payments under finance leases and under non-cancellable operating lease with a term of more than one year should be disclosed in summary form giving the amounts and periods in which the payments will become due.

Disclosures should be made of significant financing restrictions, renewal or purchase options, contingent rentals and other contingencies arising from leases.

Disclosures should be made of the basis used for allocating income so as to produce a constant periodic rate of return, indicating whether the return relates to the net investment outstanding or the net cash investment outstanding in the lease. If more than one basis is used, the bases should be disclosed.

When a significant part of the lessor's business comprises operating leases, the lessor should disclose the mount of assets by each major class of asset together with the related depreciation at each balance sheet date.

Apart from the disclosures recommended above the lessor should disclose the accounting policies followed with regard to accounting for income under finance lease, valuation of assets given on the lease and charge for depreciation.

>>> Example 1

(a) Manufacturing Limited, a company that manufactures a broad range of industrial products is in a serious cash flow position. Its overseas shareholders have not been paid dividends for three years; suppliers have threatened to stop supplies and there is a tax bill to pay at the end of September.

After consultation with the parent company a decision was made to:

Sub-divide the company's large 2 acre plot in the industrial area into two and sell the vacant half for Sh.3 million.

Sell the other half, the factory and all its contents to a Kenyan investor at the professional valuation of Shs. 80 million less a discount of 25%. As a condition for sale, the company will enter into a five-year lease of the factory and the assets in it for Shs.5 million a year.

The land has a book value of Shs.20 million while the plant and machinery are carried at Sh.79 million. Your discussions with the valuer indicates that annual rents for fully equipped factories in the same industry approximate 10% of the market value at the time the lease agreement is entered into.

Required

Calculate the effect of the profit and loss account of Manufacturing Limited of the above transactions for each of the five years.

Solution 1

(a)

Sale of vacant half of the land

	Shs '000'
Sale proceeds	3,000
Carrying value	(1,000)
Gain on disposal	2,000

Sale of the other half, the factory and its contents

Tutorial note: The lease of the factory and the assets may be classified as an operating lease since there is no indication that it is a finance lease. This is a sale and lease back transaction. Since the lease is an operating lease an actual sale has occurred.

As per IAS 17, paragraph 7

If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If a sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

In this case the sale price is below fair value. The fair value as per the professional valuation is sh.80 million yet the selling price is Sh.60 million (Shs. 80 million less 25%). The lease payments at market value should be 10% X 80 million which is Sh. 8 million. The company will enter into a five year lease for Sh. 5 million a year. Any loss will be deferred and amortised since the loss would be compensated by future lease payments.

	'000'
Selling price	60,000
Carrying value	
Land	(1,000)
Plant and machinery	(79,000)
Loss on sale	(20,000)

Effect on the profit and loss account

	1	2	**3**	**4**	**5**
	'000'	**'000'**	**'000'**	**'000'**	**'000'**
Gain on disposal	2,000	-	-	-	-
Lease rental	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Deferred loss	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)
	(7,000)	(7,000)	(7,000)	(7,000)	(7,000)

2.2 IMPAIRMENT OF ASSETS (IAS 36)

FAST FORWARD: There is an established principle that assets should not be carried at above their recoverable amount.

Introduction

An enterprise should write down the carrying value of an asset to its recoverable amount if the carrying value of an asset is not recoverable in full. IAS 36 was published in 1998 and puts in place a detailed methodology for carrying out impairment reviews and related accounting treatments and disclosures.

IAS 36 applies to all tangible, intangible and financial assets except inventories, assets arising from construction contracts, deferred tax assets, assets arising under IAS 19, employee benefits and financial assets within the scope of IAS 32, Financial instruments, disclosures and presentation. This is because those IASs already have rules for recognising and measuring impairment.

Impairment: a fall in the value of an asset so that its recoverable amount is now less than its carrying value in the balance sheet.

Carrying amount: is the net value at which the asset is included in the balance sheet (i.e. after deducting accumulated depreciation and any impairment losses).

The basic principle underlying IAS 36b is relatively straightforward. If an asset's value in the accounts is higher than its realistic value, measured as its 'recoverable amount', the asset is judged to have suffered an impairment loss. It should therefore be reduced in value, by the amount of the impairment loss. The amount of the impairment loss should be written off against profit immediately.

The main accounting issues to consider are therefore as follows:

(a) How is it possible to identify when an impairment loss may have occurred?
(b) How should the recoverable amount of the asset be measured?
(c) How should an 'impairment loss' be reported in the accounts?

Identifying a potentially impaired asset

An enterprise should carry out a review of its assets at each balance sheet date, to assess whether there are any indications of impairment to any assets. The concept of materiality applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the enterprise is required to make a formal estimate of the recoverable amount of the assets concerned.

IAS 36 suggests how indications of a possible impairment of assets might be recognised. The suggestions are based largely on common sense.

(a) External sources of information:
A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use; or
A significant change in the technological market, legal or economic environment of the business in which the assets are employed; or
An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use; or
The carrying amount of the enterprise's net assets being more than its market capitalisation

(b) Internal sources of information: evidence of obsolescence or physical damage, adverse changes in the use to which the asset is put, or the asset's economic performance.

Measuring the recoverable amount of the asset

The recoverable amount of an asset should be measured as the higher value of:

(a) The asset's net selling price, and

(b) Its value in use

The net selling price of an asset is the amount net of selling costs that could be obtained from the sale of the asset. Selling costs include sales transaction costs such as legal expenses.

(a) If there is an active market in the asset, the net selling price should be based on the market value, or on the price of recent transactions in similar assets.

(b) If there is no active market in the asset it might be possible to estimate a net selling price using best estimates of what 'knowledgeable, willing parties' might pay in an arm's length transaction.

Net selling price cannot be reduced, however, by including within selling costs any restructuring or reorganisation expenses, or any costs that have already been recognised in the accounts as liabilities.

The value in use of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset including its estimated net disposal value (if any) at the end of its expected useful life.

The cash flows used in the calculation should be pre-tax cash flows and a pre-tax discount rate should be applied to calculate the present value. Calculating a value in use therefore calls for estimates of future cash flows and the possibility exists that an enterprise might come up with over optimistic estimates of cash flows. The proposed IAS therefore states the following:

(a) Cash flow projections should be based on 'reasonable and supportable' assumptions

(b) Projections of cash flows, normally up to a maximum period of five years, should be based on the most recent budget or financial forecasts.

(c) Cash flow projections beyond this period should be obtained by extrapolating short-term projections, using either a steady or declining growth rate for each subsequent year (unless a rising growth rate can be justified). The long-term growth rate applied should not exceed the average long-term growth rate for the product, market, industry or country, unless a higher growth rate can be justified.

Composition of estimates of future cash flows

These should include:

(a) Projections of cash inflows from continuing use of the asset.

(b) Projections of cash outflows necessarily incurred to generate the cash inflows from continuing use of the asset

(c) Net cash flows received/paid on disposal of the asset at the end of its useful life.

There is an underlying principle that future cash flows should be estimated for the asset in its current condition. Future cash flows relating to restructurings to which the enterprise is not yet committed, or to capital expenditure that will improve the asset beyond the standard of performance originally assessed, are excluded.

Estimates of future cash flows should exclude:

(a) Cash inflows/outflows from financing activities

(b) Income tax receipts/payments

The amount of net cash inflow/outflow on disposal of an asset should assume an arm's length transaction.

Foreign currency future cash flows should be forecast in the currency in which they will arise and will be discounted using a rule appropriate for that currency. The resulting figure should then be translated into the reporting currency at the spot rate at the balance sheet date.

The discount rate should be a current pre-tax rate (or a rate) that reflects the current assessment of the time value of money and the risks specific to that asset. The discount should not include weighting if the underlying cash flows have already been adjusted for risk.

Recognition and measurement of an impairment loss

The rule for assets at historical cost is: if the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (i.e. the impairment loss), which should be charged as an expense in the income statement.

The rule for assets held at a revalued amount (such as property revalued under the IAS 16) is:

- To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to revaluation surplus.
- Any excess should be charged to the income statement.

The IAS goes into quite a large amount of detail about the important concept of cash generating units. As a basic rule, the recoverable amount of an asset should be calculated for the asset individually. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows cannot be attributed to the individual asset.

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash generating unit should be measured instead.

A cash generating unit is the smallest identifiable group of assets for which independent cash flows can be identified and measured.

If active market exists for the output produced by the asset or a group of assets, this asset or group should be identified as a cash generating unit, even if some or all of the output is used internally.

Cash generating units should be identified consistently from period to period for the same type of asset unless change is justified.

The group of net assets less liabilities that are considered for impairment should be the same as those considered in the calculation of the recoverable amount.

Goodwill and impairment of assets

In some cases, there may be a carrying amount for goodwill in the balance sheet. The goodwill will relate to a cash-generating unit. To carry out an exercise to determine whether the value of a cash-generating unit has been impaired, an enterprise should do a 'bottom-up' test and then, in some cases, a 'top-down' test:

(a) Bottom-up test: identify the amount of the goodwill in the balance sheet that can be allocated on a reasonable basis to the cash-generating unit. Measure the recoverable amount of the cash generating unit. Impairment has occurred if the recoverable amount is less than the carrying amount of the assets in the cash generating unit plus the allocated goodwill.

(b) Top-down test: if there is no reasonable basis for allocating a carrying amount of goodwill to the cash generating unit, the enterprise should do a top-down test. Identify the smallest cash generating unit to which the asset belongs and to which a share of the unallocated goodwill can be apportioned on a reasonable basis. Apportion a share of the unallocated goodwill to the cash generating unit. Then measure the recoverable amount of the cash generating unit. Impairment has occurred if the recoverable amount is less than the carrying amount of the assets in the cash generating unit plus the allocated goodwill.

Corporate assets

Corporate assets are group or divisional assets such as a head office building, EDP equipment or a research centre. Essentially corporate assets are assets that do not generate cash inflows independently from other assets; hence their carrying amount cannot be fully attributed to the cash generating unit under review. In testing a cash generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash generating unit. Then the same test is applied to each corporate asset for goodwill, that is bottom up or failing that top-down.

Accounting treatment for an impairment loss

If, and only if, the recoverable amount of an asset is less than its carrying amount in the balance sheet, is an impairment loss deemed to have occurred. This loss should be recognised immediately.

(a) The asset's carrying amount should be reduced to its recoverable amount in the balance sheet.

(b) The impairment loss should be recognised immediately in the income statement.

After reducing an asset to its recoverable amount, the depreciation charge on the asset should then be based on its new carrying amount, its estimated residual value (if any) and its estimated useful life.

An impairment loss should be recognised for a cash generating unit if (and only if) the recoverable amount for the cash generating unit is less than the carrying amount in the balance sheet for all the assets in the unit. When an impairment loss is recognised for a cash generating unit, the loss should be allocated between the assets in the unit in the following order.

(a) First, to the goodwill allocated to the cash generating unit

(b) Then to all other assets in the cash generating unit, on a pro-rata basis.

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

(a) Its net selling price (if determined)

(b) Its value in use (if determined)

(c) Zero

Any remaining amount of an impairment loss should be recognised as a liability if required by other IASs.

>>> Example 1

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

(a) Its carrying amount in the balance sheet is Kshs.3m

(b) The company has received an offer of Kshs.2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.

(c) The present value of the estimated cash flows from the platform's continued use is Kshs.3.3m

(d) The carrying amount in the balance sheet for the provision for dismantling and removal is currently Kshs.0.6m

What should be the value of the drilling platform in the balance sheet, and what if anything is the impairment loss?

Solution 1

Net sales price = Kshs.2.8m

Value in use = PV of cash flows from use less the carrying amount of the

Provision/liability	= Kshs.3.3m - Kshs.0.6m = Kshs.2.7m
Recoverable amount	= Higher of these two amounts, i.e. Kshs.2.8m
Carrying value	= Kshs.3m
Impairment loss	= Kshs.0.2m

The carrying value should be reduced to Kshs.2.8m

Reversal of an impairment loss

The annual review of assets to determine whether there may have been some impairment should be applied to all assets, including assets that have already been impaired in the past.

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be higher than the asset's current carrying value. In other words, there might have been a reversal of some of the previous impairment loss. In such cases:

(a) The reversal of the impairment loss should be recognised immediately as income in the income statement; and
(b) The carrying amount of the asset should be increased to its new recoverable amount

Rule: An impairment loss recognised for an asset in the prior years should be recovered if and only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised.

The asset cannot be revalued to a carrying amount that is higher than its value would have been if the asset had not been impaired originally, i.e. its depreciated carrying value had the impairment not taken place. Depreciation of the asset should now be based on its new revalued amount, its estimated residual value (if any) and its estimated remaining useful life.

An exception to the above rule is for goodwill. An impairment loss for goodwill should not be reversed in a subsequent period unless:

(a) The impairment loss was caused by a specific external event of an exceptional nature not expected to recur; and

(b) Subsequent external events have occurred that reverse the effect of that event.

>>> Example 2

A cash generating unit comprising a factory, plant and equipment etc and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash generating unit falls to Kshs.60m, resulting in an impairment loss of Kshs.80m, allocated as follows overleaf:

	Carrying amounts Before impairment Kshs.m	Carrying amounts after impairment Kshs.m
Goodwill	40	-
Patent (with no market value)	20	-
Tangible long-term assets	80	60
Total	140	60

After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the cash generating unit decreases to Kshs.90m. the carrying amount of the tangible long term assets had the impairment not occurred would have been Kshs.70m.

Required

Calculate the reversal of the impairment loss.

Solution 2

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible long-term assets to what it would have been had the impairment not taken place, i.e. a reversal of the impairment loss of Kshs.10m is recognised and the tangible long-term assets written back to Kshs.70m. Reversal of the impairment is not recognised in relation to the goodwill and patent because the effect of the external event that caused the original impairment has not reversed – the original product is still overtaken by a more advanced model.

Disclosure

IAS 36 calls for substantial disclosure about impairment of assets. The information to be disclosed include the following:

(a) For each class of assets, the amount of impairment losses recognised and the amount of any impairment losses recovered (i.e. reversals of impairment losses).

(b) For each individual asset or cash generating unit that has suffered a significant impairment loss, details of the nature of the asset, the amount of the loss, the events that led to recognition of the loss, whether recoverable amount is net selling price or value in use, and if the recoverable amount is value in use, the basis on which this value was estimated (e.g. discount rate applied).

Property, plant and equipment – compensation for the impairment or loss of items

An enterprise may receive monetary or non-monetary compensation from third parties for the impairment or loss of items of property, plant and equipment. The compensation may be used to restore the asset. Examples include:

- Reimbursement by insurance companies after an impairment of items of plant and equipment.

- Physical replacement of an impaired or lost asset

The accounting treatment is as follows:

(a) Impairment of items of property, plant and equipment should be recognised under IAS 36; disposals should be recognised under IAS 16

(b) Monetary or non-monetary compensation from third parties for items of property etc that were impaired, lost or given up, should be included in the income statement

(c) The cost of assets restored, purchased, constructed as a replacement or received as compensation should be determined and presented under IAS 16.

2.3 EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES (IFRS 6)

The main objective of IFRS 6 is to recommends the accounting treatment of assets that are used in exploring mineral resources as they have slight different purpose as compared with other property, plant and equipment and intangible assets. However an entity can still apply the requirements of IAS 16 or 38.

IFRS 6 permits an entity to develop an accounting policy for exploration and evaluation assets without specifically considering the requirements of paragraphs 11 and 12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Thus, an entity adopting IFRS 6 may continue to use the accounting policies applied immediately before adopting the IFRS. This includes continuing to use recognition and measurement practices that are part of those accounting policies.

IFRS 6 requires entities recognising exploration and evaluation assets to perform an impairment test on those assets when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount.

IFRS 6 varies the recognition of impairment from that in IAS 36 Impairment of Assets but measures the impairment in accordance with that Standard once the impairment is identified.

IFRS 6 requires disclosure of information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources, including

i. Its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.

ii. The amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

2.4 FINANCIAL INSTRUMENTS

Financial Instruments has become a very important area in accounting especially because of the developments in financial markets as far new derivatives and other financial instruments. Many companies had ignored the recording and accounting for such instruments and this has been disastrous as big companies like Enron collapsed. There has been an issue with IAS 32 which deals with Presentation, IAS 39 which deals with recognition and measurement and IFRS 7 which deals with Disclosure. IFRS 7 applies to periods commencing from 2007 and supersedes the presentation part of IAS 32.

The main objectives of the three standards are to ensure that financial instruments are properly accounted for and adequate disclosure is made by the companies. The three standards are very comprehensive especially IAS 39 which includes detailed illustration on how to teat the financial instruments in the accounts.

IAS 32 Financial Instruments: Presentation and Disclosure

Please note that the disclosure part of the standards has been superseded by IFRS 7 whose summary we shall look at later.

The stated objective of IAS 32 is to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance, and cash flows.

IAS 32 addresses this in a number of ways:

- Clarifying the classification of a financial instrument issued by an enterprise as a liability or as equity.
- Prescribing the accounting for treasury shares (a company's own repurchased shares).
- Prescribing strict conditions under which assets and liabilities may be offset in the balance sheet.
- Requiring a broad range of disclosures about financial instruments, including information as to their fair values.

Scope

IAS 32 applies in presenting and disclosing information about all types of financial instruments with the following exceptions:

- Interests in subsidiaries, associates, and joint ventures that are accounted for under IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates*, or IAS 31 *Interests in Joint Ventures*. However, IAS 32 applies to all derivatives on interests in subsidiaries, associates, or joint ventures.
- Employers' rights and obligations under employee benefit plans [see IAS 19].
- Rights and obligations arising under insurance contracts (this is the subject of a current IASB project). However, IAS 32 applies to a financial instrument that takes the form of an insurance (or reinsurance) contract but that principally involves the transfer of financial risks. Also, IAS 32 applies to derivatives that are embedded in insurance contracts.
- Contracts for contingent consideration in a business combination [see IFRS 3].
- Contracts that require a payment based on climatic, geological or other physical variables (weather derivatives) [see IAS 39].

IAS 32 applies to those contracts for buying or selling a non-financial item that can be settled net in cash or another financial instrument, except for contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.

STUDY TEXT

Important definitions

Financial instrument

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

Financial asset:

Any asset that is:

(i) Cash;
(ii) An equity instrument of another entity;
(iii) A contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
  - a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

- a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose an entity's own equity instruments does not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Financial liability:

Any liability that is a contractual obligation:

- to deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments

Equity instrument:

It as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value:

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

The definition of financial instrument used in IAS 32 is the same as that in IAS 39.

Classification as Liability or Equity

The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form.

How should a financial liability be distinguished from an equity instrument?

The critical featured of a liability is an obligation to transfer economic benefit. Therefore a financial instrument is a financial liability if it is an obligation to transfer economic benefit. A financial instrument is a financial liability if there is a contractual obligation on the issuer either to deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under potentially unfavourable conditions to the issuer.

The financial liability exists regardless of the way in which the contractual obligation will be settled. The issuer's ability to satisfy an obligation may be restricted, eg. By lack of access to foreign currency, but this is irrevant as it does not remove the issuer's obligation or the holder's right under the instrument. Where the above critical feature is not met, then the financial instrument is an equity instrument. IAS 32 explains that although the holder of an equity instrument may be entitled to a pro rata share of any distributions out of equity, the issuer does not have a contractual obligation to make such a distribution.

Although substance and legal form are often **consistent with each other,** this is not always the case. In particular, a financial instrument may have a legal form of equity, but in substance it is infact a liability. Other instruments may combine features of both equity instruments and financial liabilities.

For example, many entities issue **preferred shares** which must be **redeemed** by the issuer for a fixed (or determinable) amount at a fixed (or determinable) future date. Alternatively, the holder may have the right to require the issuer to redeem the shares at or after a certain date for a fixed amount. In such cases, the issuer has an obligation. Therefore the instrument is a **financial liability** and should be classified as such.

The classification of the financial instrument is made when it is first recognised and this classification will continue until the financial instrument is removed from the entity's balance sheet.

☐ Contingent settlement provisions

An entity may issue a financial instrument where the way in which it is settled depends on:

(i) The occurrence or non-occurrence of uncertain future events, or

(ii) The outcome of uncertain circumstances that are beyond the control of both the holder and the issuer of the instrument. For example, an entity might have to deliver cash instead of issuing equity shares. In this situation it is not immediately clear whether the entity has an equity instrument or a financial liability.

Such financial instruments should be classified as **financial liabilities** unless the possibility of settlement is remote.

☐ Settlement options

When a derivative financial instrument gives one party a choice over how it is settled (e.g. the issuer can choose whether to settle in cash or by issuing shares) the instrument is a **financial asset** or a **financial liability** unless **all the alternative choices** would result in it being an equity instrument.

☐ Compound financial instruments

Some financial instruments contain both a liability and an equity element. In such cases, IAS 32 requires the component parts of the instrument to be **classified separately,** according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

One of the most common types of compound instrument is **convertible debt.** This creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument (usually ordinary shares)of the issuer. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

Although in theory there are several possible ways of calculating the split, IAS 32 requires the following method:

a) Calculate the value for the liability component

b) Deduct this from the instrument as a whole to leave a residual value for the equity component.

The reasoning behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities.

The reasoning behind this approach is that an entity's equity is its residual value for the equity component after deducting all its liabilities.

The **sum of the carrying amounts** assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument **as a whole.**

>>> Example: Valuation of compound instruments

Rathbone Co. issues 2,000 convertible bonds at the start of 20 x 2. The bonds have a three year term, and are issued at par with a face value of KSh.1,000 per bond, giving total proceeds of KSh.2,000,000.interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any timeup to maturity into 250 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common shares is KSh.3. The dividends expected over the three year term of the bonds amount to 14c per share at the end of each year. The risk-free annual interest rate for a three year term is 5%.

Required

What is the value of the equity component in the bond?

Solution

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of liability the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

KSh.

Present value of the principal: KSh.2,000,000 payable at the end of three years

(KSh.2m x 1)* (1.09)^3
1,544,367

Present value of the interest: KSh.120,000 payable annually in arrears for three years.	
(KSh.120,000 x (1-1/(1.09)^3)/0.09*	303,755
Total liability component	1,848,122
Equity component (balancing figure)	151,878
Proceeds of the bond issue	2,000,000

*These figures can be obtained from discount and annuity tables.

The split between the liability and equity components remains the same throughout the term of the instrument, even if there are changes in the **likelihood of the option being exercised**. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payments until conversion, maturity of the instrument or some other relevant transaction takes place.

Treasury shares

If an entity **reacquires its own equity instruments,** those instruments ('treasury shares') shall be **deducted from equity.** No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid or received shall be recognised directly in equity.

Interest, dividends, losses and gains

As well as looking at balance sheet presentation, IAS 32 considers how financial instruments affect the income statement (and movements in equity). The treatment varies according to whether interest, dividends, losses or gains relate to a financial liability or an equity instrument.

- Interest, dividends, losses and gains relating to a financial instrument (or component part) classified as a **financial liability** should be recognised as **income or expense** in profit or loss.

- Distributions to holders of a financial instrument classified as an **equity instrument** should be **debited directly to equity** by the issuer.

- **Transaction costs** of an equity transaction shall be accounted for as a **deduction from equity.** (unless they are directly attributable to the acquisition of a business, in which case they are accounted for under IFRS 3).

You should look at the requirements of IAS 1 presentation of financial statements for further details of disclosure, and IAS 12 income taxes for disclosure of tax effects.

Offsetting a financial asset and a financial liability

A financial asset and financial liability should **only** be **offset,** with the net amount reported in the balance sheet, when an entity:

a) Has a **legally enforceable right** of set off, and

b) Intends to settle on a **net basis**, or to realise the asset and settle the liability simultaneously, i.e. at the same moment.

This will reflect the expected **future cash flows** of the entity in these specific circumstances. In all other cases, financial assets and financial liabilities are presented separately.

Section summary

a) Financial instruments must be classified as **liabilities** or **equity**

b) The **substance** of the financial instrument is more important than its **legal form**

c) The **critical feature of a financial liability** is the contractual obligation to deliver cash or another financial instrument.

d) **Compound instruments** are split into equity and liability parts and presented accordingly

e) **Interest**, **dividends, losses and gains** are treated according to whether they relate to a financial asset or a financial liability.

DISCLOSURE OF FINANCIAL INSTRUMENTS (SUPERSEDED BY IFRS 7)

One of the main purposes of IAS 32 is to provide full and useful disclosures relating to financial instruments.

'The purpose of the disclosures required by this standard is to provide information to enhance understanding of the significant of financial instruments to an entity's financial position, performance and cash flows and assist in assessing the amounts, timing and certainly of future cash flows associated with those instruments.'(IAS 32)

As well as specific monetary disclosures, **narrative commentary** by issuers is encouraged by the standard. This will enable users to understand management's attitude to risk, whatever the current transactions involving financial instruments are at the period end.

Different aspects of risk

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of **different types of financial risk** as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

Key terms

Market risk. There are three types of market risk: current risk, interest rate risk and price risk.

a) **Currency risk** is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates.

b) **Interest rate risk** is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates.

c) **Price risk** is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all securities traded in the market.

The term 'market risk' embodies not only the potential for loss but also the potential for gain.

Credit risk. The risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

Liquid risk (or funding risk). The risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.

Cash flow interest rate risk. The risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates. In the case of a floating rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value. (IAS 32)

The standard does not prescribe the **format or location** for disclosure of information. A combination of narrative descriptions and specific quantified data should be given, as appropriate.

The **level of detail** required is a matter of judgment. Where a large number of very similar financial instrument transactions are undertaken, these may be grouped together. Conversely, a single significant transaction may require full disclosure.

Classes of instruments will be grouped together by management in a manner appropriate to the information to be disclosed.

Risk management

An entity shall describe its **financial risk management objective and policies,** including its policy for **hedging** each main type of forecast transaction for which hedge accounting is used.

The following information should be disclosed separately for **each type** of **designed hedge** (these are described later in this chapter): a **description** of the hedge; a description of the **financial instruments** designated as hedging instruments and their **fair values** at the balance sheet date; the **nature of the risks** being hedged; and for cash flow hedges, the periods in which the cash flows are expected to occur and when they are expected to enter into the determination of profit or loss.

The following information should be disclosed where a **gain or loss** on a hedging instrument has been **recognised directly in equity:** the **amount recognised** during the period; and the **amount transferred** from equity to profit or loss during the period.

Terms, conditions and accounting policies

The following information should be disclosed for each class of financial asset, financial liability and equity instrument, both recognised and unrecognised.

a) Information about the **extent and nature** of the financial instruments, including **significant terms and conditions** that may affect the amount, timing and certainty of future cash flows.

b) **Accounting policies** and methods adopted, including the criteria for **recognition** and the basis of **measurement** applied.

Interest rate risk

The following information should be disclosed for each class of financial asset and financial liability, both recognised and unrecognised, about an entity's exposure to interest rate risk.

a) **Contractual repricing or maturity dates,** whichever are earlier

b) **Effective interest rates,** where applicable
In other words, this information shows **what interest rate is in force** at the moment and how long it is likely to be before these changes, allowing a full appreciation of interest rate risk.

Credit risk

The following should be disclosed by an entity for each class of **financial asset,** both recognised and unrecognised, about its exposure to credit risk.

a) The amount that best represents its **maximum credit risk exposure** at the balance sheet date, without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instruments.

b) Significant **concentrations** of credit risk

This information allows users of the financial statements to assess the extent to which **failures by counterparties** to discharge their obligations could reduce future cash inflows from financial assets on hand at the balance sheet date. However, an assessment of the **probability** of such losses occurring (which would be recognised in the income statement) is not required.

Fair value

Information about **fair value** should be disclosed for each class of financial asset and financial liability, in a way that permits it to be **compared with the corresponding carrying amount** in the balance sheet.

Fair value information is very important as it is widely used for business purposes in determining an entity's overall financial position and in **making decisions** about individual financial instruments. It reflects the judgment of the market as to the **present value** of expected future cash flows related to the instrument. It **permits comparisons** of financial instruments having substantially the same economic characteristics and it also provides a basis for **assessing management's stewardship** by indicating the effects of its decisions to buy, sell or hold financial assets.

Where investments in **unquoted** equity instruments are measured at **cost** under IAS 39 because their fair value cannot be measured reliably, that fact should be stated together with a **description** of the financial instruments: their **carrying amount,** an **explanation** of why fair value cannot be measured reliably and, if possible, the **range of estimates** within which value is highly likely to lie.

In addition, the following information should be disclosed.

a) For each significant class of instruments, the **methods and significant assumptions** applied in determining fair value

b) Whether fair values are determined directly by reference to published price quotations in an active market or are estimated using a valuation technique

c) The total amount of the change in fair value estimated using a valuation technique that was recognised in profit and loss during the period.

Other disclosures

IAS 32 requires various other disclosures which are intended to enhance financial statements users' understanding of financial instruments. These include **material items of income, expense and gains and losses** resulting from financial assets and financial liabilities.

IAS 39 RECOGNITION OF FINANCIAL INSTRUMENTS

IAS 39 financial instruments: Recognition and measurement establishes principles for recognising and measuring financial assets and financial liabilities.

Scope

IAS 39 applies to **all entities** and **all types of financial instruments except** those specifically excluded, as listed below.

a) Investments in **subsidiaries, associates, and joint ventures** covered by IASs 27, 28 and 31, unless:

   i. These investments are held exclusively with a view to their subsequent disposal in the near future; or

   ii. They are subsidiaries excluded from consolidation.

b) **Leases** covered in IAS 17

c) **Employee benefit plans** covered in IAS 19

d) **Insurance contracts**

e) Equity instruments **issued by the entity** e.g options and warrants#

f) **Financial guarantee** contracts

g) **Contracts for contingent consideration** in a business combination, covered in IAS 22

h) Contracts requiring payment based on climatic, geological or other **physical variables**

i) **Loan commitments** that cannot be settled net in cash or another financial instrument

j) Financial instruments, contracts and obligations under **share-based payment transactions** covered in IFRS 2

Initial recognition

Financial instruments should be recognised in the balance sheet when the entity becomes a party to the **contractual provisions of the instrument.**

Point to note: an important consequence of this is that all derivatives should be on the balance sheet.

Notice that this is **different** from the recognition criteria in the *framework* and in most other standards. Items are normally recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

>>> Example: Initial recognition

An entity has entered into two separate contracts.

a) A firm commitment (an order) to buy a specific quantity of iron

b) A forward contract to buy a specific quantity of iron at a specified date

Contract (a) is a **normal trading contract.** The entity does not recognise a liability for the iron until the goods have actually been delivered. (Note that this contract is not a financial instrument because it involves a physical asset, rather than a financial asset).

Contract (b) is a **financial instrument.** Under IAS 39, the entity recognises a financial liability (an obligation to deliver cash) on the **commitment date,** rather than waiting for the closing date in which the exchange takes place.

Note that planned future transactions, no matter how likely, are not assets and liabilities of an entity – the entity has not yet become a party to the contract.

Transition and initial recognition

In December 2004 the IASB issued an amendment to IAS 39 *Financial Instruments*: recognition and measurement introducing an **additional transitional relief** that applies on adoption of one aspect of the revised version of this standard issued in December 2003. Under the standard, the fair value of a financial instrument at the date of its acquisition is taken to be the transaction price unless a different value is available based on observable market prices – so in absence of such prices, no immediate profit ('day one profit') can arise. The new amendment means that no restatement of earlier transactions is required on first applying this prohibition on recognising day one profits; the date from which transactions are restated can be either 1 January 2004, or 25 October 2002 (the effective date of similar requirements in US GAAP, thus allowing entities who also report under US GAAP to adopt the new requirements consistently).

Derecognition

Derecognition is the removal of a previously recognised financial instrument from an entity's balance sheet.

An entity should derecognise a **financial asset when:**

a) The **contractual rights** to the cash flows from the financial asset **expire;** or

b) It **transfers substantially all the risks and rewards of ownership** of the financial asset to another party.

Question

Can you think of an example of a situation in which:

- An entity has transferred substantially all the risks and rewards of ownership,
- An entity has retained substantially all the risks and rewards of ownership,

Answer

IAS 39 includes the following examples:

a) i) an unconditional sale of a financial asset
ii) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase.

b) i) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return

ii) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity

The principle here is that of **substance over form.**

An entity should derecognise a **financial liability** when it is **extinguished – i.e.** when the obligation specified in the contract is discharged or cancelled or expires.

It is possible for only **part** of a financial asset or liability to be derecognised. This is allowed if the part comprises:

a) only specifically identified cash flows; or

b) only a fully proportionate (pro rata) share of the total cash flows

for example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

On derecognition, the amount to be included in net profit or loss for the period is calculated as follows:

Formula to learn

	KSh.	KSh.
Carrying amount of asset/liability (or the portion of asset/liability) transferred		
Less: proceeds received/paid	X	
Any cumulative gain or loss reported in equity	X	
		(X)
Difference to net profit/loss		X

Where only part of a financial asset is derecognised, the carrying amount of the asset should be allocated between the parts retained and the part transferred based on their relative fair values on the date of transfer. A gain or loss should be recognised based on the proceeds for the portion transferred.

Section summary

a) **All financial assets and liabilities** should be **recognised on the balance sheet**, including derivatives.

b) Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire or where substantially all the risks and rewards of ownership are transferred** to another party.

c) Financial liabilities should be derecognised when they are **extinguished.**

IAS 39 MEASUREMENTS OF FINANCIAL INSTRUMENTS

Initial measurement

Financial instruments are initially measured at the **fair value** of the consideration given or received (i.e. **cost) plus** (in most cases) **transaction costs** that are **directly attributable** to the acquisition or issue of the financial instrument.

The **exception** to this rule is where a financial instrument is designated as **at fair value through profit or loss** (this term is explained below). In this case, **transaction costs** are **not** added to fair value at initial recognition.

The fair value of the consideration is normally the transaction price or market prices. If market prices are not reliable, the fair value may be **estimated** using a valuation technique (for example, by discounting cash flows).

Subsequent measurement

For the purposes of measuring a financial asset held subsequent to initial recognition, IAS 39 classifies financial assets into four categories defined here.

A financial asset or liability at fair value through profit or loss meets either of the following conditions:

a) It is classified as held for trading. A financial instrument is classified as held for trading if it is:
a. Acquired or incurred principally for the purpose of selling or repurchasing it in the near term.
b. Part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.
c. A derivative (unless it is a designated and effective hedging instrument).

b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. Any financial instrument may be so designated when it is initially recognised except for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured.

Held – to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intent and ability to hold to maturity other than:

a) Those that the entity upon initial recognition designates as at fair value through profit or loss.
b) Those that the entity designates as available for sale
c) Those that meet the definition of loans and receivables

Key terms
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

a) Those that the entity intends to sell immediately or in the near term, which should be classified as held for trading and those that the entity upon initial recognition designates as at far value through profit or loss.
b) Those that the entity upon initial recognition designates as available –for-sale
c) Those for which the holder may not recover substantially all of the initial investment, other than because of credit deterioration, which shall be classified as available for sale.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or a receivable.

Available-for-sale-financial assets are those financial assets that are not:

1) Loans and receivables originated by the entity
2) Held-to-maturity investments
3) Financial assets at fair value through profit or loss

(IAS 39)

After initial recognition, all financial assets should be **measured to fair value,** without any deduction for transaction costs that may be incurred on sale of other disposal, except for:

1. **Loans and receivables**

2. **Held to maturity investments**

3. Investment in **equity instruments** that do not have a quoted market price in an active market and whose **fair value cannot be reliable measured** and derivatives that is linked to and must be settled by delivery of such unquoted equity instruments.

Loans and receivables and **held to maturity investments** should be measured at **amortised cost** using the **effective interest method.**

Key term

Amortised cost of a financial asset or financial liability is the amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation of any difference between that initial amount and the maturity amount, and minus any write-down (directly or through the use of an allowance account) for impairment or uncollectability.

The **effective interest method** is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period.

The **effective interest method** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument. (IAS 39)

>>> Example: Amortised cost

On 1 January 20 x 1 Biashara Co purchases a debt instrument for its value of KSh.1,000. The debt instrument is due to mature on 31 December 20 x 5. The instrument has a principal amount of KSh.1,250 and the instrument carries fixed interest at 4.72% that is paid annually.

How should Biashara Co. account for the debt instrument over its five year term?

Solution

Biashara Co will receive interest of KSh.59 (1,250 x 4.72%) each year and KSh.1,250 when the instrument matures.

Biashara must allocate the discount of KSh.250 and the interest receivable over the five year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years:

income statement interest received

Year	Amortised cost at Beginning of year	interest income for during year (@10%)	(cash flow)	amortised cost at end of year
	KSh.	KSh.	KSh.	KSh.
20 x 1	1,000	100	(59)	1,041
20 x 2	1,041	104	(59)	1,086
20 x 3	1,086	109	(59)	1,136
20 x 4	1,136	113	(59)	1,190
20 x 5	1,190	119	(1,250 + 59)	-

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year.

Investments whose **fair value cannot be reliably measured** should be measured at **cost**.

Classification

There is a certain amount of flexibility in that any financial instrument can be designated at fair value through profit or loss. However, this is a **once and for all choice** and has to be made on initial recognition. Once a financial instrument has been classified in this way it **cannot be reclassified,** even if it would otherwise be possible to measure it at cost or amortised cost.

In contrast, it is quite difficult for an entity **not** to remeasure financial instruments to fair value.

> Notice that derivates must be remeasured to fair value. This is because it would be misleading to measure them at cost.

For a financial instrument to be held to maturity it must meet several extremely narrow criteria. The entity must have a **positive intent** and **demonstrated ability** to hold the investment to maturity. These conditions are not met if:

a) The entity intends to hold the financial asset for an undefined period

b) The entity stands ready to sell the financial asset in response to changes in interest rates or risks, liquidity needs and similar factors (unless these situations could not possibly have been reasonably anticipated).

c) The issuer has the right to settle the financial asset at an amount significantly below its amortised cost (because this right will almost certainly be exercised)

d) It does not have the financial resources available to continue to finance the investment until maturity.

e) It is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity.

In addition, an **equity** instruments is **unlikely** to meet the criteria for classification as held to maturity.

There is a **penalty** for selling or reclassifying a 'held-to-maturity' investment other than in certain very tightly defined circumstances. If this has occurred during the **current** financial year or during the **two preceding** financial years no financial asset can be classified as held-to-maturity.

If an entity can no longer hold an investment to maturity, it is no longer appropriate to use amortised cost and the asset must be re-measured to fair value. All remaining held-to-maturity investments must also be re-measured to fair value and classified as available-for-sale (see above).

Subsequent measurement of financial liabilities

After initial recognition, all financial liabilities should be measured at **amortised cost,** with the exception of financial liabilities at fair value through profit or loss (including most derivatives). These should be measured at **fair value,** but where the fair value **is not capable of reliable measurement,** they should be measured at cost.

Question: Measurement

Hatari Co issues a bond for KSh.503,778 on 1 January 20 x 2. No interest is payable on the bond, but it will be held to maturity and redeemed on 31 December 20 x 4 for KSh.600,000. The bond has **not** been designated as at fair value through profit or loss.

Required

Calculated the change to the income statement of Hatari Co for the year ended 31 December 20x 2 and the balance outstanding at 31 December 20 x 2.

Answer

The bond is a 'deep discount' bond and is a financial liability of Hatari Co. It is measured at amortised cost. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

To calculate amortised cost we need to calculate the effective interest rate of the bond:

$$\frac{600{,}000}{503{,}778} = 1.191$$

From tables, the interest rate is 6%.

The charge to the income statement is KSh.30,226 (503,778 x 6%)

The balance outstanding at 31 December 20 x 2 is KSh.534,004 (503,778 + 30,226)

Gains and losses

Instruments at **fair value through profit or loss:** gains and losses are recognised in **profit or loss** (i.e. in the income statement).

Available for sale financial assets: gains and losses are recognised **directly in equity** through the statement of changes in equity. When the asset is derecognised the cumulative gain or loss previously recognised in equity should be recognised in profit and loss.

Financial instruments carried at **amortised cost:** gains and losses are recognised in **profit and loss** as a result of the amortisation process and when the asset is derecognised.

Financial assets and financial assets that are **hedged items:** special rules apply (discussed later in this chapter).

Question: Types of investment

Hiza Ltd. entered into the following transactions during the year ended 31 December 20 x 3:

a) Entered into a speculative interest rate option costing KSh.10,000 on 1 January 20 x 3 to borrow KSh.6,000,000 from AB bank commencing 31 March 20 x 5 for 6 months at 4%. The value of the option at 31 December 20 x 3 was KSh.15,250.
b) Purchased 6% debentures in FG Co on 1 January 20 x 1 (their issue date) for KSh.150,000 as an investment. Ellesmere Co intends to hold the debentures until their redemption at a premium in 5 year's time. The effective rate of interest of the bond is 8.0%.
c) Purchased 50,000 shares in ST Co on 1 July 20 x 3 for KSh.3.50 each as an investment. The share price on 31 December 20 x 3 was KSh.3.75.

Required

Show the accounting treatment and relevant extracts from the financial statements for the year ended 31 December 20 x 3, Hiza Ltd only designates financial assets as at fair value through profit or loss where this is unavoidable.

Solution

BALANCE SHEET EXTRACTS

	KSh.
Financial assets:	15,250
Interest rate option (W1)	15,250
4% debentures in MT Co. (W2)	153,000
Shares in EG Co (W3)	187,500

INCOME STATEMENT EXTRACTS

	KSh.
Financial income:	
Gain on interest rate option (W1)	5,250
Effective interest on 6% debentures (W2)	12,000

Workings

a) interest rate option

This is a derivative and so it must be treated as at fair value through profit or loss

Initial measurement (at cost)

DEBIT Financial asset KSh.10,000
CREDIT Cash KSh.10,000

At 31.12.20 x 3 (re-measured to fair value)
DEBIT Financial asset KSh.5,250
CREDIT Income statement KSh.5,250

b) Debentures

On the basis of the information provided, this can be treated as a held-to-maturity investment.

Initial measurement (at cost)

DEBIT Financial asset KSh.150,000
CREDIT Cash KSh.150,000

At 31.12.20 x 3 (amortised cost):

DEBIT Financial asset (150,000 x 8%) KSh.12,000
CREDIT Finance income KSh.12,000

DEBIT Cash (150,000 x 6%) KSh.9,000
CREDIT Financial asset KSh.9,000

Amortised cost at 31.12.20 x 3

(150,000 + 12,000 – 9,000) KSh.153,000

c) Shares

these are treated as an available for sale financial asset (shares cannot normally be held to maturity and they are clearly not loans or receivables).

Initial measurement (at cost):

DEBIT	Financial asset (50,000 x KSh.3.50)	KSh.175,000
CREDIT	Cash	KSh.175,000

At 31.12. 20 x 3 (re-measured to fair value)

DEBIT	Financial asset ((50,000 x KSh.3.75) - KSh.175,000))	KSh.12,500
CREDIT	Equity	KSh.12,500

Impairment and uncollectability of financial assets

At each balance sheet date, an entity should assess whether there is any objective evidence that a financial asset or group of assets is impaired.

QUESTION: Impairment

Give examples of indications that a financial asset or group of assets may be impaired.

Answer

IAS 39 lists the following:

- Significant financial difficulty of the issuer
- A breach of contract, such as a default in interest or principal payments
- The lender granting a concession to the borrowers that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty
- It becomes probable that the borrower will enter bankruptcy
- The disappearance of an active market for that financial asset because of financial difficulties.

Where there is objective evidence of impairment, the entity should determine the amount of any impairment loss.

Financial assets carried at amortised cost

The impairment loss is the **difference** between the asset's **carrying amount** and its recoverable amount. The asset's recoverable amount is the present value of estimated future cash flows, discounted at the financial instrument's **original** effective interest rate.

Financial assets carried at cost

Unquoted equity instruments are carried at cost if their fair value cannot be reliably measured. The impairment loss is the difference between the asset's **carrying amount** and the **present value of estimated future cash flows**, discounted at the current market rate of return for a similar financial instrument. Such impairment losses cannot be reversed.

Available for sale financial assets

Available for sale financial assets are carried at fair value and gains and losses are recognised directly in equity. Any impairment loss on an available for sale financial asset should be **removed from equity** and **recognised in net profit or loss for the period** even though the financial asset has not been derecognised.

The impairment loss is the difference between its **acquisition cost** (net of any principal repayment and amortisation) and **current fair value** (for equity instruments) or recoverable amount (for debt instruments), less any impairment loss on that asset previously recognised in profit or loss.

Impairment losses relating to equity instruments cannot be reversed, impairment losses relating to debt instruments may be reversed if, in a later period, the fair value of the instrument increases and the increase can be objectively related to an event occurring after the loss was recognised.

>>> Example: Impairment

Broadfield Co purchased 5% debentures in X co at 1 January 20 x 3 (their issue date) for KSh.100,000. The term of the debentures was 5 years and the maturity value is KSh.130,525. The effective rate of interest on the debentures is 10% and the company has classified them as held-to-maturity financial asset.

At the end of 20 x 4 x Co went into liquidation. All interest had been until the date. On 31 December 20 x 4 the liquidator of X Co announced that no further interest would be paid and only 80% of the maturity value would be repaid, on the original repayment date.

The market interest rate on similar bonds is 8% on that date.

Required

a) What value should the debentures have been stated at just before the impairment became apparent?

b) At what value should the debentures be stated at 31 December 20 x 4, after the impairment?

c) How will the impairment be reported in the financial statements for the year ended 31 December 20 x 4?

Solution

6 The debenture are classified a held –to-maturity financial asset and so they would have been stated at amortised cost:

	KSh.
Initial cost	100,000
Interest at 10%	10,000
Cash at 5%	(5,000)
At 31 December 20 x 3	105,000
Interest at 10%	10,500
Cash at 5%	(5,000)
At 31 December 20 x 4	110,500

7 After the impairment, the debentures are stated at their recoverable amount (using the **original** effective interest rate of 10%):
80% x KSh.130,525 x 0.751 = KSh.78,419

8 The impairment of KSh.32,081 (KSh.110,500 - KSh.78,419) should be recorded:

Dr Income statement KSh.32,081
Cr Financial asset KSh.32,081

Section summary

a) Initial recognition, financial instruments are measured at cost.

b) Subsequent measurement depends on how a financial asset is classified.

c) Financial assets at **fair value through profit or loss** are measured at **fair value;** gains and losses are recognised in **profit or loss.**

d) **Available for sale** assets are measured at **fair value;** gains and losses are taken to **equity**.

e) **Loans and receivables** and **held to maturity** investments are measured at **amortised cost;** gains and losses are recognised in **profit or loss.**

f) Financial **liabilities** are normally measured at **amortised cost,** unless they have been classified as at fair value through profit and loss.

Hedging

IAS 39 **requires hedge accounting** where there is a **designated hedging relationship** between a hedging instrument and a hedged item. It is **prohibited otherwise.**

Key term

Hedging, for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, by the change in fair value or cash flows of a hedged item.

A **hedged item** is an asset, liability, firm commitment, or forecasted future transaction that:

a) Exposes the entity to risk of changes in fair value or changes in future cash flows, and that

b) Is designated as being hedged.

A **hedging instrument** is a designated derivative or (in limited circumstances) another financial asset or liability whose fair value or cash flows are expected to offset changes in the value or cash flows of a designated hedged item. (A non-derivative financial asset or liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates).

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. (IAS 39)

In simple terms, entities **hedge** to **reduce** their exposure to risk and uncertainty, such as changes in prices, interest rates of foreign exchange rates. Hedge accounting recognises hedging relationships by allowing (for example) losses on a hedged item to be offset against gains on a hedging instrument.

Generally only assets, liabilities etc that involve external parties can be designated as hedged items. The foreign currency risk of an intragroup monetary item (eg payable/receivable between two subsidiaries) may qualify as a hedged item in the group financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. This can happen (per IAS 21) when the transaction is between entities with different functional currencies.

In addition the foreign currency risk of a highly probable group transaction may qualify as a hedged item if it is in a currency other than the functional currency of the entity and the foreign currency risk will affect profit or loss.

>>> Example: Hedging

A company owns inventories of 20,000 gallons of oil which cost KSh.400,000 on 1 December 20 x 3.

In order to hedge the fluctuation in the market value of the oil the company signs a futures contact to deliver 20,000 gallons of oil on 31 March 20 x 4 at the futures price of KSh.22 per gallon.

The market price of oil on 31 December 20 x 3 is KSh.23 per gallon and the futures price for delivery on 31 March 20 x 4 is KSh. 24 per gallon.

Required

Explain the impact of the transactions on the financial statements of the company:

a) Without hedge accounting
b) With hedge accounting

Solution

The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the contract.

Without hedge accounting:

The futures contract is a derivative and therefore must be remeasured to fair value under IAS 39. The loss on the futures contract is recognised in the income statement:

DEBIT	Income statement (20,000 x 24 – 22)	KSh.40,000
CREDIT	Financial liability	KSh.40,000

With hedge accounting

The loss on the futures contract is recognised in the income statement as before.

The inventories are revalued to fair value:

	KSh.
Fair value at 31 December 20 x 4 (20,000 x 23)	460,000
Cost	(400,000)
Gain	60,000

The gain is also recognised in the income statement

DEBIT	Inventory	KSh.60,000
CREDIT	Income statement	KSh.60,000

The net effect on the income statement is a gain of KSh.20,000 compared with a loss of KSh.40,000 without hedging.

The standard identifies three types of hedging relationship

Key terms

Fair value hedge: a hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and could affect profit or loss.

Cash flow hedge: a hedge of the exposure to variability in cash flows that

a) Is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction (such as an anticipated purchase or sale), and that

b) Could affect profit or loss.

Hedge of a net investment in a foreign operation: AS 21 defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation. (IAS 39)

The hedge in the example above is a **fair value hedge** (it hedges exposure to changes in the fair value of a recognised asset: the oil).

Conditions for hedge accounting

Before a hedging relationship qualifies for hedge accounting, **all** of the following **conditions** must be met.

- The hedging relationship must be **designated at its inception as a hedge** based on the entity's risk management objective and strategy. The must be formal documentation (including identification of the hedged item, the hedging instrument, the nature of the risk that is to be hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's value or cash flows attributable to the hedged risk).

- The hedge is expected to be **highly effective** in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. (Note: the hedge need not necessarily be fully effective).

- For **cash flow hedges,** a **forecast transaction** that is the subject of the hedge must be **highly probable** and must present an exposure to variations in cash flows that could ultimately affect profit and loss.

- The effectiveness of the hedge can be **measured reliably**.

- The hedge is **assessed** on an ongoing basis (annually) and has been **effective during the reporting period.**

Accounting treatment

Fair value hedges

The **gain or loss** resulting from **re-measuring** the hedging instrument at fair value is **recognised in profit or loss.**

The gain or loss on the hedged item attributable to the hedged risk should **adjust the carrying amount** of the hedged item and be **recognised in profit or loss**.

Cash flow hedges

The portion of the gain or loss on the hedging instrument that is determined to be an **effective** hedge shall be **recognised directly in equity** through the statement of changes in equity.

The **ineffective portion** of the gain or loss on the hedging instruments should be **recognised in profit or loss.**

When a hedging transaction results in the recognition of an asset or liability, changes in the value of the hedging instrument recognised in equity either:

- Are adjusted against the carrying of the asset or liability, or

- Affect the income statement at the same time as the hedged item (for example, through depreciation or sale).

Hedges of a net investment in a foreign operation

- The effective portion of the gain or loss on the hedging instrument is recognised directly in equity through the statement of changes in equity.

- The ineffective portion is recognised in profit and loss.

On disposal of the foreign operation, gains and losses on the hedging instrument that have been taken to equity are 'recycled' and recognised in profit or loss.

>>> Example: Cash flow hedge

Alpha Co signs a contract on 1 November 20 x 1 to purchase an asset on 1 November 20 x 2 for £60,000,000. Bets reports in US $ and hedges this transactions by entering into a forward contract to by £60,000,000 on 1 November 20 x 2 at US$1: £1.5.

Spot and forward exchange rates at the following dates are:

	Spot	Forward (for delivery on 1.11.x 2)
1.11 x 1	US$1: £1.45	US$1:£1.5
31.12. x1	US$1: £1.20	US$1:£1.24
1.11. X 2	US$1: £1.0	US$1:£1.0 (actual)

Required

Show the double entries relating to these transactions at 1 November 20 x 1, 31 December 20 x 1 and 1 November 20 x 2.

Solution

Entries at 1 November 20 x 1

The value of the forward contract at inception is zero so no entries recorded (other than any transaction costs), but risk disclosures will be made.

The contractual commitment to buy the asset would be disclosed if material (IAS 16).

Entries at 31 December 20 x 1

Gain on forward contract:

	$
Value of contract at 31.12. x 1 (£60,000,000/1.24)	48,387,097
Value of contract at 1.11.x 1 (£60,000,000/1.5)	40,000,000
Gain on contract	8,387,097

Compare to movement in value of asset (unrecognised):

Increase in $cost of asset (£60,000,000/1.20 - £60,000,000/1.45)	$8,620,690

As this is higher, the hedge is deemed fully effective at this point:

DEBIT	Financial asset (forward a/c)	$8,387,097	
CREDIT	Equity		$8,387,097

Entries at 1 November 20 x 2

Additional gain on forward contract

	$
Value of contract at 1.11.x2 (£60,000,000/1.0)	60,000,000
Value of contract at 31.12.x1 (£60,000,000/1.24)	48,387,097
Gain on contract	11,612,903

Compare to movement in value of asset (unrecognised):

Increase in $cost of asset

(£60,000,000/1.0 - £60,000,000/1.2

Therefore, the hedge is not fully effective during this period, but is still highly effective (and hence hedge accounting can be used):

$10,000/ $11,612,903 = 86% which is within the 80% - 125% bandings

DEBIT Financial asset (forward a/c)	$11,612,903	
CREDIT Equity		$10,000,000
CREDIT Income statement		$1,612,903

Purchase of asset at market price

DEBIT asset (£60,000,000/1.0)	$60,000,000	
CREDIT Cash		$60,000,000

Settlement of forward contract

DEBIT Cash	$20,000,000	
CREDIT financial asset (forward a/c)		$20,000,000

STUDY TEXT

Realisation of gain on hedging instrument

The cumulative gain of $18,387,097 recognised in equity:

(i) Is transferred to the income statements as the asset is used, i.e. over the asset's useful life: or

(ii) Adjusts the initial cost of the asset (reducing future depreciation).

Section Summary

- **Hedge accounting** means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.

relationship is clearly defined, measurable and actually effective.

- There are three types of hedge; **fair value** hedge; **cash flow** hedge; hedge of a **net investment in a foreign operation**.

- The accounting treatment of a hedge **depends on its type.**

Please refer to the appendix in IAS 39 for further illustrations on financial instruments.

IFRS 7 FINANCIAL INSTRUMENTS: DISCLOSURES

Overview of IFRS 7

- Adds certain new disclosures about financial instruments to those currently required by IAS 32;

- Replaces the disclosures now required by IAS 30; and

- Puts all of those financial instruments disclosures together in a new standard on *Financial Instruments: Disclosures*. The remaining parts of IAS 32 deal only with financial instruments presentation matters.

Disclosure Requirements of IFRS 7:

- An entity must group its financial instruments into classes of similar instruments and, when disclosures are required, make disclosures by class.

The two main categories of disclosures required by IFRS 7 are:

1. Information about the significance of financial instruments.

2. Information about the nature and extent of risks arising from financial insturments.

Information about the significance of financial instruments

Balance Sheet

- Disclosure of the significance of financial instruments for an entity's financial position and performance. This includes disclosures for each of the following categories:

  - Financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
  - Held-to-maturity investments.
  - Loans and receivables.
  - Available-for-sale assets.
  - Financial liabilities at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
  - Financial liabilities measured at amortised cost.

- Special disclosures about financial assets and financial liabilities designated to be measured at fair value through profit and loss, including disclosures about credit risk and market risk and changes in fair values

- Reclassifications of financial instruments from fair value to amortised cost or vice versa

- Disclosures about derecognitions, including transfers of financial assets for which derecogntion accounting is not permitted by IAS 39

- Information about financial assets pledged as collateral and about financial or non-financial assets held as collatersl

- Reconciliation of the allowance account for credit losses (bad debts).

- Information about compound financial instruments with multiple embedded derivatives.

- Breaches of terms of loan agreements.

Income Statement and Equity

- Items of income, expense, gains, and losses, with separate disclosure of gains and losses from:
  - Financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
  - Held-to-maturity investments.
  - Loans and receivables.
  - Available-for-sale assets.
  - Financial liabilities measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
  - Financial liabilities measured at amortised cost.

- Interest income and interest expense for those financial instruments that are not measured at fair value through profit and loss

- Fee income and expense

- Amount of impairment losses on financial assets

- Interest income on impaired financial assets

Other Disclosures

- Accounting policies for financial instruments

- Information about hedge accounting, including:
  - Description of each hedge, hedging instrument, and fair values of those instruments, and nature of risks being hedged.
  - For cash flow hedges, the periods in which the cash flows are expected to occur, when they are expected to enter into the determination of profit or loss, and a description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur.
  - If a gain or loss on a hedging instrument in a cash flow hedge has been recognised directly in equity, an entity should disclose the following:

- The amount that was so recognised in equity during the period.

- The amount that was removed from equity and included in profit or loss for the period.

- The amount that was removed from equity during the period and included in the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non- financial liability in a hedged highly probable forecast transaction.

  - For fair value hedges, information about the fair value changes of the hedging instrument and the hedged item.
  - Hedge ineffectiveness recognised in profit and loss (separately for cash flow hedges and hedges of a net investment in a foreign operation).

- Information about the fair values of each class of financial asset and financial liability, along with:
  - Comparable carrying amounts.
  - Description of how fair value was determined.
  - Detailed information if fair value cannot be reliably measured.

Note that disclosure of fair values is not required when the carrying amount is a reasonable approximation of fair value, such as short-term trade receivables and payables, or for instruments whose fair value cannot be measured reliably.

Nature and extent of exposure to risks arising from financial instruments

Qualitative disclosures

- The qualitative disclosures describe:
  - Risk exposures for each type of financial instrument.
  - Management's objectives, policies, and processes for managing those risks.
  - Changes from the prior period.

Quantitative disclosures

- The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These disclosures include:
  - Summary quantitative data about exposure to each risk at the reporting date.
  - Disclosures about credit risk, liquidity risk, and market risk as further described below.
  - Concentrations of risk.

Credit Risk

- Disclosures about credit risk include:
  - Maximum amount of exposure (before deducting the value of collateral), description of collateral, information about credit quality of financial assets that are neither past due nor impaired, and information about credit quality of financial assets whose terms have been renegotiated.
  - For financial assets that are past due or impaired, analytical disclosures are required.
  - Information about collateral or other credit enhancements obtained or called.

Liquidity Risk

- Disclosures about liquidity risk include:
  - A maturity analysis of financial liabilities.
  - Description of approach to risk management.

Market Risk

- Market risk is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk reflects interest rate risk, currency risk, and other price risks.

- Disclosures about market risk include:
  - A sensitivity analysis of each type of market risk to which the entity is exposed.
  - IFRS 7 provides that if an entity prepares a sensitivity analysis for management purposes that reflects interdependencies of more than one component of market risk (for instance, interest risk and foreign currency risk combined), it may disclose that analysis instead of a separate sensitivity analysis for each type of market risk.

Application Guidance

An appendix of mandatory application guidance is part of the standard.

There is also an appendix of non-mandatory implementation guidance that describes how an entity might provide the disclosures required by IFRS 7.

Effective Date

IFRS 7 is effective for annual periods beginning on or after 1 January 2007, with earlier application encouraged. Early appliers are given some relief with respect to comparative prior period disclosures.

Withdrawn and Amended Pronouncements

IFRS 7 supersedes:

- IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions

The disclosure requirements of IAS 32 Financial Instruments: Presentation and Disclosure. However the presentation requirements of IAS 32 remain unchanged

CHAPTER SUMMARY

Lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time.

Lessor: This is the person, who under an agreement conveys to another person (the lessee) the right to use in return for rent, an asset for an agreed period of time.

Lessee: this is a person, who under an agreement obtains from another person (the lessor) the right to use, in return for rent, an asset for an agreed period of time.

Lease term: the non-cancellable period for which the lessee has contracted to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum lease payments*:* the payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with the residual value.

Gross investment in the lease: the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor.

Unearned finance income: the difference between the lessor's gross investment in the lease and its present value.

Net investment in the lease: the gross investment in the lease less unearned finance income.

Impairment: a fall in the value of an asset so that its recoverable amount is now less than its carrying value in the balance sheet.

Carrying amount: is the net value at which the asset is included in the balance sheet (i.e. after deducting accumulated depreciation and any impairment losses).

Financial instrument: A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Currency risk: is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates.

Interest rate risk: is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates.

Price risk: is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all securities traded in the market.

Credit risk: The risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

Liquid risk (or funding risk): The risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments.

Cash flow interest rate risk: The risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

CHAPTER QUIZ

1. What is a non-cancelable lease?

2. Distinguish between a financial asset and financial liability.

3. Give examples of indications that a financial asset or group of assets may be impaired.

ANSWERS TO THE CHAPTER QUIZ

1. Non-cancelable lease is a lease that is cancelable only:

- Upon the occurrence of some remote contingency
- With the permission of the lessor
- If the lessee enters into a new lease for the same or any equivalent asset with the same lessor, or
- Upon payment by the lessee of an additional amount such that at inception continuation of lease is reasonably certain

2. a) Financial asset is any asset that is:

(i) cash;
(ii) an equity instrument of another entity;
(iii) a contractual right:

- to receive cash or another financial asset from another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is:
- a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
- a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

b) Financial liability is any liability that is:

(i) a contractual obligation:
- to deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(iii) a contract that will or may be settled in the entity's own equity instruments

3. IAS 39 lists the following:

- Significant financial difficulty of the issuer
- A breach of contract, such as a default in interest or principal payments
- The lender granting a concession to the borrowers that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty
- It becomes probable that the borrower will enter bankruptcy
- The disappearance of an active market for that financial asset because of financial difficulties.

PAST PAPER ANALYSIS

Leases were tested in the following examinations:

12/’07

12/’04

Impairment of Assets was tested in the following examinations:

12/’04

05/’02

12/’00

EXAM QUESTIONS

QUESTION ONE

(a) In the context of IAS 17 (Leases), briefly explain the meaning of the following terms:

(i) Finance lease. (2 marks)
(ii) Guaranteed residual value. (2 marks)
(iii) Contingent rent. (2 marks)

(b) Silversands Manufacturing Company Ltd. has entered into an agreement with a finance company, to lease a machine for a four year period. Under the terms of the agreement, the machine is to be made available to Silversands Manufacturing Company Ltd. on 1 January 2005, when an immediate payment of Sh. 2,550,000 will be made, followed by seven semi-annual payments of an equivalent amount.

The fair market price of the machine on 1 January 2005 is expected to be Sh. 16,320,000. The estimated life of this type of machine is four years. The implicit rate of interest in the transaction is 6.94% payable semi-annually and the corporate tax rate is 30%. Silversands Manufacturing Company Ltd. has a policy of depreciating machines of this type over a four year period on the straight line basis.

Assume the lease is to be capitalised.

Required:

(i) Show how the above transactions will be reflected in the profit and loss account of Silversands Manufacturing Company Ltd. for each of the four years ending 31 December 2005, 2006, 2007 and 2008. (8 marks)

(ii) Balance sheet extracts of Silversands Manufacturing Company Ltd. as at 31 December 2005 and 2006. (6 marks)
(use the actuarial method to allocate the interest charge)

(**Total: 20 marks)**

(CPA DEC 2004)

QUESTION TWO (ACCA)

(a) IAS 36 *Impairment of assets* was issued in June 1998 and subsequently amended in March 2004. Its main objective is to prescribe the procedures that should ensure that an entity's assets are included in its balance sheet at no more than their recoverable amounts. Where an asset is carried at an amount in excess of its recoverable amount, it is said to be impaired and IAS 36 requires an impairment loss to be recognised.

Required:

(i) Define an impairment loss explaining the relevance of fair value less costs to sell and value in use; and state how frequently assets should be tested for impairment; (6 marks)

Note: your answer should NOT describe the possible indicators of impairment.

(ii) Explain how an impairment loss is accounted for after it has been calculated. (5 marks)

(b) The assistant financial controller of the Wilderness group, a public listed company, has identified the matters below which she believes may indicate impairment to one or more assets:

(i) Wilderness owns and operates an item of plant that cost Ksh.640,000 and had accumulated depreciation of Ksh.400,000 at 1 October 2004. It is being depreciated at 121/2% on cost. On 1 April 2005 (exactly half way through the year) the plant was damaged when a factory vehicle collided into it. Due to the unavailability of replacement parts, it is not possible to repair the plant, but it still operates, albeit at a reduced capacity. Also it is expected that as a result of the damage the remaining life of the plant from the date of the damage will be only two years. Based on its reduced capacity, the estimated present value of the plant in use is Ksh.150,000. The plant has a current disposal value of Ksh.20,000 (which will be nil in two years' time), but Wilderness has been offered a trade-in value of Ksh.180,000 against a replacement machine which has a cost of Ksh.1 million (there would be no disposal costs for the replaced plant). Wilderness is reluctant to replace the plant as it is worried about the long-term demand for the product produced by the plant. The trade-in value is only available if the plant is replaced.

Required:

(i) **Prepare extracts from the balance sheet and income statement of Wilderness in respect of the plant for the year ended 30 September 2005. Your answer should explain how you arrived at your figures.** (7 marks)

(ii) On 1 April 2004 Wilderness acquired 100% of the share capital of Mossel, whose only activity is the extraction and sale of spa water. Mossel had been profitable since its acquisition, but bad publicity resulting from several consumers becoming ill due to a contamination of the spa water supply in April 2005 has led to unexpected losses in the last six months. The carrying amounts of Mossel's assets at 30 September 2005 are:

	Ksh.'000
Brand (Quencher – see below)	7,000
Land containing spa	12,000
Purifying and bottling plant	8,000
Inventories	5,000
	32,000

The source of the contamination was found and it has now ceased.

The company originally sold the bottled water under the brand name of 'Quencher', but because of the contamination it has rebranded its bottled water as 'Phoenix'. After a large advertising campaign, sales are now starting to recover and are approaching previous levels. The value of the brand in the balance sheet is the depreciated amount of the original brand name of 'Quencher'.

The directors have acknowledged that Ksh.1·5 million will have to be spent in the first three months of the next accounting period to upgrade the purifying and bottling plant.

Inventories contain some old 'Quencher' bottled water at a cost of Ksh.2 million; the remaining inventories are labelled with the new brand 'Phoenix'. Samples of all the bottled water have been tested by the health authority and have been passed as fit to sell. The old bottled water will have to be relabelled at a cost of Ksh.250,000, but is then expected to be sold at the normal selling price of (normal) cost plus 50%.

Based on the estimated future cash flows, the directors have estimated that the value in use of Mossel at 30 September 2005, calculated according to the guidance in IAS 36, is Ksh.20 million. There is no reliable estimate of the fair value less costs to sell of Mossel.

Required:

Calculate the amounts at which the assets of Mossel should appear in the consolidated balance sheet of Wilderness at 30 September 2005. Your answer should explain how you arrived at your figures.

(7 marks)

STUDY TEXT

CASE STUDY

Case Study: An entity has purchased the whole of the share capital of another entity for a purchase consideration of $20 million. The goodwill arising on the transaction was $5 million. It was planned at the outset that the information systems would be merged in order to create significant savings. Additionally the entity was purchased because of its market share in a particular jurisdiction and because of its research projects. Subsequently the cost savings on the information systems were made. The government of the jurisdiction introduced a law that restricted the market share to below that anticipated by the entity, and some research projects were abandoned because of lack of funding.

The question is; what are potential indicators of the impairment of goodwill in this case?

The entity would have paid for the goodwill in anticipation of future benefits arising there from. The benefit in terms of the cost savings on the information systems has arisen, but the market share increase and the successful outcome of the research projects has not occurred.

Therefore, **these events may indicate the impairment of goodwill. Goodwill has to be impairment tested at least annually under IFRS 3.**

Source: www.google.co.ke- Case Studies on Impairment of Assets

CHAPTER THREE

ASSETS AND LIABILITIES (PART B)

CHAPTER THREE

ASSETS AND LIABILITIES (PART B)

▶ OBJECTIVES

After this chapter, the student will know how to:

- Calculate and account for Corporation Tax
- Calculate and account for Deferred Tax
- Determine the nature of employee benefits and to account for them

▶ INTRODUCTION

IAS 12 on Income Taxes deals with two main types of taxes;

- Corporation Tax
- Deferred Tax

The main bulk of the standard is on deferred tax as it has detailed guidelines on the approach to be used in computing deferred tax, accounting for the deferred tax and disclosure requirements.

IAS 19 Employee benefits:

This is a very difficult area because employee benefit costs are inherently complex and their accounting is both problematic and controversial.

IAS 19 (revised) Employee benefits has replaced the previous IAS 19 Retirement benefits costs. Note the increased scope of the new standard, which covers all employee benefit costs, except share – based payment, not only retirement benefit (pension) costs. Before we look at IAS 19, we should consider the nature of employee benefit costs and why there is an accounting problem which must be addressed by a standard.

▶ DEFINITION OF KEY TERMS

Corporation tax is the tax payable by a company as a result of generating profits from trading.

Deferred tax is the corporation tax that is likely to be incurred on the activities of a company during a particular period but, because of differences between the way activities are included in the accounting profit and taxable income, will be paid in another period.

Temporary differences include differences between the fair values and the tax values of assets and liabilities acquired and the effect of revaluing assets and liabilities acquired and the effect of revaluing assets for accounting purposes.

Timing Differences are items reported in the accounts in periods different from those in which they are reflected in tax computations. These differences originate in one period and reverse in one or more subsequent periods.

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.

Short-term employee benefits are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

Post-employment benefits are formal or informal arrangements under which an entity provides post employment benefits for one or more employees.

▶ EXAM CONTEXT

In past examinations, the examiner has tested the students' knowledge on:

- Corporation tax
- Deferred tax
- Employee benefits

Students should therefore understand these topics.

▶ INDUSTRY CONTEXT

Profit making organisations calculate corporation taxes and, therefore, this chapter enables them to know the various ways to calculate their corporation taxes and also to account for them.

Organisations learn how tocalculate deferred tax which is important in the following ways:

- ⊙ The figures used to calculate stock market indicators such EPS and P/E ratio require the computation of profit-after tax.
- ⊙ Deferred tax is important in establishing the relationship between shareholder's funds and other sources of finance.
- ⊙ It also ensures compliance with the fundamental accounting concept of accruals.
- ⊙ It reports a tax liability which is likely to arise in the future.
- ⊙ It provides the post-tax profits that can be used to assess a suitable dividend declaration.

3.1 CORPORATION TAX

FAST FORWARD: IAS 12 does not prescribe how this tax should be computed as this is determined by the various tax rules and regulations of a country.

Corporation tax is the tax payable by a company as a result of generating profits from trading.

Once the tax has been computed the standard gives the specific accounting treatment of the amount. IAS 12 requires that the tax payable should be shown as a separate item in the income statement and referred to as income tax expense. If part of the amount is unpaid by the year end then it should be shown in the balance sheet as a current liability and referred to as current tax.

In practice many firms use an estimate for the corporation tax for the purpose of preparing and finalizing on the financial statements. In the next or subsequent financial period, when the firm agrees with the tax authorities the actual tax payable, then there may arise an under or over provision of previous years tax. IAS 12 requires that this under or over provision to be treated like a change in accounting estimate as per IAS 8. This means that an under provision of previous years' tax will be added to the current years income tax expense while an over provision will be deducted.

>>> Example

Assume that a company had estimated that during the year ended 2004, the corporation tax payable was Sh 1000,000 and this amount remained unpaid as at 31 December 2004. On 30 June 2005 the company agrees with the tax authorities on the amount due and this is paid on the same date. Meanwhile during the year ended 31 December 2005, the firm estimates that the corporation tax payable for the year as sh. 1,200, 000. The company had made installment tax payments for year 2005 for sh. 800,000.

Required

Compute the income tax expense and the balance sheet liability for the year 2005 assuming that the actual tax liability for 2004 agreed with the tax authority was:

1. Sh 1,100,000
2. Sh.900,000

a) There is an under provision for previous years' tax because the firm had provided for only Sh.1,100,000 while the amount agreed is Sh.1,100,000. The income tax expense for 2005 will be given as current years estimate plus the under provision
(Sh.1, 200,000 + 100,000). = 1,300,000.

b) There is an over provision for previous years' tax because the firm had provided for Sh.1,100,000 while the amount agreed is only Sh.900,000. The income tax expense for 2005 will be given as current years estimate less the over provision
(Sh.1, 200,000 - 100,000). = 1,100,000
The balance sheet liability in both cases will be the current years' tax less the installment taxes for the year 2005 (1,200,000 – 800,000) = Sh.400,000.

3.1.1 DEFERRED TAX

This section is concerned with the determination of the amount of the charge against income in respect of an accounting period and the presentation of such an amount in the financial statements. We will also discuss accounting for the tax effect of revaluation of assets.

In short, we will explore the accounting principles and practices for deferred taxation.

Provisions of IAS 12 on income taxes

FAST FORWARD: IAS 12 requires that deferred tax should be provided in full for all temporary difference using the liability method.

The standard adopts the balance sheet approach under which deferred tax is calculated on all temporary differences, which are differences between the tax and accounting bases of assets and liabilities.

Temporary differences include differences between the fair values and the tax values of assets and liabilities acquired and the effect of revaluing assets and liabilities acquired and the effect of revaluing assets for accounting purposes.

- Current and deferred tax is recognised in the income statement unless the tax arises from a business combination that is an acquisition or a transaction or event that is recognized in equity. The tax consequences which accompany a change in the tax status of an enterprise or its controlling or significant shareholder should be taken to income, unless these consequences directly relate to changes in the measured amount of equity.

  Only those tax consequences that directly relate to changes in the measured amount of equity in the same or different period should be charged or credited to equity and not taken to the income statement.

- Deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date. Discounting of deferred tax assets and liabilities is not permitted.

- The measurement of deferred tax assets and liabilities should reflect the tax consequences that would follow from the manner in which the enterprise expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities. When a non-depreciable asset under IAS 16 (PPE) is re-valued, the deferred tax arising from that revaluation is determined based on the tax applicable to the recovery of the carrying amount of that asset through sale.

- An enterprise should recognise a deferred tax asset for all deductible temporary differences to the extent that it s probable that taxable profit will be available against which the deductible temporary difference can be utilized. The same principles apply to recognition of deferred tax assets for unused tax losses carried forward.

- For presentation purposes, current tax assets and liabilities should be offset if and only if the enterprise has a legally enforceable right to set off and intends to either settle on a net basis, or to realise the asset and settle the liability simultaneously. An enterprise is able to offset deferred tax assets and liabilities if and only if it is able to offset current tax balances and the deferred balances relate to income taxes levied by the same taxation authority.

Disclosures

- Tax expense (income) must be shown separately on the face of the income statement, with separate disclosure made of its major components and any tax expense (income) relating to extra ordinary items.

- Tax expense (income) relating to the gain or loss on discontinuance for discontinued operations and to the profit or loss from the ordinary activities of the discontinued operation for the period must also be disclosed.

- An explanation is required of the relationship between tax expense (or income) and accounting profit either of numerical reconciliation between the average effective tax rate and the applicable tax rate. An explanation is required of any changes in the applicable tax rate(s) compared to the previous period.

- The aggregate amount of temporary differences for which both deferred tax assets or liabilities have not been recognized (i.e. for unremitted "re-invested" earnings of subsidiaries should be disclosed. For each type of temporary difference and for unused tax losses and credits, disclosure is required of the amount of deferred tax assets and liabilities recognized and the amount of deferred tax income or expense recognized. The amount of any deferred tax asset and evidence supporting its recognition must be disclosed when its utilization is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences, and the enterprise has suffered a loss in the current or previous period in the tax jurisdiction to which the deferred tax asset relates. Separate disclosure is also required of the aggregate current and deferred tax relating to items that are charged or credited to equity.

Flow-through method

Supporters of flow-through accounting also argue that it is the most transparent and intuitively sensible way of communicating an entity's tax position. The financial statements show the actual tax charge for the year in the clearest possible manner, and the associated notes (which would disclose such matters as accumulated timing differences and the items reconciling the actual tax charge to a standard rate) would be no more detailed and possibly more intelligible than those resulting from other possible accounting methods.

Some supporters of flow-through accounting further argue that even if, in principle timing differences did give rise to tax liabilities, in practice such liabilities could not always be measured reliably. The future tax consequences of current transactions depend upon complex interaction of future events, such as the profitability, investment and financing transactions of the entity, and changes in tax rates and laws. Only those that could be measured reliably typically very short-term discrete timing differences – should be provided for. Thus they advocate a modified flow-through approach.

Full provision method

The full provision method is based on the view that every transaction has a tax consequence and it is possible to make a reasonable estimate of the future tax consequences of transactions that have occurred by the balance sheet date. Such future tax consequences cannot be avoided: whatever happens in future, the entity will pay less or more tax as a result of the reversal of a timing difference that exists at the balance sheet date than it would have done in the absence of that timing difference. Deferred tax should, therefore, be provided for in full on timing differences.

Partial provision method

The partial provision method also starts from the premise that the future reversal of timing differences gives rise to a tax asset or liability. However, rather than focusing on the individual components of the tax computation, the partial provision method emphasizes the interaction of those components in a single net assessment. To the extent that timing differences are expected to continue in future (i.e. the existing timing differences being replaced by future timing differences as they reverse), the tax is viewed as being deferred permanently.

Where, for example, fixed asset expenditure attracts tax deductions before the fixed assets are depreciated, timing differences arise. The timing differences increase with time under conditions of inflation or expansion, with the result that new timing differences more than replace those that reverse. In consequence, effective tax rates are reduced. The partial provision method allows the lower effective tax rates to be reflected in the profit and loss account, to the extent that the reduction is not expected to reverse in future years.

The attraction of the partial provision method is that it reflects an entity's ongoing effective tax rate. It results in tax charges that reflect the amount of tax that it is expected will actually be paid and excludes amounts that are expected to be deferred 'permanently'.

Reasons for rejecting the partial provision method

The partial provision method allowed companies to avoid creating provisions for tax that they argued they were unlikely to pay. However, by the early 1990s, concerns were being expressed about the method and the way in which it was being applied. It was noted in particular that:

1. The recognition rules and anticipation of future events were subjective and inconsistent with the principles underlying other aspects of accounting.

2. The partial provision method had not been regarded as appropriate for dealing with the long-term deferred tax assets associated with provisions for post-retirement benefits. As a result, SSAP 15 had been amended in 1992 to permit such assets to be accounted for on a full provision basis. The amendment introduced inconsistencies into SSAP 15.

3. There were variations in the way in which SSAP 15 was applied in practice. Different entities within the same industry and with similar prospects seemed to take quite different views on the levels of provisions necessary. There was evidence that some companies provided for deferred tax in full for simplicity's sake rather than because their circumstances required it. The different approaches being taken reduced the comparability of financial statements.

4. Because of its recognition rules and anticipation of future events, the partial provision method was increasingly being rejected by standard-setters in other countries. The US Financial Accounting Standards Board (FASB) had issued a standard FAS 109 'Accounting for Income Taxes' requiring full provision. The International Accounting Standards Committee(IASC) had published proposals for similar requirements and other standard –setters had started to move in the same direction.

When rejecting the partial provision method, the FASB and IASC argued in particular that:

a. Every tax timing difference represented a real liability, since everyone would reverse and, whatever else happened, an entity would pay more tax in future as a result of the reversal than it would have done in the absence of the timing difference.

b. It was only the impact of new timing differences arising in future that prevented the total liability from reducing. It was inappropriate (and inconsistent with other areas of accounting) to take account of future transactions when measuring an existing liability.

c. The assessment of the liability using the partial provision method relied on management intentions regarding future events. Standard setters were uncomfortable with this, having already embodied in a number of other standards the principle that liabilities should be determined on the basis of obligations rather than management decisions or intentions.

In view of the criticisms of the partial provision method, the Board decided to review SSAP 15. In 1995 it published a Discussion Paper, 'Accounting for Tax'. The Discussion Paper proposed that SSAP 15 should be replaced with an FRS requiring full provision for deferred tax.

Most respondents to the Discussion Paper opposed the move to full provision at that stage, preferring instead to retain the partial provision method. In the meantime however, IASC had approved its standard, IAS12 (revised, 1996) 'Income Taxes', which required use of the full provision method. The Board reconsidered the arguments and arrived at the view that:

- Whilst it did not agree with all of the criticisms of the partial provision method expressed internationally and could see the logic for all three methods of accounting for tax, it shared some of the concerns regarding the subjectivity of the partial provision method and its reliance on future events; and

- As more companies adopted international accounting standards, the partial provision method would become less well understood and accepted, particularly as it was regarded as less prudent than the internationally accepted method. Hence, the retention of the partial provision method in the UK could damage the credibility of UK financial reporting.

For these reasons, the Board took the view that deferred tax was not an area where a good case could be made for departing from principles that had been widely accepted internationally. Following informal consultation, it developed a draft FRS, FRED 19 'Deferred Tax', which proposed requirements based more closely on a full provision method. The FRED was published for consultation in August 1999.

The responses to FRED 19 indicated that, whilst many amongst the financial community remained disappointed that there had not been international acceptance of the partial provision method, most accepted the arguments for greater harmonization with international practice and supported the proposed move to a full provision method.

Reasons for rejecting flow-through accounting

For the reasons outlined in paragraphs 5 –7 above, a number of Board members believe that the clearest and most transparent method of communicating an entity's tax position is by flow-through accounting combined with detailed disclosures. The possibility of moving to flow-through accounting was therefore suggested in the Board's Discussion Paper.

However, flow-through accounting would not have moved UK accounting more into line with international practice and received little support from those responding to the Board's Discussion Paper. Most respondents agree with the view that taxable profit was, in both form and substance, an adjusted accounting profit and that it was possible to attribute tax effects to individual transactions. Further, they regarded tax systems as sufficiently stable to allow reasonable estimates to be made of the deferred tax consequences of events reported up to he balance sheet date. They added their concerns that flow-through accounting would make their results more volatile, could sometimes understate an entity's liability to tax and that any modification to it would require arbitrary cut-off points that could be difficult to rationalize.

In view of the lack of support from respondents and the Boards' commitment to international harmonization, Board members who would have preferred flow-through accounting accepted that the FRS should instead require full provision for deferred tax.

3.1.2 THE NEED FOR DEFERRED TAXATION

Deferred tax is the corporation tax that is likely to be incurred on the activities of a company during a particular period but, because of differences between the way activities are included in the accounting profit and taxable income, will be paid in another period.

The need for deferred taxation arises in a number of ways:

i. The figures used to calculate stock market indicators such EPS and P/E ratio require the computation of profit-after tax.

ii. Deferred tax is important in establishing the relationship between shareholder's funds and other sources of finance.

iii. It also ensures compliance with the fundamental accounting concept of accruals.

iv. It reports a tax liability which is likely to arise in the future.

v. It provides the post-tax profits that can be used to assess a suitable dividend declaration.

3.1.3 THE BASIS OF DEFERRED TAXATION

From the accountant's viewpoint there are two quite distinct profit figures:

(a) Accounting profit - that is the profit reported to the shareholders. This profit is based on accounting concepts and principles.
(b) Tax-adjusted profit - that is the profit on which tax is assessed - taxable income (tax loss). This profit is determined in accordance with the rules laid down in the Income Tax Act upon which the provision for taxes payable is determined. This profit takes into account capital allowances, stock relief, and disallowable expenditure and so on.

The reasons why these profits may differ fall into two groups of differences.

(a) Timing Differences - that is items reported in the accounts in periods different from those in which they are reflected in tax computations. These differences originate in one period and reverse in one or more subsequent periods.

The timing difference originates in 1983 when the interest is accrued and reversed in 1984 when the interest is taxed (on a cash basis).

There were no interest accruals in the balance sheet at 31.12.83 and 31.12.84.

The movement on deferred tax account over the two years may be calculated as follows:

Deferred Tax Account

	KSh		KSh
Bal (31.12.83) c/f	10,500	Balance (1.1.83)	-
	10,500	P & L A/c (31.9.83) (35% x 30,000)	10,500
P & L A/c (1984)	10,500	Bal (1.1.84) b/f	10,500
	10,500		10,500

The effect on the financial statement is

Profit and Loss Account

	KShs	KShs	KShs	KShs
Profit on ordinary activities		400,000		430,000
Tax expense				
Corporation tax	150,500		140,000	
Deferred tax	(10,500)	140,000	10,500	150,500
Profit before tax		260,000		289,500

Deferred tax provision	**NIL**	**KShs 10,500**

Let us have an example relating to accelerated capital allowances.

- A company purchased a fixed asset on 1.1.92 at a cost of KSh 400,000. The residual value of the asset is assumed to be NIL and it is to be depreciated on a straight line basis over 4 years. The company claims 100% first year allowance and the corporation tax rate for each of the four years is assumed to be 35%. Profit after charging depreciation is KSh 2,000,000 in each of the four years and there are no other timing differences. No capital expenditure takes place in 1993, 1994 or 1995.

Assuming deferred tax is to be provided in full, the calculations are as follows.

Year	Profit before deprecation and taxes	Depreciation	Capital Allowance	Taxable Accounting Income	(Adjusted) Taxation Taxable Income	
	KSH	KSH	KSH	KSH		
1992	2,100,000	100,000	(400,000)	2,000,000	2,000,000 – 400,000 + 100,000 =	1,700,000
1993	2,100,000	100,000	-	2,000,000	2,000,000 + 100,000 =	2,100,000
1994	2,100,000	100,000	-	2,000,000	2,000,000 + 100,000 =	2,100,000
1995	2,100,000	100,000	-	2,000,000	2,000,000 + 100,000 =	2,100,000

STUDY TEXT

The timing differences can be analysed as follows:

Year	AI Taxable Income	Taxation Taxable Income	Timing Difference	Deferred Tax @ 35% x Timing Differece
1992	2,000,000	1,700,000	300,000	105,000
1993	2,000,000	2,100,000	(100,000)	(35,000)
1994	2,000,000	2,100,000	(100,000)	(35,000)
1995	2,000,000	2,100,000	(100,000)	(35,000)

AI = Accounting Income

Note that the timing difference originated in 1992 (300,000) and reversed through 1993 - 1995.

The extracts from financial statements (P & L) will be:

	1992 (KSh)	**1993 (KSh)**	**1994 (KSh)**	**1995 (KSh)**
Accounting Profit	2,000,000	2,000,000	2,000,000	2,000,000
Income Tax Expense				
Corporation tax payable	595,000	735,000	735,000	735,000
Deferred Tax	105,000	(35,000)	(35,000)	(35,000)
Profit after tax	1,300,000	1,300,000	1,300,000	1,300,000

The journal entries to record the income tax expense and related deferred tax liability for 1992 and 1993 are:

1992

Dr. Income tax Expense (2,000,000 x 35%)	700,000	
Cr. Income tax payable (1,700,000 x 35%)		595,000
Cr. Deferred tax liability		105,000

1993

Dr. Income tax Expense (2,000,000 x 35%)	700,000	
Dr. Income tax liability	35,000	
Cr. Income tax payable (2,100,000 x 35%)		735,000

1994

Dr. Income tax Expense (2,000,000 x 35%)	700,000	
Dr. Deferred tax liability	35,000	
Cr. Income tax payable (2,100,000 x 35%)		735,000

1995

Dr. Income tax Expense (2,000,000 x 35%)	700,000	
Dr. Deferred tax liability	35,000	
Cr. Income tax payable (2,100,000 x 35%)		735,000

3.1.4 METHODS OF ACCOUNTING FOR TIMING DIFFERENCES

There is some controversy whether deferred tax should be included in the accounts or just be ignored. Two schools of thought emerged - leading to two broad methods of accounting for timing differences.

These are:

(a) Taxes payable method

(b) Deferred Tax Accounting method

Taxes Payable Method

- It ignores deferred tax and thus the income tax expense is normally equal to the provision for tax payable. The extent and potential tax effect of timing differences are sometimes disclosed in notes to the financial statements.

Deferred Tax Accounting Method

- Under this method, income tax is considered to be an expense incurred by the enterprise in earning income and is accrued in the same periods as the revenue and expenses to which it relates. The resulting tax effects of timing differences are included in the tax charge in the income statement and in the deferred tax balances in the balance sheet.

- There are two approaches to the calculation of deferred tax:
  - Full deferral
  - Partial deferral

- These approaches are concerned with whether, and to what extent, deferred tax on timing differences needs to be provided within the accounts, as opposed to simply being referred to in a memorandum note.

- Full deferral requires that full tax effects of all timing differences are recognised as they arise. The approach is arithmetically accurate but can lead to the build up of large, meaningless provisions appearing on the balance sheet.

- Partial deferral requires that the income tax expense excludes the tax effects of certain timing differences when there is reasonable evidence that those timing differences will not reverse for some considerable period (at least 3 years) ahead. It is also necessary for there to be indication that after this period, these timing differences are likely to reverse. (Para. 3.16 & 3.17 - KAS 10).

- A further problem is the method used to evaluate the deferred tax account i.e what corporation tax rate(s) should be applied to the timing differences.

There are two major methods:

(a) Deferral Method

(b) Liability Method

Deferral Method

FAST FORWARD: Originating timing differences are recorded at the rate of corporation tax ruling in the period in which the timing difference occurred.

- The deferred tax account in the balance sheet is viewed as deferred revenue (expenditure) and, therefore, subsequent changes in the rate of tax give no cause for adjustment. The reversal amount will be exactly matched with the original difference.

- There are two further approaches to deferral method. These are:
  i. Average rate
  ii. First in First out.

The average rate assumes that reversals do come out of the opening balance (when the capital allowance first appeared). An average rate of tax is therefore calculated by dividing the balance in the deferred account with the balance in the timing differences.

In FIFO the reversal is assumed to come from the first amount credited to the deferred taxation account. That is the deferred taxation created by the first year tax rate. So the reversal is calculated using the first year rate.

Liability Method

- The deferred tax provision in the balance sheet is assessed at the rate of corporation tax expected to be applicable when the timing differences are expected to reverse. Unless the rate of corporation tax is known in advance, the most recent rate would normally be used.

- Under this method, it is necessary to make adjustments each time the rate changes.

The two methods are illustrated in the following example:

Assume XYZ Co. made the following capital expenditures:

	KShs
20X1	31,500
20X2	42,000
20X3	15,750
20X4 - 20X9 →	No capital expenditure expected

Expenditure qualifies for a capital allowance of 25% (reducing balance). Asset life is expected to be restricted to 3 years, therefore depreciation is charged, on a straight line basis, overtime period. Assets have no residual value. Corporation tax rates are as follows:

20X1 - 50%

20X2 - 45%

20X3 - 40%

20X4 - 35%

20X5 - 20X9 - 35% (expected)

Required:

Calculate the timing differences using the

(a) Liability Method
(b) Deferral Method Accounting that reversals are accounted for
    i. On an average method
    ii. On FIFO basis
(c) Show the deferred taxation account using the liability method.

Solution:

With different tax rates applying to the annual capital expenditures it is necessary to analyse the deferred tax by individual expenditures.

	20X1	20X2	20X3	20X4	20X5
20X1 Expenditure (31,500)	KSH	KSH	KSH	KSH	KSH
Capital allowance	7,875	5,906	17,719	-	-
Depreciation	10,500	10,500	10,500	-	-
Timing differences	(2,625)	(4,594)	7,219		
20X2 Expenditure (42,000)					
Capital allowance	10,500	7,875	23,625		
Depreciation	14,000	14,000	14,000		
Timing differences	(3,500)	(6,125)	9,625		
20X3 Expenditure (15,750)					
Capital allowance	3,938	2,953	8,859		
Depreciation	5,250	5,250	5,250		
Timing differences	(1,312)	(2,297)	3,609		

The deferred tax account will appear as follows:

	20X1	20X2	20X3	20X4	20X5
Total capital allowances	7,875	16,406	29,532	26,578	8,859
Total Depreciation	10,500	24,500	29,750	19,250	5,250
Timing differences	(2,625)	(8,094)	218	7,328	3,609
Cumulative Timing Difference	(2,625)	(10,719)	10,937	(3,609)	-
Tax rate	50%	45%	40%	35%	35%

Timing Difference	Cumulative Timing Difference	Liability Method	Deferral Average	Deferral FIFO	
20X1 – origin	(2,625)	(2,625)	1,313	1,313	1,313
(50%)					
20X2 – origin	(4,594)			2,297	2,297
– 20X1	(3,500)	(8,094)	3,642	1,575	1,575
(45%) origin					
– 20X2 Tax rate			(131)		
		(10,719)	3,511	3,872	3,872
adj. (negative			4,824	5,185	5,185
– 5% x 2,625)					
	7,219				
Deferred tax bal.	(6,125)			(3,465)	(3,610)
(31.12.X2)	(1,312)			2,756	2,756
		(218)	87	525	525
20X3 (40%)					
- Reversal – 20X1		______	(536)		______
- origin - 20X2		10,937	(449)	(184)	(329)
- origin - 20X3			4,375	5,001	4,856
Tax rate adj.					
(negative – 5% x	9,625				
10,719)	(2,297)			(4,428)	(4,331)
		7,338	(2,568)	919	919
Deferred Tax bal.					
(31.12.X3)			(547)		
		3,599	(3,115)	(3,509)	(3,412)
20X4 (35%)				1,492	1,444
- Reversal - 1992			1,260		
- origin - 20X3					
Tax rate adj.					
(negative – 5% x					
10,937)					
Deferred Tax bal.					
(31.12.X4)					

STUDY TEXT

Notes:

(a) Liability Method
Overall cumulative timing difference for each year is relevant and not the individual timing differences.

(b) Deferral - Average - 20X3 - average rate was computed as follows:

$\frac{5,185}{10,719} \times 100 = 48\%$

Average - 20X4 =

$\frac{5,001}{10,937} \times 100 = 46\%$

(c) Deferral - FIFO - 20X3

50% X 7,219 = 3,610

The deferred taxation account using the liability method is given below:

Deferred Taxation Account (Liability Method)

		Kshs			Kshs
31.12.X1	Bal c/d	1,313	20 X1	Profit and Loss A/c	1,313
			1.1.X2	Balance b/f	1,313
31.12.X1	Bal c/d	4,824	20 X2	Profit and Loss A/c	3,511
		4,824			4,824
20X3	Profit and Loss A/c	449	1.1.X3	Balance b/f	4,824
31.12.X3	Bal c/d	4,375			
		4,824			4,824
20X4	P & L A/c	3,115	1.1.X4	Balance b/f	4,375
31.12.X4	Bal c/d	1,260			
		4,375			4,375

3.1.5 TAX LOSSES

- A loss for tax purposes which is available to relieve future profits from tax constitutes a timing difference.

- The existence of a credit amount in the deferred tax balance provides evidence that there is a tax saving relating to a tax loss carry forward can be realised at least in part.

- This is especially so if the tax relief attributable to the loss can be included in the period of the loss and the debit is carried forward as a reduction of the deferred tax credit balance in the balance sheet.
(Read IAS 12 Para. 3.19 - 3.22)

>>> Example:

Omwachi Ltd has no originating or reversing timing difference in 20X1 or 20X2 i.e. reported accounting profits are equal to the profit on which tax is assessed. The balance on deferred tax account as at 1.1.X1 was KSh 190,000. Trading losses in 20X1 amounted to KSh 160,000. In 20X2 trading profits amounted to KSh 190,000. The movement on deferred tax account over the two years would be as follows:

Corporation tax rate is 35%

Deferred Tax Account

	KShs		**KShs**
Expected tax Relief		1.1.X1 Bal. b/f	190,000
(35% x 160,000)	56,000		
31.12.X1 Bal c/d	134,000		
	190,000		190,000
		1.1.X2 Bal. b/f	134,000
		Deferred tax reinstated	
31.12.X2 Bal c/d	190,000	(35% x 160,000)	56,000
	190,000		190,000

DISCLOSURE REQUIREMENTS - IAS 12

i. The income tax relating to an item that is charged or credited to shareholders interest should be accounted for in the same manner as the relevant item and the amount should be disclosed.

ii. The tax charge related to income from the ordinary activities of the enterprise.

iii. The tax charge relating to universal items, to prior period items, and to changes of accounting policy - IAS8.

iv. The tax effects, if any, related to assets that have been revalued to amounts in excess of historical cost or previous revaluation.

v. The following items in respect to tax losses should be disclosed.

- The amount of the tax saving included in net income for the current period as a result of the realisation of a tax loss carry forward that had not been accounted for in the year of the loss.
- the amount and future availability of tax losses for which the related tax effects have been included in the net income of any period.

vi. The method used to account for the deferred tax should also be disclosed.

vii. The amount of timing differences not accounted for, both current and cumulative should be disclosed.

JUNE 20X0

2

(i) Flow-through method

P & L a/c (Extract)

	1997	1998	1999	20X0
	Sh '000'	Sh '000'	Sh '000'	Sh '000'
Taxable Profit (Cap allow)	4,250	4,250	4,250	4,250
Tax @ 33%	(1,402.50)	(1,402.50)	(1,402.50	(1,402.50)
	2,847.50	2,847.50	2,847.50	2,847.50
Deferred Tax	NIL	NIL	NIL	NIL

Balance Sheet (Extract)

Provision for liabilities & Charges	NIL	NIL	NIL	NIL

(ii) Full Provision Method

P & L a/c (Extract)

	1997	1998	1999	20X0
Taxable Profits	4,250	4,250	4,250	4,250
Tax @ 33%	(1,402.50)	(1,402.50)	(1,402.50)	(1,402.50)
	2,847.50	2,847.50	2,847.50	2,847.50
Deferred Tax	528	(132)	(264)	660

Balance Sheet (Extract)

Provision for liabilities & Charges	528	396	132	792

(iii) Partial – Provision Method

(Shs. 396,000 of the T/D will reverse in 1998 and 1999)

P & L (Extract)

	1997	1998	1999	20X0
Taxable Profits	4,250	4,250	4,250	4,250
Tax @ 33%	(1,402.50)	(1,402.50)	(1,402.50)	(1,402.50)
	2,847.50	2,847.50	2,847.50	2,847.50
Deferred Tax	396 i.e (528 – 132)	(132)	(264)	-

Balance sheet (Extract)

Provision for Liabilities & Charges	396	264	NIL	NIL

Workings

Deferred tax Calculations

Capital allowances	2,000	400	400	2,800
Depreciation	(400)	(800)	(1,200)	(800)
	1,600	(400)	(800)	2,000
Tax @ 33%	528	(132)	(264)	660

3.1.6 SUMMARY OF APPROACHES TO DEFERRED TAX

APPROACH	ADVANTAGE	DISADVANTAGES
(a) No provision	Tax charge in P/L is based on tax payable and is objective	Ignores reasoned assessment of what tax effects of transactions will be. Inconsistent with Companies Act and IAS 12 Possible understatement of tax liabilities
(b) Full provision	Recognises full tax charge in P/L Calculations are objective	Possible distortion of tax liabilities in Balance Sheet Possible fictitious effects of transactions for remote occurring in a period Ignores reasoned assessment of what tax effects of transactions will be.
(c) Partial Provision	Realistic - deferred tax provision takes account of circumstances of the company	Calculations may depend on subjective opinions and estimates. Difficult to apply to small companies.

3.2 SHARE BASED PAYMENTS (IFRS 2)

This is a very controversial area and has not been examined before. It is a recent standards issued by IASB and deals with the accounting treatment of transactions that have been settled by way of issuing shares and not for cash or if cash is paid it is tied to the value of the companies share. This ranges from paying suppliers and employees by way of shares or pegging the payments to the value of the companies share.

IFRS 2 Provisions

A share-based payment is a transaction in which the entity receives or acquires goods or services either as consideration for its equity instruments or by incurring liabilities for amounts based on the price of the entity's shares or other equity instruments of the entity. The accounting requirements for the share-based payment depend on how the transaction will be settled, that is, by the issuance of (a) equity, (b) cash, or (c) equity or cash.

Scope

The concept of share-based payments is broader than employee share options. IFRS 2 encompasses the issuance of shares, or rights to shares, in return for services and goods. Examples of items included in the scope of IFRS 2 are share appreciation rights, employee share purchase plans, employee share ownership plans, share option plans and plans where the issuance of shares (or rights to shares) may depend on market or non-market related conditions.

IFRS 2 applies to all entities. There is no exemption for private or smaller entities. Furthermore, subsidiaries using their parent's or fellow subsidiary's equity as consideration for goods or services are within the scope of the Standard.

There are two exemptions to the general scope principle.

(i) First, the issuance of shares in a business combination should be accounted for under IFRS 3 Business Combinations. However, care should be taken to distinguish share-based payments related to the acquisition from those related to employee services.

(ii) Second, IFRS 2 does not address share-based payments within the scope of paragraphs 8-10 of IAS 32 Financial Instruments: Disclosure and Presentation, or paragraphs 5-7 of IAS 39 Financial Instruments: Recognition and Measurement. Therefore, IAS 32 and 39 should be applied for commodity-based derivative contracts that may be settled in shares or rights to shares.

IFRS 2 does not apply to share-based payment transactions other than for the acquisition of goods and services. Share dividends, the purchase of treasury shares, and the issuance of additional shares are, therefore, outside its scope.

Recognition and Measurement

The issuance of shares or rights to shares requires an increase in a component of equity. IFRS 2 requires the offsetting debit entry to be expensed when the payment for goods or services does not represent an asset. The expense should be recognised as the goods or services are consumed. For example, the issuance of shares or rights to shares to purchase inventory would be presented as an increase in inventory and would be expensed only once the inventory is sold or impaired.

The issuance of fully vested shares, or rights to shares, is presumed to relate to past service, requiring the full amount of the grant-date fair value to be expensed immediately. The issuance of shares to employees with, say, a three-year vesting period is considered to relate to services over the vesting period. Therefore, the fair value of the share-based payment, determined at the grant date, should be expensed over the vesting period.

As a general principle, the total expense related to equity-settled share-based payments will equal the multiple of the total instruments that vest and the grant-date fair value of those instruments. In short, there is truing up to reflect what happens during the vesting period. However, if the equity-settled share-based payment has a market related performance feature, the expense would still be recognised if all other vesting features are met. The following example provides an illustration of a typical equity-settled share-based payment.

Illustration – Recognition of Employee Share Option Grant

Company grants a total of 100 share options to 10 members of its executive management team (10 options each) on 1 January 20X5. These options vest at the end of a three-year period. The company has determined that each option has a fair value at the date of grant equal to 15. The company expects that all 100 options will vest and therefore records the following entry at 30 June 20X5 - the end of its first six-month interim reporting period.

Dr. Share Option Expense 250

Cr. Equity 250

[(100 x 15) / 6 periods] = 250 per period

If all 100 shares vest, the above entry would be made at the end of each 6-month reporting period. However, if one member of the executive management team leaves during the second half of 20X6, therefore forfeiting the entire amount of 10 options, the following entry at 31 December 20X6 would be made:

Dr. Share Option Expense 150

Cr. Equity 150

[(90 x 15)/ 6 periods = 225 per period. [225 x 4] -[250+250+250] = 150

Measurement Guidance

Depending on the type of share-based payment, fair value may be determined by the value of the shares or rights to shares given up, or by the value of the goods or services received:

1. **General fair value measurement principle.** In principle, transactions in which goods or services are received as consideration for equity instruments of the entity should be measured at the fair value of the goods or services received. Only if the fair value of the goods or services cannot be measured reliably would the fair value of the equity instruments granted be used.

2. **Measuring employee share options.** For transactions with employees and others providing similar services, the entity is required to measure the fair value of the equity instruments granted, because it is typically not possible to estimate reliably the fair value of employee services received.

3. **When to measure fair value - options.** For transactions measured at the fair value of the equity instruments granted (such as transactions with employees), fair value should be estimated at grant date.

4. **When to measure fair value - goods and services.** For transactions measured at the fair value of the goods or services received, fair value should be estimated at the date of receipt of those goods or services.

5. **Measurement guidance.** For goods or services measured by reference to the fair value of the equity instruments granted, IFRS 2 specifies that, in general, vesting conditions are not taken into account when estimating the fair value of the shares or options at the relevant measurement date (as specified above). Instead, vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted is based on the number of equity instruments that eventually vest.

6. **More measurement guidance.** IFRS 2 requires the fair value of equity instruments granted to be based on market prices, if available, and to take into account the terms and conditions upon which those equity instruments were granted. In the absence of market prices, fair value is estimated using a valuation technique to estimate what the price of those equity instruments would have been on the measurement date in an arm's length transaction between knowledgeable, willing parties. The standard does not specify which particular model should be used.

7. **If fair value cannot be reliably measured.** IFRS 2 requires the share-based payment transaction to be measured at fair value for both listed and unlisted entities. IFRS 2 permits the use of intrinsic value (that is, fair value of the shares less exercise price) in those "rare cases" in which the fair value of the equity instruments cannot be reliably measured. However this is not simply measured at the date of grant. An entity would have to remeasure intrinsic value at each reporting date until final settlement.

8. **Performance conditions.** IFRS 2 makes a distinction between the handling of market based performance features from non-market features. Market conditions are those related to the market price of an entity's equity, such as achieving a specified share price or a specified target based on a comparison of the entity's share price with an index of share prices of other entities. Market based performance features should be included in the grant-date fair value measurement. However, the fair value of the equity instruments should not be reduced to take into consideration non-market based performance features or other vesting features.

Modifications, Cancellations, and Settlements

The determination of whether a change in terms and conditions has an effect on the amount recognised depends on whether the fair value of the new instruments is greater than the fair value of the original instruments (both determined at the modification date).

Modification of the terms on which equity instruments were granted may have an effect on the expense that will be recorded. IFRS 2 clarifies that the guidance on modifications also applies to instruments modified after their vesting date. If the fair value of the new instruments is more than the fair value of the old instruments (e.g. by reduction of the exercise price or issuance of additional instruments), the incremental amount is recognised over the remaining vesting period in a manner similar to the original amount. If the modification occurs after the vesting period, the incremental amount is recognised immediately. If the fair value of the new instruments is less than the fair value of the old instruments, the original fair value of the equity instruments granted should be expensed as if the modification never occurred.

The cancellation or settlement of equity instruments is accounted for as an acceleration of the vesting period and therefore any amount unrecognised that would otherwise have been charged should be recognised immediately. Any payments made with the cancellation or settlement (up to the fair value of the equity instruments) should be accounted for as the repurchase of an equity interest. Any payment in excess of the fair value of the equity instruments granted is recognised as an expense.

New equity instruments granted may be identified as a replacement of cancelled equity instruments. In those cases, the replacement equity instruments should be accounted for as a modification. The fair value of the replacement equity instruments is determined at grant date, while the fair value of the cancelled instruments is determined at the date of cancellation, less any cash payments on cancellation that is accounted for as a deduction from equity.

Disclosure

Required disclosures include:

The nature and extent of share-based payment arrangements that existed during the period;

How the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined; and

the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

Please see the appendix of the standard for more illustrative examples.

3.3 EMPLOYEE BENEFITS

Nature of employee benefits

When a company or other entity employs a new worker, that worker will be offered a package of pay and benefits. Some of these will be short-term and the employee will receive the benefit at about the same time as he or she earns it, for example basic pay, overtime etc. Other employee benefits are deferred, however, the main example being retirement benefits (i.e. a pension).

The cost of these deferred employee benefits to the employer can be viewed in various ways. They could be described as deferred salary to the employee. Alternatively, they are a deduction from the employee's true gross salary, used as a tax efficient means of saving. In some countries, tax efficiency arises on retirement benefit contributions because they are not taxed on the employee, but they are allowed as a deduction from taxable profits of the employer.

3.3.1 Accounting for employee benefit costs

Accounting for short-term employee benefit costs tends to be quite straightforward, because they are simply recognised an expense in the employer's financial statements of the current period.

Accounting for the cost of deferred employee benefits is much more difficult. This is because of the large amounts involved, as well as the long time scale, complicated estimates and uncertainties. In the past, entities accounted for these benefits accounted for these benefits simply by charging the income statements of the employing entity on the basis of actual payments made. This led to substantial variations in reported profits of these entities and disclosure of information on these costs was usually sparse.

IAS 19 Employee benefits

IAS 19 is intended to prescribe the following:

- When the cost of employee benefits should be recognised as a liability or an expense.
- The amount of the liability or expense that should be recognised.

As a basic rule, the standard states the following:

1. A liability should be recognised when an employee has provided a service in exchange for benefits to be received by the employee at some time in the future.

2. An expense should be recognised when the entity enjoys the economic benefits from a service provided by an employee regardless of when the employee received or will receive the benefits from providing the service.

The basic problem is therefore fairly straightforward. An entity will often enjoy the economic benefits from the services provided by its employees in advance of the employees receiving all the employment benefits from the work they have done, for example they will not receive pension benefits until after they retire.

3.3.2 Categories of employee benefits

The standard recognises five categories of employee benefits, and proposals a different accounting treatment for each. These four categories are as follows:

a) Short-term benefits including:

   a. Wages and salaries
   b. Social security contributions
   c. Paid annual leave
   d. Paid sick leave
   e. Paid maternity/Paternity leave
   f. Profit shares and bonuses paid within 12 months of the year end
   g. Paid jury service
   h. Paid military service
   i. Non-monetary benefits, e.g. medical care, cars, free goods.

b) Post-employment benefits,

E.g. Pensions and post employment medical care

c) Other long-term benefits

e.g. profit shares, bonuses or deferred compensation payable later than 12months after the year end, sabbatical leave, long-service benefits.

d) Termination benefits

e.g. early retirement payments and redundancy payments.

Benefits may be paid to the employees themselves, to their dependants (spouses, children, etc) or to third parties.

Definitions

IAS 19 has several important definitions. They are grouped together here, but you should refer back to them where necessary.

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.

Short –term employee benefits are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

Post-employment benefits are formal or informal arrangements under which an entity provides post employment benefits for one or more employees.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Multi – employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

a. Pool the assets contributed by various entities that are not under common control, and
b. Use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

Other long-term employee benefits are employee benefits (other than post employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

Termination benefits are employee benefits payable as a result of either:

a) An entity's decision to terminate an employee's employment before the normal retirement date, or

b) An employee's decision to accept voluntary redundancy in exchange for those benefits.

Vested employee benefits are employee benefits that are not conditional on future employment.

The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

Interest cost is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

Plan assets comprise:

a) Assets held by a long-term employee benefit fund; and

b) Qualifying insurance policies

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

a) Are held by an entity (a fund) that is legally separates from the reporting entity and exists solely to pay or fund employee benefits; and
b) Are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

   i) The remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

   ii) The assets are returned to the reporting entity to reimburse it for employee benefits already paid

A qualifying insurance policy is an insurance policy issued by an insurer that is not a related policy (as defined in IAS 24) of the reporting entity, if the process of the policy:

a) Can be used only to pay or fund employee benefits under a defined benefit plan: or

b) Are not available to the reporting entity's own creditor's (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

   i) The proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations of the plan or the reporting entity; or

   ii) The assets are returned to the reporting entity to reimburse it for employee benefits already paid.

The return of plan assets is interest, dividends and other revenue derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less any cost of administering the plan and loess any tax payable by the plan itself.

Actuarial gains and losses comprise:

a) Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), and

b) The effects of changes in actuarial assumptions.

Past service cost is the increase in the present value of the defined benefit obligation for employee service in prior periods, resulting from the current periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced).

Asset ceiling amendment

The revisions to IAS 19 in May 2002 seek to prevent what the IASB regards as a 'counter-intuitive' result produced by the interaction of two aspects of the existing IAS 19.

a) Permission to defer recognition of actuarial gains and losses.

b) Imposition of an upper limit on the amount that can be recognised as an asset (the asset ceiling)

The issue affects only those entities that have, at the beginning or end of the accounting period, a surplus in a defined benefit plan that, based on the current terms of the plan, the entity cannot fully recover through refunds or deductions in future contributions

The issue is the impact of the wording of the asset ceiling.

- Sometimes a gain is recognised when a pension plan is in surplus only because of the deferring and amortising of an actuarial loss or added past service cost in the current period.

- Conversely, a loss may be recognised because of a deferral of actuarial gains.

The revisions to IAS 19 introductions a limited amendment that would prevent gains (losses) from being recognised solely as a result of past services cost or actuarial losses (gains) arising in the period. No change is currently proposed to the general approach of allowing deferral of actuarial gains and losses. During its deliberations on the amendments to IAS 19, the IASB concluded that there were further conceptual and practical problems with these provisions. The IASB intends to conduct a comprehensive review of these aspects of IAS 19 as part of its work on convergence of accounting standards across the world.

There are two key issues or problems to consider.

a) It may be necessary to rely on actuarial assumptions about what the future amount of benefits payable will be.

b) If benefits are payable later than 12months after the end of the accounting period, the future benefits payable should be discounted to a present value.

3.3.3 SHORT TERM EMPLOYEE BENEFITS

FAST FORWARD: There are **no actuarial assumptions** to be made, and there is **no requirement to discount** future benefits (because they are all by definition, payable no later than 12 months after the end of the accounting period).

Recognition and measurement

The rules for short term benefits are essentially an application of basic accounting principles and practice.

Unpaid short-term employee benefits as at the end of an accounting period should be recognised as an accrued expense. Any short-term benefits **paid in advance** should be recognised as a prepayment (to the extent that it will lead to, e.g. a reduction in future payments or a cash refund).

The cost of short-term employee benefits should be recognised as an **expense** in the period when the economic benefits is given, as employment costs (except in so far as employment costs may be included within the cost of an asset, e.g. property, plant and equipment).

Short term absences

There may be **short-term accumulating compensated absences.** These are absences for which an employee is paid, and if the employee's entitlement has not been used up at the end of the period, they are carried forward to the next period. An example is paid holiday leave, where any unused holidays in one year are carried forward to the next year. The cost of the benefits of such absences should be **charged as an expense** as the employees render service that increases their entitlement to future compensated absences.

There may be **short-term non-accumulating compensated absences.** These are absences for which an employee is paid when they occur, but an **entitlement to the absences does not accumulate.** The employee can be absent, and be paid, but only if and when the circumstances arise. Examples are maternity/paternity pay, (in most cases) sick pay, and paid absence for injury service.

>>> Example: Unused holiday leave

A company gives its employees an annual entitlement to paid holiday leave. If there is any unused leave at the end of the year, employees are entitled to carry forward the unused leave for up to 12 months. At the end of 20x9, the company's employees carried forward in total 50 days of unused holiday leave. Employees are paid Sh.100per day.

Required

State the required accounting for the unused holiday carried forward.

Solution

The short-term accumulating compensated absences should be recognised as a cost in the year when the entitlement arises, i.e. in 20 x 9.

Profit sharing or bonus plans

Profit shares or bonuses payable within 12 months after the end of the accounting period should be recognised as an expected cost when the entity has a **present obligation to pay it,** i.e. when the employer has no real option but to pay it. This will usually be when the employer recognises the profit or other performance achievement to which the profit share or bonus relates.

>>> Example: Profit sharing plan

Sema co runs a profit sharing plan under which it pays 3% of its net profit for the year to its

Required

Which costs should be recognised by Sema co for the profit share?

Solution

Sema co should recognise a liability and an expense of 2.5% of net profit.

Disclosure

There are **no specific disclosure requirements for short-term employee benefit** in the proposed standard.

3.3.4 POST EMPLOYMENT BENEFITS

FAST FORWARD: The post employment benefits are paid out of the income from the plan asset (dividends interest) or from money from the sale of some plan assets.

Many employers provide-employment benefits for their employees after they have stopped working .**pension schemes** are the most obvious examples, but an employer might provide post-employment death benefits to the dependants of former employees, or post-employment medical cares

Post-employment benefit schemes are often referred to us **'plans'.** The 'plan' receives regular contributions from the employer (and sometimes from current employees as well) and the money is invested in asset, such as stocks and shares and other investments.

There are two types or categories of post –employment benefit plan, as given in the definition in section 1 above.

- **Defined contribution plans.** With such plans, the employer (and possibly current employees too) pay regular contributions into the plan of a given or 'defined' amount each year. The contribution are invested , and the size of the post employment benefits paid to former employees depends on how well or how badly the plan's investment perform. If the investment performs well, the plan will be able to afford higher benefits than if the investments perform less well.

- **Defined benefit plans.** With these plans, the size of the post-employment benefit is predetermined, i.e. the benefit are defined (and possibly current employees too) pay contributions into the plan, and the contributions are invested. The size of the investment is at an amount that is expected to earn enough returns to meet the obligation to pay the post-employment benefits. If however, it becomes apparent that the assets in the fund are insufficient, the employer will be required to make additional contributions into the contributions to make up the expected short fall. On the other hand, if the fund's asset appear to be larger than they need to be, and in excess of what is required to pay the post employment benefits, the employer may be allowed to take a 'contribution holiday' (i.e. stop paying in contributions for a while).

It is important to make clear distinction between the following:

- **Funding** a defined benefit plan, i.e. paying contributions into the plan.

- **Accounting** for the cost of funding a defined benefit plan.

Before we examine accounting for both these types of schemed me we need to mention a couple of other issues addressed by the standard.

Multi-employer plans

FAST FORWARD: IAS 19 requires an entity to classify such a plan as a defined contribution plan or a defined benefit plan, depending on its terms (including any constructive obligation beyond those terms).

For a multi-employer plan that is a **defined benefit plan.** The entity should account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same as for any other defined benefit plan and maker full disclosure.

When there is **insufficient information** to use defined benefit accounting, then the multi employer benefit plan should be accounted for as defined contribution plan and additional disclosures made (that the plan is a defined benefit plan and information about any known surplus or deficit).

State plans

This are established by legislation to cover some or all entities and are operated by or its agents. These plans cannot be controlled or influenced by the entity. State plans should be treated the same as multi-employer plans by the entity.

Insurance benefits

Insurance premiums paid by an employer to fund an employee post-employment benefit plan should be accounted for as **defined contribution** to the plan, unless the employer, has legal or constructive obligation to pay the employee benefits directly when they fall due, or to make further payments in the event that the insurance company does not pay all the post-employment benefits (relating to services given in prior years and the current period) for which insurance has been paid.

>>> Examples: insurance benefits.

a) For example, Employer pays insurance premiums to fund post-employment medical care for former employees. It has no obligation beyond paying the annual insurance premiums. The premium paid each year should be accounted for as defined contribution.

a) Employer similarly pays insurance premiums for the same purpose, but retains the liability to pay for the medical benefits itself. In the case of employer B, the rights under the insurance policy should be recognised as an asset, and should account for the obligation to employees as a liability as if there were no insurance policy.

Summary

a) There are two categories of **post-retirements benefits:**
   a. Defined contribution schemes
   b. Defined benefit scheme.

b) **Defined contribution schemes** provide benefits commensurate with the fund available to produce them.

c) **Defined benefit schemes** provide promised benefits and so contributions are based on estimates of how the fund will perform.

d) **Defined contribution scheme costs** are easy to account for and this is covered in the next section.

The remaining section of the chapter deals with the more difficult question of how **defined benefit scheme costs** are accounted for.

a) Defined contribution plans

Accounting for payments into defined contribution plans is straightforward.

a. The **obligation** is determined by the amount paid into the plan in each period.
b. There are no actuarial assumptions to make.
c. If the obligation is settled in the current period (or at least no later than 12 months after the end of the current period) there is **no requirement for discounting.**

IAS 19 requires the following

1. **Contribution** to a defined contribution plan should be recognised as an **expense** in the period they are payable (except to the extent that labour costs may be included within the cost of assets.

2. Any liability for **unpaid contributions** that are due as at the end of the period should be recognised as a **liability** (accrued expense).

3. Any **excess contributions** paid should be recognised as an asset (prepaid expense), but only to the extent that the prepayment will lead to, e.g. a reduction in future payments or a cash refund.

In the (unusual) situation where contributions to a defined contribution plan do not fall due entirely within 12months after the end of the period in which the employees performed the related service, then these should be **discounted.** The discount rate to be used is discussed in the next paragraphs.

b) Defined benefit plans: recognition and measurement

Accounting for defined benefit plans is much more complex. The complexity of accounting for defined benefit plans stems largely from the following factors.

a) The future benefits (arising from employee service in the current or prior years) **cannot be estimated exactly,** but whatever they are, the employer will have to pay them, and the liability should therefore be recognised now. To estimate these future obligations, it is necessary to use **actuarial assumptions.**

b) The obligations payable in future years should be valued, by discounting, on a **present value** basis. This is because the obligations may be settled in many years' time.

c) If actuarial assumptions change, the amount of required contributions to the fund will change, and there may be **actuarial gains or losses.** A contribution into a fund in any period is not necessarily the total for that period, due to actuarial gains or losses.

Outline of the method

An outline of the method used for an employer to account for the expenses and obligation of a defined benefit plan is given below. The stages will be explained in more detail later.

Step 1 **Actuarial assumptions** should be used to make a reliable estimate of the amount of future benefits employees have earned from service in relation to the current and prior years. Assumptions include, for example, assumptions about employee turnover, mortality rates, future increases in salaries (if these will affect the eventual size of future benefits such as pension payments).

Step 2 These **future benefits** should be attributed to service performed by employees in the current period, and in prior periods, using the **Projected Unit Credit Method.** This gives a total present value of future benefit obligations arising from past and current periods of service.

Step 3 The **fair value** of any plan assets should be established.

Step 4 The size of any **actuarial gains or losses** should be determined, and the amount of these that will be recognised.

Step 5 If the benefits payable under the plan have been improved, the **extra cost arising from past service** should be determined.

Step 6 If the **benefits payable** under the plan have been reduced or Cancelled, the resulting gain should be determined.

Constructive obligation

IAS 19 makes it very clear that it is not only its legal obligation under the formal terms of a defined benefit plan that an entity must account for, but also for any **constructive obligation** that it may have. A constructive obligation which will arise from the entity's informal practices, exist when an entity has no realistic alternative but to pay employee benefits, for example if any change in the informal practices would cause unacceptable damage to employee relationships.

The Projected Unit Credit Method

With this method, it is assumed that each period of service by an employee gives rise to an **additional unit of future benefits.**

>>> Example: Projected Unit Credit Method

An employer pays a lump sum to employees when they retire. The lump sum is equal to 1% of their salary in the final year of service, for every year of service they have given.

a) An employee is expected to work for 5 years (actuarial assumption)
b) His salary is expected to rise by 8% pa (actuarial assumption)
c) His salary in 20 x 1 is Sh.10,000
d) The discount rate applied is 10%pa

Required

Calculate the amounts chargeable to each of years 20 x 1 to 20 x 5 and the closing obligation each year, assuming no change in actuarial assumptions.

Solution

Since his salary in 20 X 1 is Sh.10,000, his salary in 20 x 5 is expected to be Sh.13,605. His lump sum entitlement is therefore expected to be Sh.136 for each year's service, i.e. Sh.680 in total.

Using the Projected Unit Credit Method, and assuming that the actuarial assumptions do not change over any of 20x1 to 20x5, the calculations are as follows.

Future benefit attributable to:

	20x1	20x2	20x3	20x4	20x5
	Sh.	Sh.	Sh.	Sh.	Sh.
Prior years	0	136	272	408	544
Current year (1% of final salary)	136	136	136	136	136
	136	272	408	544	680

The future benefit builds up to Sh.680 over the five years, at the end of which the employee is expected to leave and the benefit is payable.

These figures, however, are not discounted. The benefit attributable to the current year should be discounted, in this example at 10%, from the end of 20 x 5.

	20x1	20x2	20x3	20x4	20x5
	Sh	Sh	Sh	Sh	Sh
Opening obligation (note 1)	-	93	204	336	494
Interest (note 2)	-	9	20	34	50
Current service cost (note 3)	93	102	112	124	136
(Closing obligation (note 4)	93	102	112	124	136
	93	204	336	494	680

* There is a rounding error of Sh.1 in the calculations. To make the total add up to Sh.680, the interest of Sh.49.4 has therefore been rounded up to Sh.50 in compensation.

Notes

1. The opening obligation is the closing obligation of the previous period, brought forward.

2. Interest is charged on this opening obligation to the current year.

3. The current service cost is the future obligation attributed to the current period (in this example Sh.136 in each year).

4. The closing obligation is the total of the opening obligation brought forward, the interest charge on that amount and the current year service cost.

5. The calculations in the example above assume that actuarial forecasts are exactly correct. If these were to prove incorrect (which is likely in practice), there could be an adjustment to make, resulting in an actuarial gain or an actuarial loss.

Interest cost

The interest cost in the income statement is the **present value of the defined benefit obligation** as at the start of the year multiplied by the discount rate.

Note that the interest charge is *not* the opening balance sheet liability multiplied by the discount rate, because the liability is stated after deducting the market value of the plan assets and after making certain other adjustments, for example for actuarial gains or losses. Interest is the **obligation** multiplied by the discount rate.

The balance sheet

In the balance sheet, the amount recognised as a **defined benefit liability** (which may be a negative amount, i.e. an asset) should be the total of the following:

a) The **present value of the defined obligation** at the balance sheet date, **plus.**

b) Any **actuarial gains** or minus any **actuarial losses** that have not yet been recognised, **minus**

c) Any **past service cost** not yet recognised (if any), minus

d) The **fair value of the assets of the plan** as at the balance sheet date (if there are any) out of which the future obligations to current and past employees will be directly settled.

If this total is a **negative amount,** there is a balance sheet asset and this should be shown in the balance sheet as the **lower** of (a) and (b) below.

a) The figure as calculated above.

b) The total of the present values of:
   a. Any unrecognised actuarial losses and past service costs
   b. Any refunds expected from the plan
   c. Any reductions in the future contributions to the plan because of the surplus.

The determination of a discount rate is covered below.

The income statement

The **expense** that should be recognised in the income statement for post-employment benefits in a defined benefit plan is the total of the following.

- The **current service cost**
- **Interest**
- The **expected return on any plan assets**
- The actuarial gains or losses, to the extent that they are recognised
- **Past service cost** to the extent that is recognised
- The effect of any **curtailments** or **settlements**

Attributing benefit to periods of service

Consider a situation where a defined benefit plan provides for annual pension for former employees retirement. The size of the pension is 2.5% of the employee's salary in his/her final year, for each full year of service. The pension is payable from the age of 65.

The post-employment benefit for each employee is an annual pension of 2.5% of his/her final year's salary for every full year of service. This annual payment obligation should first be converted to a present 'lump sum' value as at the retirement date, using actuarial assumptions. Having established an obligation as at the expected retirement date, the **current service cost** is calculated as the present value of that obligation, i.e. the present value of monthly pension payments of 2.5% of final salary, multiplied by the number of years of service up to the balance sheet date.

For example, if an employee is expected to earn Sh.10,000 in his final year of employment, and is expected to live for 15 years after retirement, the benefit payable for each year of employment would be calculated as the discounted value, as at retirement date, of Sh.250 per annum for 15 years. This should then be converted to a present value (as at the balance sheet date) to determine the current service cost for the year for that employee.

Probabilities should be taken into consideration in the calculations. Suppose that a benefit of Sh.1,000 for every year of service is payable to employees when they retire at the age of 60, provided that they remain with the employer until they retire (i.e. that they don't leave to work for someone else). Suppose also that an employee joins the firm at the age of 40, with 20 years to work to retirement.

The benefit attributable to each year of service is Sh.1,000 **multiplied by the probability** that the employee will remain with the employer until he/she is 60. Since the benefit is payable at retirement as a lump sum, it should be discounted to a present value as at the balance sheet date to determine the current service cost for a given year. The obligation should be calculated as the present value of Sh.40,000 (40years x Sh.1,000) **multiplied by the same probability.**

No added obligations arise **after all significant post – employment benefits have vested;** in other words, no extra post – benefit obligations arise after an employee has already done everything necessary to qualify in full for the post-employments benefit. Suppose for example that employees have an entitlement to a lump sum payment on retirement of Sh.20,000. The benefit vests after 10 years.

In accounting for this **lump sum benefit on retirement,** a benefit of Sh.2,000 should be attributed to each of the first ten years of an employee's service. The current service cost in each of the ten years should be the present value of Sh.20,000. if an employee has 25years to go to retirement form the time he/she joins the firm there should be a service cost in each of the first ten years, and none in the 15years thereafter (other than the interest cost on the obligation).

Question: Service periods

Under Huduma co. plan, all employees are paid a lump sum retirement benefit of Sh.100,000. They must be still employed aged 55 after 20years' service, or still employed at the age of 65, no matter what their length of service.

Required

State how this benefit should be attributed to service periods.

Answer

This answer is in three parts.

a) In the case of those employees joining before age 35, service first leads to benefits under this plan at the age of 35, because an employee could leave at the age of 30 and return at the age of 33, with no effect on the amount/timing of benefits. In addition, service beyond age 55 will lead to no further benefits. Therefore, for these employees Huduma Co. Should allocate Sh.100,000 ÷20 = Sh.5,000 to each year between the ages of 35 and 55.

b) In the case of employees joining between the ages of 35 and 45, service beyond 20 years will lead to no, further benefit. For these employees, Huduma Co. should allocate Sh.100,000 ÷ 20 = Sh.5,000 to each of the first 20 years.

c) Employees joining at 55 exactly will receive no further benefit past 65, so Huduma Co should allocate Sh.100,000 ÷ 10 = Sh.10,000 to each of the first 10 years.

The current service cost and the present value of the obligation for all employees reflect the probability that the employee may not complete the necessary period of service.

Actuarial assumptions

Actuarial assumptions are needed **to estimate the size of the future (post-employment) benefits** that will be payable under a defined benefits scheme. The main categories of actuarial assumptions are as follows:

- **Demographic assumptions** are about mortality rates before and after retirement, the rate of employee turnover, early retirement, claim rates under medical plans for former employees, and so on.

- **Financial assumptions** are the discount rate to apply, the expected return on plan assets, future salary levels (allowing for seniority and promotion as well as inflation) and the future rate of increase in medical costs (not just inflationary cost rises, but also cost rises specific to medical treatments and to medical treatments required given the expectations of longer average life expectancy).

The standard requires actuarial assumptions to be neither too cautions nor too imprudent: they should be **'unbiased'.** They should also be based on '**market expectations**' at the balance sheet date, over the period during which the obligations will be settled.

The **discount rate** adopted should be determined by reference to **market yields** (at the balance sheet date) on high quality fixed-rate corporate bonds. In the absence of a 'deep' market in such bonds, the yields on comparable government bonds should be used as reference instead. The maturity that is consistent with the expected maturity of the post employment benefit obligations, although a single weighted average discount rate is sufficient.

The guidelines comment that there may be some difficulty in obtaining a **reliable yield for long-term maturities,** say 30 or 40 years from now. This should not however be a significant problem: the present value of obligations payable in many years time will be relatively small and unlikely to be sensitive to errors in the assumption about the discount rate for long term maturities (beyond the maturities of long-term corporate or government bonds).

Actuarial gains or losses

Actuarial gains or losses arise because of the following:

a) **Actual events** (e.g. Employee turnover, salary increases) differ from the actuarial assumptions that were made to estimate the defined benefit obligations.

b) **Actuarial assumptions are revised** (e.g. a different discount rate is used, or a different assumption is made about future employee turnover, salary rises, mortality rates, and so on).

c) **Actual returns on plan assets** differ from expected returns

Since actuarial assumptions are rarely going to be exact, some actuarial gains or losses are inevitable. The proposed standard suggests that, given the inevitability of actuarial gains or losses, they **should not be recognised unless they appear 'significant'.** They are not sufficient to warrant recognition if they fall within a tolerable range or 'corridor'.

The standard requires the following:

a) An entity should, as a **general rule**, recognise actuarial gains and losses as an item of income or expense (income statement), and as a part of the deferred benefit liability (balance sheet).

b) However, only a portion of such actuarial gains or losses (as calculated above) should be recognised if the **net cumulative actuarial gains/losses exceed** the *greater* of:

   i. 10% of the present value of the defined benefit obligation (i.e. before deducting plan assets), and
   ii. 10% of the fair value of the plan assets.

A separate calculation should be made for each defined benefit plan: two or more plans should not be aggregated.

The excess calculated under paragraph 5.26(b) should be **divided by the expected average remaining working lives of participating employees** and this gives the portion of actuarial gains and losses to be recognised.

IAS 19 allows, however, any systematic method to be adopted if it results in **faster recognition** of actuarial gains and losses. The same basis must be applied to both gains and losses and applied consistently between periods.

Immediate recognition – amendment to IAS 19

In December 2004, the IASB issued an amendment to IAS 19. This allows an entity to **recognise actuarial gains and losses immediately** in the period in which it arises, outside profit and loss. These gains and losses need to be presented in the **statement of recognised income and expenses.** This statement would be compulsory for entities recognising actuarial gains and losses in reserves. If the entity adopts this approach, it must do so:

a) For all its defined benefits plans.

b) For all its actuarial gains and losses

In addition, the amendment requires **improved disclosures,** including many also required by FRS 17, and slightly eases the methods whereby the amounts recognised in the consolidated financial statements have to be allocated to individual group companies for the purposes of their own reporting under IFRSs.

Past service cost

A past service cost arises when an entity either introduces a defined benefits plan or **improves the benefits payable** under an existing plan. As a result, the entity has taken on additional obligations that it has not hitherto provided for. For example, an employer might decide to introduce a medical benefits scheme for former employees. This will create a new defined benefit obligation that has not yet been provided for. How should this obligation be accounted for?

A past service cost may be in respect of either **current employees or past employee.** IAS 19 has introduced a different accounting treatment for past service cost, according to whether they relate to **current employees or past employees.**

a) For **current employees,** the past service cost should be recognised as part of the defined benefit liability in the balance sheet. For the income statement, the past service cost should be amortised on a straight line basis over the average period until the benefits become vested.

b) For **past employees** (if the change affects them) the past service cost should be recognised in full immediately the plan is introduced or improved (i.e. because they are immediately 'vested'), as part of the defined benefit liability and as an expense (in full) to the financial period.

Question (past service costs)

Wakili Co operates a pension plan that provides a pension of 2% of final salary for every year of service and the benefits become vested after five years' service. On 1 January 20 x 6 Wakili Co improved the pension to 2.5% of final salary for every year of service starting from 1 January 20x2.

At the date of improvement, the present value of the additional benefits for service from 1 January 20x2 to 1 January 20 x 6 is as follows.

	Sh.m
Employees with more than 5 years' service at 1/11x 6	300
Employees with less than 5 years' service at 1/11x6	
(average period until vesting = 3years	240
	540

Required

State the correct accounting treatment for past service costs.

Answer

Wakili Co. should recognise Sh.300m immediately, because these benefits are already vested. Sh.240m should be recognised on a straight – line basis over three years from 1 January 20 x 6.

Plan assets

The contributions into a plan by the employer (and employees) are invested, and the plan builds up assets in the form of stocks and shares, etc. The **fair value of these plan assets** are deducted from the defined benefits obligation, in calculating the balance sheet liability. This makes sense, because the employer is not liable to the defined benefits scheme to the extent that the assets of the fund are sufficient to meet those obligations.

The standard includes the following specific requirements:

a) The fair value of the plan assets should be **net of any transaction costs** that would be incurred in selling them.

b) The plan assets should **exclude any contributions due** from the employer but not yet paid.

Return on Plan assets

It is also necessary to recognise the distinction between:

- The **expected return** on the plan assets, which is an actuarial assumption, and
- The **actual return** made by the plan assets in a financial period.

The **expected return** on the plan assets is a component element in the income statement, not the actual returns. The **difference between the expected return and the actual return** may also be included in the income statement, but within the actuarial gains or losses. This difference will only be reported it the actuarial gains or losses are outside the 10% corridor for these gains or losses, otherwise they will not be included in the expense item because they are not regarded as significant.

>>> Example: Plan assets

At 1 January 20 x 2 the fair value of the assets of a defined benefit plan were valued at Sh.1m. Net cumulative actuarial gains and losses were Sh.76,000.

On 31 December 20x2, the plan received contributions from the employer of Sh.490,000 and paid out benefits of 190,000.

After these transactions, the fair value of the plan's assets at 31 December 20 x 2 was Sh.1.5m. The present value of the defined benefit obligation was Sh.1,479,200 and actuarial losses on the obligation for 20 x 2 were Sh.6,000.

The expected return on the plan assets (net of investment transaction costs) is 8% per annum.

The reporting entity made the following estimates at 1 January 20 x 2, based on market prices at that date.

	%
Dividend/interest income (after tax payable by fund)	9.25
Realised and unrealised gains (after tax) on plan assets	2.00
Administration costs	(1.00)
	10.25

Required

Calculate the expected and actual return on plan assets, calculate any actuarial gain or loss and state the required accounting.

Solution

The expected and actual return for 20 x 2 are as follows.

	Sh.
Return on Sh.1m held for 12months at 10.25%	102,500
Return on Sh.(490,000 – 190,000) = Sh.300,000	15,000
For 6months at 5% (i.e. 10.25% annually compounded every 6months)	117,500

	Sh.
Fair value of plan assets at 31/12/x2	1,500,000
Less fair value of plan assets at 1/1 x 2	1,000,000
Less contributions received	(470,000)
Add benefits paid	190,000
Actual return on plan assets	200,000

Actuarial gain = Sh.(200,000 – 117,500) = Sh.82,500.

Therefore cumulative net unrecognised actuarial gains = Sh.(76,000 + 82,500 – 6, 000) = Sh.152,500.

The limits of the corridor are set at the *greater* of:

10% x Sh.1,500,000 and

10% x Sh.1,479,920.

In 20 x 3, the entity should recognise an actuarial gain of Sh.(152,500 – 150,000) = Sh.2,500, divided by the expected average remaining working life of the relevant employees.

For 20 x 3, the expected return on plan assets will be based on market expectations at 1/1 x 3 for returns over the entire life of the obligation.

The following accounting treatment is required:

- In the **income statement,** an expected return on fund assets of Sh.117,500 will be recognised, together with an actuarial gain of Sh.2,500 divided by the expected average remaining useful life of the employees.

- In the **balance sheet**, the defined benefit liability will adjust the defined benefit obligation as at 31 December 20 x 2. The unrecognised actuarial gain (i.e. the gain within the 10% corridor) should be added, and the market value of the plan assets as at that date should be subtracted.

Summary

The recognition and measurement of defined benefit plan costs are complex issues.

- Learn the **outline method** of accounting
- Learn the calculations for the **Projected Unit Credit Method**
- Learn the recognition method for the:
  - Balance sheet
  - Income statement

Defined benefit plans: Other matters

This section looks at the presentation and disclosure of defined benefit plans, but we begin here by looking at the special circumstances of curtailment and settlements.

1. Curtailments and settlements

A **curtailments** occurs when an entity cuts back on the benefits available under a defined benefit scheme, so that there is either a significant reduction in the number of employees eligible for the post – employment benefits (e.g. because a large number of staff have been made redundant due to plant closure), or there is a reduction in the post-employment benefits that will be given for the future service of current employees.

A **settlement** occurs either when an employer pays off its post – employment benefit obligations in exchange for making a lump sum payment, or when an employer reduces the of post-employment benefits payable in future in respect of **past service.**

A curtailment and settlement might **happen together,** for example when an employer brings a defined benefit plan to an by settling the obligation with one-of lump sum payment and then scrapping the plan.

Gains or losses arising from curtailment or settlement of a defined benefit plan should be **recognised in full in the financial year that they occur.** These gains or losses will comprise the following.

Any **change in the present value of the future obligations** of the entity as a result of the curtailment or settlement.

Any **change in the fair value of the plan asset as** consequence of the curtailment or settlement.

Any related **actuarial gains/ losses** and **past service cost** that had not previously been recognised.

An entity should **remeasure the obligation** (and the related plan assets, if any) using current actuarial assumptions, before determining the effect of curtailment or settlement.

QUESTION

Hossan Co. discontinued a business segment. Employees of the discontinued segment will earn no further benefits (i.e. this is a curtailment without a settlement). Using current actuarial assumptions (including current market interest rates and other current market prices) immediately before the curtailment, the Hewsan Co. had a defined benefit obligation with a net present value of Sh.500,000, plan assets with a fair value of Sh.410,000 and net cumulative unrecognised actuarial gains of Sh.25,000. The entity had first adopted IAS 19 (revised) one year later. This increased the net liability by Sh.50,000, which the entity chose to recognise over five years (this is permitted under the transitional provisions: see below).

Required

Show the required treatment for the curtailment

Answer

Of the previously unrecognised actuarial gains and transitional amounts, 10% (Sh.50,000/ Sh.500,000) relates to the part of the obligation that was eliminated through the curtailment. Therefore, the effect of the curtailment is as follows.

	Before Curtailment	Curtailment gain	After curtailment
	Sh.'000	Sh.'000	Sh.'000
Net present value of obligation	500.0	(50.0)	450.0
Fair value of plan assets	(410.0)	-	(410.0)
	90.0	(50.0)	40.0
Unrecognised actuarial gains	25.0	(2.5)	22.5
Unrecognised transitional amount (Sh.50,000 x 4/5)	(40.0)	4.0	(36.0)
Net liability recognised in balance sheet	75.0	43.5	26.5

Presentation and disclosure

The standard states that an entity **should not offset** an set relating to one plan against a liability relating to a different plan, unless the entity has a legally enforceable right of offset and intends to use it.

> The disclosure requirements given below are substantial and you won't be expected to know all the details in the exam. Just try to appreciate the reasons for the disclosure and the general approach.

Exam focus

Point

A reporting entity should disclosure the following information about post retirement defined benefit plans.

- **Accounting policy** for recognising actuarial gains and losses.
- **General description** of the type of plan
- **Reconciliation** of the assets and liabilities recognised in the balance sheet, showing the following as a minimum.
  - Present value at the balance sheet date of defined benefit obligations that are wholly unfunded.
  - Present value (before deducting the fair value of plan assets) at the balance sheet date of defined benefit obligations that are wholly or partly funded.
  - Fair value of any plan assets at the balance sheet date.
  - Net actuarial gains or losses not recognised in the balance sheet.
  - Past service cost not yet recognised in the balance sheet.
  - Any amount not recognised as an asset, because of the limit.
  - Amounts recognised in the balance sheet.
- Amounts included in the **fair value** of plan assets for:
  - Each category of the reporting entity's own financial instruments, and
  - Any property occupied by, or other assets used by, the reporting entity
- Reconciliation showing the movements during the period in the net liability (or asset) recognised in the **balance sheet.**
- Total expense recognised in the **income statement** for each of the following and the

line item(s) of the income statement in which they are included.

- Current service cost
- Interest cost
- Expected return on plan assets
- Actuarial gains and losses
- Past service cost
- Effect of any curtailment or settlement

❖ **Actual return on plan assets.**

❖ Principal **actuarial assumptions** used as at the balance sheet date, including, where applicable:

- Discount rates
- Expected rates of return on any plan assets for the periods presented in the financial statements.
- Expected rates of salary increases (and of changes in an index or other variable specified in the formal or constructive terms of a plan as the basis for future benefit increases.
- Medical cost trend rates
- Any other material actuarial assumptions used

Disclose each actuarial assumption in **absolute terms** (e.g. as an absolute percentage) and not just as a margin between different percentages or other variables.

It would be useful for you to do one last question on accounting for post employment defined benefit schemes. Questions on these are most likely in the exam.

CHAPTER SUMMARY

Corporation tax: is the tax payable by a company as a result of generating profits from trading.

Deferred tax: is the corporation tax that is likely to be incurred on the activities of a company during a particular period but, because of differences between the way activities are included in the accounting profit and taxable income, will be paid in another period.

Temporary differences include differences between the fair values and the tax values of assets and liabilities acquired and the effect of revaluing assets and liabilities acquired and the effect of revaluing assets for accounting purposes.

The full provision method is based on the view that every transaction has a tax consequence and it is possible to make a reasonable estimate of the future tax consequences of transactions that have occurred by the balance sheet date.

Timing Differences: is items reported in the accounts in periods different from those in which they are reflected in tax computations. These differences originate in one period and reverse in one or more subsequent periods.

Full deferral: requires that full tax effects of all timing differences are recognised as they arise. The approach is arithmetically accurate but can lead to the build up of large, meaningless provisions appearing on the balance sheet.

Partial deferral: requires that the income tax expense excludes the tax effects of certain timing differences when there is reasonable evidence that those timing differences will not reverse for some considerable period (at least 3 years) ahead.

Employee benefits: are all forms of consideration given by an entity in exchange for service rendered by employees.

Short –term employee benefits are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

Post-employment benefits are formal or informal arrangements under which an entity provides post employment benefits for one or more employees.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Multi – employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

a) Pool the assets contributed by various entities that are not under common control, and

b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

Other long-term employee benefits are employee benefits (other than post employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

Termination benefits are employee benefits payable as a result of either:

a) an entity's decision to terminate an employee's employment before the normal retirement date, or

b) an employee's decision to accept voluntary redundancy in exchange for those benefits.

Vested employee benefits are employee benefits that are not conditional on future employment.

The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

CHAPTER QUIZ

1. What should be disclosed in relation to taxes?

2. What were the reasons for rejecting the partial provision method?

3. What are the categories of employee benefits?

4. Explain the following:
   i) Assets held by a long-term employee benefit fund
   ii) A qualifying insurance policy
   iii) The return of plan assets
   iv) Actuarial gains and losses
   v) Past service cost

ANSWERS TO THE CHAPTER QUIZ

1. Disclosures

i. Tax expense (income) must be shown separately on the face of the income statement, with separate disclosure made of its major components and any tax expense (income) relating to extra ordinary items.

ii. Tax expense (income) relating to the gain or loss on discontinuance for discontinued operations and to the profit or loss from the ordinary activities of the discontinued operation for the period must also be disclosed.

iii. An explanation is required of the relationship between tax expense (or income) and accounting profit either of numerical reconciliation between the average effective tax rate and the applicable tax rate. An explanation is required of any changes in the applicable tax rate(s) compared to the previous period.

iv. The aggregate amount of temporary differences for which either deferred tax assets or liabilities have not been recognized (i.e. for unremitted “re-invested” earnings of subsidiaries should be disclosed. For each type of temporary difference and for unused tax losses and credits, disclosure is required of the amount of deferred tax assets and liabilities recognized and the amount of deferred tax income or expense recognized. The amount of any deferred tax asset and evidence supporting its recognition must be disclosed when its utilization is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences, and the enterprise has suffered a loss in the current or previous period in the tax jurisdiction to which the deferred tax asset relates. Separate disclosure is also required of the aggregate current and deferred tax relating to items that are charged or credited to equity.

2. Reasons for rejecting the partial provision method.

The partial provision method allowed companies to avoid creating provisions for tax that they argued they were unlikely to pay. However, by the early 1990s, concerns were being expressed about the method and the way in which it was being applied. It was noted in particular that:

i. The recognition rules and anticipation of future events were subjective and inconsistent with the principles underlying other aspects of accounting.

ii. The partial provision method had not been regarded as appropriate for dealing with the long-term deferred tax assets associated with provisions for post-retirement benefits. As a result, SSAP 15 had been amended in 1992 to permit such assets to be accounted for on a full provision basis. The amendment introduced inconsistencies into SSAP 15.

iii. There were variations in the way in which SSAP 15 was applied in practice. Different entities within the same industry and with similar prospects seemed to take quite different views on the levels of provisions necessary. There was evidence that some companies provided for deferred tax in full for simplicity’s sake rather than because their circumstances required it. The different approaches being taken reduced the comparability of financial statements.

Because of its recognition rules and anticipation of future events, the partial provision method was increasingly being rejected by standard-setters in other countries. The

US Financial Accounting Standards Board (FASB) had issued a standard FAS 109 'Accounting for Income Taxes' requiring full provision. The International Accounting Standards Committee (IASC) had published proposals for similar requirements and other standard –setters had started to move in the same direction.

When rejecting the partial provision method, the FASB and IASC argued in particular that:

(i) Every tax timing difference represented a real liability, since everyone would reverse and, whatever else happened, an entity would pay more tax in future as a result of the reversal than it would have done in the absence of the timing difference.
(ii) It was only the impact of new timing differences arising in future that prevented the total liability from reducing. It was inappropriate (and inconsistent with other areas of accounting) to take account of future transactions when measuring an existing liability.
(iii) The assessment of the liability using the partial provision method relied on management intentions regarding future events. Standard setters were uncomfortable with this, having already embodied in a number of other standards the principle that liabilities should be determined on the basis of obligations rather than management decisions or intentions.

3. **The standard recognises four categories of employee benefits. These are:**

(i) Short-term benefits including:

- Wages and salaries
- Social security contributions
- Paid annual leave
- Paid sick leave
- Paid maternity/Paternity leave
- Profit shares and bonuses paid within 12 months of the year end
- Paid jury service
- Paid military service
- Non-monetary benefits, e.g. medical care, cars, free goods.

(ii) Post employment benefits e.g. Pensions and post employment medical care

(iii) Other long-term benefits e.g. profit shares, bonuses or deferred compensation payable later than 12months after the year end, sabbatical leave, long-service benefits.

(iv) Termination benefits e.g. early retirement payments and redundancy payments.

4. **(i) Assets held by a long-term employee benefit fund** are assets (other than non-transferable financial instruments issued by the reporting entity) that:

a) Are held by an entity (a fund) that is legally separates from the reporting entity and exists solely to pay or fund employee benefits; and
b) Are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid

(ii) **A qualifying insurance policy** is an insurance policy issued by an insurer that is not a related policy (as defined in IAS 24) of the reporting entity, if the process of the policy:

a) Can be used only to pay or fund employee benefits under a defined benefit plan: or

b) Are not available to the reporting entity's own creditor's (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

i) The proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations of the plan or the reporting entity; or

ii) The assets are returned to the reporting entity to reimburse it for employee benefits already paid.

(iii) **The return of plan assets** is interest, dividends and other revenue derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less any cost of administering the plan and loess any tax payable by the plan itself.

(iv) **Actuarial gains and losses comprise:**

a) Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), and

b) The effects of changes in actuarial assumptions.

(v) **Past service cost** is the increase in the present value of the defined benefit obligation for employee service in prior periods, resulting the in the current periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced).

PAST PAPER ANALYSIS

Corporation tax was tested in the following examinations:

06/'03

12/'01

06/'01

Deferred tax was tested in the following examinations:

06/'06

06/'03

12/'01

06/'01

Employee benefits was tested in the following examinations:

12/'07

06/'06

12/'03

EXAM QUESTIONS

QUESTION ONE

(a) Explain the following terms with reference to International Accounting Standard 19 (Employee Benefits):

(i) Current service cost (2 marks)

(ii) Past service cost (2 marks)

(iii) Vested employee benefits (2 marks)

(b) ABC Ltd. contributes sh.30 million per annum to a pension scheme and treats the amount as current service cost pension expense.

On 1 July 1998, the actuarial valuation of the scheme showed a deficit of sh.600 million. The actuary recommended that the deficit be cleared within four years by paying sh.150 million per year in addition to the annual service costs. The average remaining service life of employees in the scheme on 1 July 1998 was eight years.

Required:

For each of the remaining eight service years of the employees, calculate the pension expense and pension expense and pension liability or prepayment. (6 marks)

(c) XYZ Ltd. contributes sh.60 million annually to a pension scheme and treats the amount as being `equivalent to annual service cost.

On 1 January 1996, the actuarial valuation showed that the scheme had a surplus of sh.320 million. The actuary recommended non-contribution to the scheme for three years then a resumption of annual contribution of sh.40 million per annum for the following seven years before reverting to the standard annual contribution of sh.60 million.

The average remaining service years of employees, calculate the pension expense and pension liability or prepayment. (8 marks)

(Total: 20 marks)

(CPA 2006)

CASE STUDY

Case Study: Abbey

2009-02-01

As a financial institution, Abbey regards financial education as being paramount to the wellbeing of its 16,000 employees, particularly during the current economic climate.

It is planning to launch a workplace financial education programme to help staff cope with the credit crunch, following on from an initiative built around its sharesave scheme last year.

Maria Strid, head of reward, says: “We feel it is important to keep investment in financial education high.” The company’s intranet site is also used for updating staff on perks. “To ensure employees can easily access all benefits, we have invested in an online benefits communication platform. This has made it easy for staff to see what Abbey offers that can make a difference to take-home pay, for example, discounted retail vouchers.”

Source: www.google.com- case studies on employee benefits

PART B

CHAPTER FOUR

PRESENTATION AND ANALYSIS OF FINANCIAL STATEMENTS (PART A)

STUDY TEXT

CHAPTER FOUR

PRESENTATION AND ANALYSIS OF FINANCIAL STATEMENTS (PART A)

OBJECTIVES

After this chapter, the student will be able to:

- Prepare cashflow statements
- Calculate earnings per share
- Prepare segmental reports

INTRODUCTION

A trading and profit account is the usual method of describing what has happened in a business during the past year, and it incorporates many adjustments in order to show a more true and fair view of the profit.

EPS is the amount of earnings for a period that is attributable to each ordinary/equity share. As per IAS 33 'Earnings per share', enterprises whose ordinary shares or potential ordinary shares are publicly traded and those enterprises that are in the process of issuing ordinary shares or potential ordinary shares in public securities market should calculate and disclose earnings per share.

Potential ordinary shares are securities, which are not presently equity shares but, which have the potential of causing additional equity shares to be issued in the future.

IAS 24 is about companies disclosing requirements about transactions with related companies or parties. It is one of the shortest standard and therefore not difficult to comprehend.

DEFINITION OF KEY TERMS

Free Cash flows: Is the Cash from operations less the amount of capital expenditures required to maintain the firm's present productive capacity.

Rights issue is regarded as an issue for cash at full market price and partly a bonus issue on the combined number of original and assumed rights shares.

Parties are considered to be **related** if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.

A **related party transaction** is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

▶ EXAM CONTEXT

In past examinations, the examiner has tested the students' knowledge on the following topics:

- Cashflow statements
- Earnings per share
- Related parties
- Segmental reports

Students should therefore understand these topics.

▶ INDUSTRY CONTEXT

This chapter will enable firms to know how to prepare cashflow statements which are necessary to:

a. Assess the enterprise's ability to generate positive future cash flows;

b. Assess the enterprise's ability to meet its obligations, pay dividends and meet its needs for external reporting;

c. Assess the reasons for differences between net income and related cash receipts and payments; and

d. Assess the effects on the enterprise's financial position of both cash and non-cash investing and financing transactions during the period.

Firms will also be able to calculate their earnings per share and prepare segment reports.

4.1 INTERIM FINANCIAL STATEMENTS (1AS 34)

4.1.0. Introduction and scope

IAS 34 *Interim Financial Reporting* prescribes the minimum content for an interim financial report, and the principles for recognition and measurement in complete and condensed financial statements for an interim period. The Standard has been effective since 1 January 1999, and was most recently amended as a consequential amendment of IAS 1(2007) *Presentation of Financial Statements*, resulting in changes in terminology, and in the titles and layout of certain of the financial statements to be included in interim financial reports. These amendments are effective for periods beginning on or after 1 January 2009.

IFRS 8 *Operating Segments*, which supersedes IAS 14 *Segment Reporting* and is effective for periods beginning on or after 1 January 2009, has expanded the segment information to be disclosed in interim financial reports. In this guide, it is assumed that the interim accounting period under consideration begins on or after 1 January 2009 – no reference is made to the requirements of IAS 34 applicable to earlier periods.

4.1.1 Scope of IAS 34

IAS 34 applies to interim financial reports that are described as complying with International Financial Reporting Standards. [IAS 34.3]

Interim financial reports are financial reports containing either a complete set of financial statements (as described in IAS 1) or a set of condensed financial statements (as described later in this guide) for an interim period. An interim period is a financial reporting period shorter than a full financial year. [IAS 34.4]

4.1.2 No requirement to prepare Interim Financial Reports

IAS 34 does not contain any rules as to which entities should publish interim financial reports, how frequently, or how soon after the end of an interim period. The Standard notes that governments, securities regulators, stock exchanges, and accountancy bodies often require entities with publicly-traded debt or equity to publish interim financial reports, and that those regulations will generally specify the frequency and timing of such reports. However, IAS 34 *encourages* publicly-traded entities:

[IAS 34.1]

- to provide interim financial reports at least as of the end of the first half of their financial year; and
- to make their interim financial reports available no later than 60 days after the end of the interim period.

4.1.3 No requirement for Interim Financial Reports to comply with IAS 34

Each financial report, annual or interim, is evaluated on a stand-alone basis for compliance with IFRSs. It is important to note that entities that prepare annual financial statements in accordance with IFRSs are not precluded from preparing interim financial reports that do not comply with IFRSs, provided that the interim report does not state that it is IFRS-compliant. The fact that an entity has not published interim financial reports during a financial year, or that it has published interim financial reports that do not comply with IAS 34, does not prevent the entity's annual financial statements from conforming to IFRSs, if they are otherwise IFRS-compliant. [IAS 34.1 & 2]

4.1.4 Preliminary Announcements

IAS 34 does not address the content of preliminary interim earnings announcements (i.e. those earnings announcements issued shortly after the end of an interim period that disclose abbreviated preliminary financial information for the interim period just ended). IAS 34.3 does state, however, that if an interim financial report is described as complying with IFRSs, it must comply with all of the requirements of IAS 34.

Therefore, if any reference to IFRSs is made in a preliminary interim earnings announcement, the following sentences (or something substantively similar) should be included in that earnings release.

> 'While the financial figures included in this preliminary interim earnings announcement have been computed in accordance with International Financial Reporting Standards (IFRSs) applicable to interim periods, this announcement does not contain sufficient information to constitute an interim financial report as that term is defined in IFRSs. The directors expect to publish an interim financial report that complies with IAS 34 in March 20X2.'

4.2. CONTENT OF AN INTERIM FINANCIAL REPORT

4.2.1 General principles underlying the preparation of financial statements

If an entity presents a complete set of financial statements for interim reporting purposes (as described in IAS 1 *Presentation of Financial Statements* – see chapter 3 of this guide), it must apply IAS 1 in full. If an entity presents a condensed set of financial statements for interim reporting purposes, IAS 1.4 contains the following guidance.

> "This Standard does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34 *Interim Financial Reporting*. However,

paragraphs 15-35 apply to such financial statements."

Paragraphs 15-35 of IAS 1, which therefore apply when preparing all interim financial reports (whether condensed or complete), deal with:

- Fair presentation and compliance with ifrss;
- Going concern;
- Accrual basis of accounting;
- Materiality and aggregation; and
- Offsetting.

4.2.2 Minimum components

Entities reporting in accordance with IAS 34 are required to include in their interim financial reports, at a minimum, the following components:

[IAS 34.8]

- a condensed statement of financial position;
- a condensed statement of comprehensive income, presented as either:
- a condensed single statement; or
- a condensed separate income statement and a condensed statement of comprehensive income;
- a condensed statement of changes in equity;
- a condensed statement of cash flows; and
- Selected explanatory notes.

If, in its annual financial statements, an entity presents the components of profit or loss in a separate income statement as described in IAS 1.81, it should also present interim condensed information in a separate statement. [IAS 34.8A]

Note that the titles of the financial statements listed above have been amended as a consequential amendment of IAS 1(2007). Entities are permitted to use titles for these statements other than those set out above. An entity would be expected to use the same titles in its interim financial report as are used in its annual financial statements.

These amendments are effective for periods beginning on or after 1 January 2009 and entities should describe their effect on the financial statements in the first interim financial report for that year.

4.3 PERIODS REQUIRED TO BE PRESENTED

4.3.1 Entities that report half-yearly

Based on the requirements of IAS 34.20, example 2.3.1 illustrates the statements required to be presented in the interim financial report of an entity that reports half-yearly, with a 31 December 20X9 year end.

>>> Example 2.3.1

Statements required for entities that report half-yearly

Statement	**Current**	**Comparative**
Statement of financial position at	30 June 20X9	31 December 20X8
Statement of comprehensive income (and, where applicable, separate income statement)		
– 6 months ended	30 June 20X9	30 June 20X8
Statement of changes in equity		
– 6 months ended	30 June 20X9	30 June 20X8
Statement of cash flows		
– 6 months ended	30 June 20X9	30 June 20X8

Content of an interim financial report 3

4.3.2 Entities that report quarterly

Based on the requirements of IAS 34.20, example 2.3.2 illustrates the statements required to be presented in the half-yearly interim financial report of an entity that reports quarterly, with a 31 December 20X9 year end.

>>> Example 2.3.2

Statements required for entities that report quarterly

Statement	**Current**	**Comparative**
Statement of financial position at	30 June 20X9	31 December 20X8
Statement of comprehensive income (and, where applicable, separate income statement)		
– 6 months ended	30 June 20X9	30 June 20X8
– 3 months ended	30 June 20X9	30 June 20X8
Statement of changes in equity		
– 6 months ended	30 June 20X9	30 June 20X8
Statement of cash flows		
– 6 months ended	30 June 20X9	30 June 20X8

4.3.3 Entities with seasonal businesses

The requirements of IAS 34.20, as discussed above, specify the minimum periods for which interim financial statements are to be presented.

However, entities may wish to provide additional information. For example, an entity whose business is highly seasonal is encouraged to disclose financial information relating to the twelve months up to the end of the interim period, and comparative information for the equivalent twelvemonth period in the prior year. [IAS 34.21]

4.3.4 Change of financial year end

>>> Example 2.3.4

Comparative interim period when financial year end changes

Company A's financial year ends on 31 March. It reports half-yearly. It prepared annual financial statements for the year ended 31 March 20X1.

Subsequently, it published a half-yearly report for the six months ended 30 September 20X1.

Company A changes its financial year end to 31 December and prepares 'annual' financial statements for the nine months ended 31 December

20X1. Its half-yearly interim report for 20X2 will be for the six months ended 30 June 20X2. What comparative period should be used for the

June 20X2 interim financial report?

IAS 34 does not consider the circumstances where there is a change in the financial year end. IAS 34.20 requires the presentation of comparative information for the statement of comprehensive income, statement of changes in equity, and statement of cash flows, for "comparable interim periods". In many circumstances, using the period from 1 January 20X1 to 30 June 20X1 as the comparative period may be preferable to using the amounts previously reported for the period from 1 April 20X1 to 30 September 20X1, because this would enable users to compare trends over time, particularly in a seasonal business. However, based on the particular facts and circumstances, other periods may be appropriate (e.g. where local regulations prescribe the comparative period(s) to be presented following a change in financial year end).

Content of an interim financial report 5

4.3.5 Comparative financial statements when interim financial reports are produced for the first time

When an entity is preparing its first interim financial report under IAS 34, unless the report relates to the first period of operation, it should generally include comparatives as discussed in the previous sections. In the exceptional circumstances where the entity does not have available

in its accounting records the financial information needed to prepare the comparative interim financial statements, the entity has no choice but to omit prior period comparative financial statements.

In the circumstances described, however, the omission of the comparative financial statements represents a non-compliance with IAS 34.

Therefore, the interim financial report cannot be described as complying with IAS 34 without an 'except for' statement regarding the omission of prior period comparative figures. Both the fact of, and the reason for, the omission should be disclosed.

4.4 CONSOLIDATED FINANCIAL STATEMENTS

If the entity's most recent annual financial statements were consolidated statements, then the interim financial report should also be prepared on a consolidated basis. If the entity's annual financial report included the parent's separate financial statements in addition to consolidated financial statements, IAS 34 neither requires nor prohibits the inclusion of the parent's separate statements in the entity's interim report. [IAS 34.14]

Where the entity has disposed of all of its subsidiaries during the interim period, such that it has no subsidiaries at the end of the interim reporting period, it should prepare its interim financial report on a consolidated basis because it had subsidiaries at some point during the interim period. The statement of comprehensive income, statement of changes in equity and statement of cash flows will include the impact of the subsidiaries up to the date(s) of disposal and the effects of the disposal.

4.5 MATERIALITY

Materiality is defined in IAS 1.7 as follows.

> "Omissions or misstatements of items are material if they could, individually or collectively; influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement, judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

IAS 34.23 requires that, in deciding how to recognise measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

While materiality judgments are always subjective, the overriding concern is to ensure that an interim financial report includes all of the information that is relevant to understanding the financial position and performance of the entity during the interim period. Therefore, it is generally inappropriate to base quantitative estimates of materiality on projected annual figures.

4.6. CONDENSED OR COMPLETE INTERIM FINANCIAL STATEMENTS

Where the minimum required information for interim financial statements prescribed by IAS 34.8 (as listed in section 2.2 above) is presented, the resultant financial statements are described as 'condensed'. However, entities also have the option of including a complete set of financial statements in their interim financial reports. Where an entity takes this alternative, the form and content of the financial statements must conform to the requirements of IAS 1 *Presentation of Financial Statements* for a complete set of financial statements, in addition to complying with the requirements of IAS 34. [IAS 34.7 & 9] Therefore, the measurement and disclosure requirements of all relevant Standards apply. These include all measurement and disclosure requirements of IAS 34 and, in particular, the selected explanatory note disclosures listed in IAS 34.16 (see chapter 4 of this guide).

The requirements of IAS 1 (other than the general principles referred to in section 2.1 above) are not generally applicable to condensed interim financial statements.

4.6.1 Items to appear on the face of condensed financial statements

IAS 34 requires, for each component (statement of financial position, statement of comprehensive income, statement of changes in equity, and statement of cash flows), that each of the headings and subtotals that were included in the entity's most recent annual financial statements should be disclosed. Additional line items are required if their omission would make the condensed interim financial statements misleading. [IAS 34.10]

In prescribing the minimum content, IAS 34 uses the phrase "each of the headings and subtotals", thereby seeming to imply that not all of the line items that were presented in the most recent annual financial statements are necessarily required. Such an interpretation would do a disservice, however, to a user of the financial statements who is trying to assess trends in the interim period in relation to financial years.

Therefore, the phrase should be interpreted, in nearly all cases, to mean the line items that were included in the entity's most recent annual financial statements. The line items in most published financial statements are already highly aggregated and it would be difficult to think of a line item in the annual statement of comprehensive income, in particular, that would not also be appropriate in an interim statement of comprehensive income.

For the statement of financial position, a too literal interpretation of "each of the headings and subtotals" might lead to an interim statement of financial position that presented lines only for total current assets, total non-current assets, total current liabilities, total non-current liabilities and total equity, which would generally be insufficient for trend analysis.

For the statement of changes in equity, all material movements in equity occurring in the interim period should be disclosed separately.

In the case of the statement of cash flows, some aggregation of the lines from the annual statement may be appropriate, but subtotals for 'operating', 'investing' and 'financing' only are unlikely to be sufficient.

If a particular category of asset, liability, equity, income, expense or cash flows was so material as to require separate disclosure in the financial statements in the most recent annual financial statements, such separate disclosure will generally be appropriate in the interim financial report.

Further aggregation would only be anticipated where the line items in the annual statements are unusually detailed.

Under IAS 34.10, additional line items should be included if their omission would make the condensed interim financial statements misleading.

Therefore, a new category of asset, liability, income, expense, equity or cash flow arising for the first time in the interim period may require presentation as an additional line item in the condensed financial statements.

A category of asset, liability, income, expense, equity or cash flow may be significant in the context of the interim financial statements even though it is not significant enough to warrant separate presentation in the annual financial statements. In such cases, separate presentation in the condensed interim financial statements may be required.

4.6.2 Use of the term 'condensed'

The requirements discussed in the previous section will result in the presentation of at least some statements that include all of the line items, headings and subtotals that were presented in the most recent annual financial statements. The question then arises as to whether such statements should, in practice, be described as 'condensed'.

Given that the notes supplementing the interim financial statements are limited, the presentation package taken together is condensed from what would be reported in a complete set of financial statements under IAS 1 and other Standards. In such circumstances, the information presented in the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows is condensed – even if the appearance of the statements has not changed. These interim statements should therefore be described as 'condensed', because otherwise a user might infer that they constitute a complete set of financial statements under IAS 1, which they do not. A complete set of financial statements must include a full note presentation consistent with the annual presentation.

4.7 SELECTED EXPLANATORY NOTES

IAS 34 specifies that an interim financial report should contain selected explanatory notes.

4.7.1 Required disclosures

The disclosure requirements of IAS 34 are based on the assumption that anyone reading the interim financial report will have access to the most recent annual financial statements. Therefore, not all of the supplementary notes in the annual financial statements are required for interim reporting purposes, because this would result in repetition, or the reporting of relatively insignificant changes. The explanatory notes included with the interim financial information are intended to provide an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. [IAS 34.15]

The list below sets out the minimum explanatory notes required by IAS 34. The information is generally presented on a financial year-to-date basis.

However, the entity is also required to disclose any events or transactions that are material to an understanding of the current interim period.

[IAS 34.16]

The following information should be disclosed in the notes to the interim financial statements, if material to an understanding of the interim period and if not disclosed elsewhere in the interim financial report: [IAS 34.16]

(a) A statement that the same accounting policies and methods of computation are followed in the interim financial statements as were followed in the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change (see chapter 5 of this guide);

(b) Explanatory comments about the seasonality or cyclicality of interim operations;

(c) The nature and amount of items affecting assets, liabilities, equity, net income or cash flows, that is unusual because of their size, nature or incidence;

(d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year, or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;

(e) Issuances, repurchases and repayments of debt and equity securities;

(f) Dividends paid (aggregate or per share), separately for ordinary shares and other shares;

(g) The following segment information (see 4.3 below):

   (i) Revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;

   (ii) Intersegment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;

   (iii) A measure of segment profit or loss;

   (iv) Total assets for which there has been a material change from the amount disclosed in the last annual financial statements;

   (v) A description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss; and

   (vi) A reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items should be separately identified and described in that reconciliation;

(h) Material events subsequent to the end of the interim period that have not been reflected in the interim financial statements;

(i) The effect of changes in the composition of the entity during the interim period, including business combinations (see 4.4 below), obtaining or losing control of subsidiaries and long-term investments, restructurings and discontinued operations; and

(j) Changes in contingent liabilities or contingent assets since the end of the last reporting period.

4.8 ACCOUNTING POLICIES FOR INTERIM REPORTING

4.8.1 Same accounting policies as annual financial statements

The accounting policies applied in the interim financial statements should be consistent with those applied in the most recent annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. [IAS 34.28]

Entities are required to disclose in their interim financial reports that this requirement has been met. [IAS 34.16(a)]

4.8.2 Changes in accounting policies

Preparers of interim financial reports in compliance with IAS 34 are required to consider any changes in accounting policies that will be applied for the next annual financial statements, and to implement the changes for interim reporting purposes. Such changes will generally encompass:

- Changes required by an IFRS that will be effective for the annual financial statements; and
- Changes that are proposed to be adopted for the annual financial statements, in accordance with the requirements of IAS 8 *Accounting*

Policies, Changes in Accounting Estimates and Errors, on the basis that they will result in the financial statements providing reliable and more relevant information.

If there has been any change in accounting policy since the most recent annual financial statements, the interim financial report is required to include a description of the nature and effect of the change. [IAS 34.16(a)]

If a new Standard that is effective in the current financial year requires disclosures in annual financial statements, those disclosures would not ordinarily be required in a condensed interim financial report, unless specifically required by IAS 34 or by the new Standard. For example, IFRS 7

Financial Instruments: Disclosures would not generally affect an entity's interim financial report because disclosures in accordance with IFRS 7 are not required unless their omission would make the condensed interim financial statements misleading. In contrast, IFRS 8 *Operating Segments* resulted in consequential amendments to IAS 34, which require more detailed segment information in the interim financial report (see section 4.3 above).

If a new Standard or Interpretation has been published during the first interim period but it is not effective until after the end of the annual reporting period, an entity may decide in the second interim period to adopt this Standard or Interpretation early for its annual financial statements. The fact that the new Standard or Interpretation was not early adopted in its first interim financial statements does not generally preclude the entity from adopting a new policy in the second interim period or at the end of the annual reporting period. The requirements for restating previously reported interim periods are discussed at section 5.3.

4.8.3 Restatement of previously reported interim periods

A change in accounting policy, other than one for which the transitional provisions are specified by a new IFRS, should be reflected by:

[IAS 34.43]

* restating the financial statements of prior interim periods of the current financial year, and the comparable interim periods of prior financial years that will be restated in annual financial statements in accordance with IAS 8; or

- when it is impracticable to determine the cumulative effect at the beginning of the financial year of applying a new accounting policy to all prior periods, adjusting the financial statements of prior interim periods of the current financial year, and comparable interim periods of prior financial years, to apply the new accounting policy prospectively from the earliest date practicable.

IAS 8 states that retrospective application of a new accounting policy is impracticable when an entity cannot apply it after making every reasonable effort to do so.

IAS 34.44 states that an objective of these principles is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. That is not to say that voluntary changes in accounting policy part-way through the year are prohibited.

Such changes are permitted, provided that the conditions of IAS 8 are met. What IAS 34.44 requires is that, where a change in accounting policy is adopted at some point during the year, the amounts reported for earlier interim periods should be restated to reflect the new policy.

(*Source: www.iasplus.com- IAS 34) -Read the full report*

4.9 FIRST TIME ADOPTION OF IFRS (IFRS 1)

FAST FORWARD: It is a very important standard as it explains what assets or liabilities should be recognized or derecognized by adopting IFRSs and what adjustments may be required if this happens.

This standard is important for entities adopting IFRS for the first time and it was an important project for IASB as it tried to make the transition from local standards to IFRS for many European countries smooth.

The standard has provided detailed guidance on the transition by way of illustrative examples.

Objective

IFRS 1, First-time Adoption of International Financial Reporting Standards, sets out the procedures that an entity must follow when it adopts IFRSs for the first time as the basis for preparing its general purpose financial statements.

Definition of first-time adoption

A first-time adopter is an entity that, for the first time, makes an explicit and unreserved statement that its general purpose financial statements comply with IFRSs.

An entity may be a first-time adopter if, in the preceding year, it prepared IFRS financial statements for internal management use, as long as those IFRS financial statements were not and given to owners or external parties such as investors or creditors. If a set of IFRS financial statements was, for any reason, given to an external party in the preceding year, then the entity will already be considered to be on IFRSs, and IFRS 1 does not apply.

An entity can also be a first-time adopter if, in the preceding year, its published financial statements asserted:

- Compliance with some but not all IFRSs.
- Included only a reconciliation of selected figures from previous GAAP to IFRSs. (Previous GAAP means the GAAP that an entity followed immediately before adopting to IFRSs.)
  However, an entity is not a first-time adopter if, in the preceding year, its published financial statements asserted:
- Compliance with IFRSs even if the auditor's report contained a qualification with respect to conformity with IFRSs.
- Compliance with both previous GAAP and IFRSs.

Effective date of IFRS 1

IFRS 1 applies if an entity's first IFRS financial statements are for a period beginning on or after 1 January 2004. Earlier application is encouraged.

Overview for an entity that adopts IFRSs for the first time in its annual financial statements for the year ended 31 December 2005.

1. **<u>Accounting policies.</u>** Select its accounting policies based on IFRSs in force at 31 December 2005. (The exposure draft that preceded IFRS 1 had proposed that an entity could use the IFRSs that were in force during prior periods, as if the entity had always used IFRS. That option is not included in the final standard.)

2. **<u>IFRS reporting periods.</u>** Prepare at least 2005 and 2004 financial statements and restate retrospectively the opening balance sheet (beginning of the first period for which full comparative financial statements are presented) by applying the IFRSs in force at 31 December 2005.

   a. Since IAS 1 requires that at least one year of comparative prior period financial information be presented, the opening balance sheet will be 1 January 2004 if not earlier.

   b. If a 31 December 2005 adopter reports selected financial data (but not full financial statements) on an IFRS basis for periods prior to 2004, in addition to full financial statements for 2004 and 2005, that does not change the fact that its opening IFRS balance sheet is as of 1 January 2004.

Adjustments required to move from previous GAAP to IFRSs at the time of first-time adoption

1. **<u>Derecognition of some old assets and liabilities.</u>** The entity should eliminate previous-GAAP assets and liabilities from the opening balance sheet if they do not qualify for recognition under IFRSs. For example:

   a. IAS 38 does not permit recognition of expenditure on any of the following as an intangible asset:
      - research
      - start-up, pre-operating, and pre-opening costs
      - training
      - advertising and promotion
      - moving and relocation

      If the entity's previous GAAP had recognised these as assets, they are eliminated in the opening IFRS balance sheet.

b. If the entity's previous GAAP had allowed accrual of liabilities for "general reserves", restructurings, future operating losses, or major overhauls that do not meet the conditions for recognition as a provision under IAS 37, these are eliminated in the opening IFRS balance sheet.
c. If the entity's previous GAAP had allowed recognition of reimbursements and contingent assets that are not virtually certain, these are eliminated in the opening IFRS balance sheet.

2. **Recognition of some new assets and liabilities.** Conversely, the entity should recognise all assets and liabilities that are required to be recognised by IFRS even if they were never recognised under previous GAAP. For example:

    a. IAS 39 requires recognition of all derivative financial assets and liabilities, including embedded derivatives. These were not recognised under many local GAAPs.

    b. IAS 19 requires an employer to recognise its liabilities under defined benefit plans. These are not just pension liabilities but also obligations for medical and life insurance, vacations, termination benefits, and deferred compensation. In the case of "over-funded" plans, this would be a defined benefit asset.

    c. IAS 37 requires recognition of provisions as liabilities. Examples could include an entity's obligations for restructurings, onerous contracts, decommissioning, remediation, site restoration, warranties, guarantees, and litigation.

    d. Deferred tax assets and liabilities would be recognised in conformity with IAS 12.

3. **Reclassification.** The entity should reclassify previous-GAAP opening balance sheet items into the appropriate IFRS classification. Examples:

    a. IAS 10 does not permit classifying dividends declared or proposed after the balance sheet date as a liability at the balance sheet date. In the opening IFRS balance sheet these would be reclassified as a component of retained earnings.

    b. If the entity's previous GAAP had allowed treasury stock (an entity's own shares that it had purchased) to be reported as an asset, it would be reclassified as a component of equity under IFRS.

    c. Items classified as identifiable intangible assets in a business combination accounted for under the previous GAAP may be required to be classified as goodwill under IAS 22 because they do not meet the definition of an intangible asset under IAS 38. The converse may also be true in some cases. These items must be reclassified.

    d. IAS 32 has principles for classifying items as financial liabilities or equity. Thus mandatorily redeemable preferred shares and puttable shares that may have been classified as equity under previous GAAP would be reclassified as liabilities in the opening IFRS balance sheet.

⊙ Note that IFRS 1 makes an exception from the "split-accounting" provisions of IAS 32. If the liability component of a compound financial instrument is no longer outstanding at the date of the opening IFRS balance sheet, the entity is not required to reclassify out of retained earnings and into other equity the original equity component of the compound instrument.

e. The reclassification principle would apply for the purpose of defining reportable segments under IAS 14.

f. The scope of consolidation might change depending on the consistency of the previous-GAAP requirements to those in IAS 27. In some cases, IFRS will require consolidated financial statements where they were not required before.

g. Some offsetting (netting) of assets and liabilities or of income and expense items that had been acceptable under previous GAAP may no longer be acceptable under IFRS.

4. **Measurement.** The general measurement principle – there are several significant exceptions noted below – is to apply IFRS in measuring all recognised assets and liabilities. Therefore, if an entity adopts IFRS for the first time in its annual financial statements for the year ended 31 December 2005, in general it would use the measurement principles in IFRSs in force at 31 December 2005.

5. **Adjustments required to move from previous GAAP to IFRS at the time of first-time adoption.** These should be recognised directly in retained earnings or other appropriate category of equity at the date of transition to IFRSs.

How to recognise adjustments required to move from previous GAAP to IFRSs

Adjustments required to move from previous GAAP to IFRSs at the time of first-time adoption should be recognised directly in retained earnings or, if appropriate, another category of equity at the date of transition to IFRSs.

Exceptions to the basic measurement principle in IFRS 1

1. **Optional exceptions.** There are some important exceptions to the general restatement and measurement principles set out above. The following exceptions are individually optional, not mandatory:

Business combinations that occurred before opening balance sheet date

a. An entity may keep the original previous-GAAP accounting, that is, not restate:
   1. previous mergers or goodwill written-off from reserves;
   2. the carrying amounts of assets and liabilities recognised at the date of acquisition or merger;
   3. how goodwill was initially determined (do not adjust the purchase price allocation on acquisition).

a. IFRS 1 includes an appendix explaining how a first-time adopter should account for business combinations that occurred prior to transition to IFRS.
b. However, should it wish to do so, an entity can elect to restate all business combinations starting from a date it selects prior to the opening balance sheet date.
c. In all cases, the entity must make an initial IAS 36 impairment test of any remaining goodwill in the opening IFRS balance sheet, after reclassifying, as appropriate, previous GAAP intangibles to goodwill.
d. IFRS 1 includes an appendix explaining how a first-time adopter should account for business combinations that occurred prior to transition to IFRS.

Property, plant, and equipment, intangible assets, and investment property carried under the cost model

a. These assets may be measured at their fair value at the opening IFRS balance sheet date (this option applies to intangible assets only if an active market exists). Fair value becomes the "deemed cost" going forward under the IFRS cost model. (Deemed cost is an amount used as a surrogate for cost or depreciated cost at a given date.)

b. If, before the date of its first IFRS balance sheet, the entity had revalued any of these assets under its previous GAAP either to fair value or to a price-index-adjusted cost, that previous-GAAP revalued amount at the date of the revaluation can become the deemed cost of the asset under IFRS.

c. If, before the date of its first IFRS balance sheet, the entity had made a one-time revaluation of assets or liabilities to fair value because of a privatisation or initial public offering, and the revalued amount became deemed cost under the previous GAAP, that amount (adjusted for any subsequent depreciation, amortisation, and impairment) would continue to be deemed cost after the initial adoption of IFRS.

IAS 19 - Employee benefits: actuarial gains and losses

An entity may elect to recognise all cumulative actuarial gains and losses for all defined benefit plans at the opening IFRS balance sheet date (that is, reset any corridor recognised under previous GAAP to zero), even if it elects to use the IAS 19 corridor approach for actuarial gains and losses that arise after first-time adoption of IFRS. If an entity does not elect to apply this exemption, it must restate all defined benefit plans under IAS 19 since the inception of those plans (which may differ from the effective date of IAS 19).

IAS 21 - Accumulated translation reserves

An entity may elect to recognise all translation adjustments arising on the translation of the financial statements of foreign entities in accumulated profits or losses at the opening IFRS balance sheet date (that is, reset the translation reserve included in equity under previous GAAP to zero). If the entity elects this exemption, the gain or loss on subsequent disposal of the foreign entity will be adjusted only by those accumulated translation adjustments arising after the opening IFRS balance sheet date. If the entity does not elect to apply this exemption, it must restate the translation reserve for all foreign entities since they were acquired or created.

2. **Mandatory exceptions.** There are also three important exceptions to the general restatement and measurement principles set out above that are mandatory, not optional. These are:

IAS 39 - Derecognition of financial instruments

A first-time adopter is not permitted to recognise financial assets or financial liabilities that had been derecognised under its previous GAAP in a financial year beginning before 1 January 2001 (the effective date of IAS 39). This is consistent with the transition provision in IAS 39.172(a). However, if an SPE was used to effect the derecognition of financial instruments and the SPE is controlled at the opening IFRS balance sheet date, the SPE must be consolidated.

IAS 39 - Hedge accounting

The conditions in IAS 39.122-152 for a hedging relationship that qualifies for hedge accounting are applied as of the opening IFRS balance sheet date. The hedge accounting practices, if any, that were used in periods prior to the opening IFRS balance sheet may not be retrospectively changed. This is consistent with the transition provision in IAS 39.172(b). Some adjustments may be needed to take account of the existing hedging relationships under previous GAAP at the opening balance sheet date.

Information to be used in preparing IFRS estimates retrospectively

In preparing IFRS estimates retrospectively, the entity must use the inputs and assumptions that had been used to determine previous GAAP estimates in periods before the date of transition to IFRS, provided that those inputs and assumptions are consistent with IFRS. The entity is not permitted to use information that became available only after the previous-GAAP estimates were made except to correct an error.

Changes to disclosures

For many entities, new areas of disclosure will be added that were not requirements under the previous GAAP (perhaps segment information, earnings per share, discontinuing operations, contingencies, and fair values of all financial instruments) and disclosures that had been required under previous GAAP will be broadened (perhaps related party disclosures).

Disclosure of selected financial data for periods before the first IFRS balance sheet

IAS 1 only requires one year of full comparative financial statements. If a first-time adopter wants to disclose selected financial information for periods before the date of the opening IFRS balance sheet, it is not required to conform that information to IFRS, conforming that earlier selected financial information to IFRSs is optional.

If the entity elects to present the earlier selected financial information based on its previous GAAP rather than IFRS, it must prominently label that earlier information as not complying with IFRS and, further, it must disclose the nature of the main adjustments that would make that information comply with IFRS. This latter disclosure is narrative and not necessarily quantified.

Of course, if the entity elects to present more than one year of full comparative prior period financial statements at the time of its transition to IFRSs, that will change the date of the opening IFRS balance sheet.

Disclosures in the financial statements of a first-time adopter

IFRS 1 requires disclosures that explain how the transition from previous GAAP to IFRS affected the entity's reported financial position, financial performance, and cash flows. This includes:

1. Reconciliations of equity reported under previous GAAP to equity under IFRS both (a) at the date of the opening IFRS balance sheet and (b) the end of the last annual period reported under the previous GAAP. For an entity adopting IFRSs for the first time in its 31 December 2005 financial statements, the reconciliations would be as of 1 January 2004 and 31 December 2004.

2. Reconciliations of profit or loss for the last annual period reported under the previous GAAP to profit or loss under IFRSs for the same period.

3. Explanation of material adjustments that were made, in adopting IFRSs for the first time, to the balance sheet, income statement, and cash flow statement.

4. If errors in previous-GAAP financial statements were discovered in the course of transition to IFRSs, those must be separately disclosed.

5. If the entity recognised or reversed any impairment losses in preparing its opening IFRS balance sheet, these must be disclosed.

6. Appropriate explanations if the entity has availed itself of any of the specific recognition and measurement exemptions permitted under IFRS 1 - for instance, if it used fair values as deemed cost.

Disclosure of an impending change to IFRS

If an entity is going to adopt IFRS for the first time in its annual financial statements for the year ended 31 December 2005, certain disclosure are required in its interim financial statements prior to the 31 December 2005 statements, but only those interim financial statements purport to comply with IAS 34. Explanatory information and a reconciliation are required in the interim report that immediately precedes the first set of IFRS annual financial statements. The information includes changes in accounting policies compared to those under previous GAAP.

Compliance in interim reports in the year of first-time adoption of IFRS

If an entity that adopts IFRS for the first time in its annual financial statements for the year ended 31 December 2005, it is required to apply IFRS 1 in its interim financial reports for periods within the year ended 31 December 2005 if those interim reports are described as conforming to International Financial Reporting Standards. It would not be required to apply IFRS 1 if those interim reports are described as conforming to previous GAAP.

Different IFRS adoption dates of investor and investee

A parent or investor may become a first-time adopter earlier than or later than its subsidiary, associate, or joint venture investee. In these cases, IFRS 1 is applied as follows:

1. If the subsidiary has adopted IFRSs in its entity-only financial statements before the group to which it belongs adopts IFRS for the consolidated financial statements, then the subsidiary's first-time adoption date is still the date at which it adopted IFRS for the first-time, not that of the group. However, the group must use the IFRS measurements of the subsidiary's assets and liabilities for its first IFRS financial statements except for adjustments relating to the business combinations exemption and to conform group accounting policies.

2. If the group adopts IFRSs before the subsidiary adopts IFRSs in its entity-only financial statements, then the subsidiary has an option either (a) to elect that the group date of IFRS adoption is its transition date or (b) to first-time adopt in its entity-only financial statements.

3. If the group adopts IFRSs before the parent adopts IFRSs in its entity-only financial statements, then the parent's first-time adoption date is the date at which the group adopted IFRSs for the first time.

4. If the group adopts IFRSs before its associate or joint venture adopts IFRSs in its entity-only financial statements, then the associate or joint venture should have the option to elect that either the group date of IFRS adoption is its transition date or to first-time adopt in its entity-only financial statements.

Conclusion

IFRS 1 is a complex accounting standard consisting of three parts (as do all IFRS):

(a) the standard itself
(b) a basis for conclusions which summarises the IASB's considerations in arriving at the requirements of the standard
(c) an implementation guide which explains, with the aid of many practical examples, how the standard's requirements should be implemented and how IFRS 1 interacts with other IFRS.

>>> Example

(a) IFRS 1 'First-time Adoption of International Financial Reporting Standards' was issued in June 2003. Its main objectives are to ensure high quality information that is transparent and comparable over all periods presented and to provide a starting point for subsequent accounting under International Financial Reporting Standards (IFRS) within the framework of a cost benefit exercise.

Required:

(i) Describe the circumstances where the presentation of an entity's financial statements is deemed to be the first-time adoption of IFRSs and explain the main financial reporting implementation issues to be addressed in the transition to IFRSs. (7 marks)
(ii) Describe IFRS 1's accounting requirements where an entity's previous accounting policies for assets and liabilities do not comply with the recognition and measurement requirements of IFRSs. (8 marks)

(b) Transit, a publicly listed holding company, has a reporting date of 31 December each year. Its financial statements include one year's comparatives. Transit currently applies local GAAP accounting rules, but is intending to apply IFRSs for the first time in its financial statements (including comparatives) for the year ending 31 December 2005. Its summarised consolidated balance sheet (under local GAAP) at 1 January 2004 is:

Additional information:

(i) Transit's depreciation policy for its property, plant and equipment has been based on tax rules set by its government. If depreciation had been based on the most appropriate method under IFRSs, the carrying value of the property, plant and equipment at 1 January 2004 would have been $800,000.
(ii) The development costs originate from an acquired subsidiary of Transit. They do not qualify for recognition under IFRSs. They have a tax base of nil and the deferred tax related to these costs is $100,000.
(iii) The inventory has been valued at prime cost. Under IFRSs it would include an additional $30,000 of overheads.
(iv) The restructuring provision does not qualify for recognition under IFRSs.
(v) Based on IFRSs, the deferred tax provision required at 1 January 2004, including the effects of the development expenditure, is $360,000.

STUDY TEXT

Required:

Prepare a summarized balance sheet for Transit at the date of transition to IFRSs (1 January 2004) applying the requirements of IFRS 1 to the above items.

Note: Reconciliation to previous GAAP is not required. (10 marks)
(25 marks)

Solution

(a)

(i) It is important to determine which financial statements constitute the first-time adoption of International Financial Reporting Standards (IFRSs) because IFRS 1 only applies to those financial statements. It does not apply to subsequent financial statements that are prepared under IFRSs as these must be prepared under the whole body of IFRSs (including IASs). A first time adopter is an entity that makes an explicit and unreserved statement that its financial statements comply with (all) IFRSs. Compliance with some, but not all, IFRSs is insufficient as is compliance with all IFRSs without the inclusion of an explicit statement of compliance.

The main issues to be addressed in the transition to IFRSs are:
- deciding the date of transition.
- selecting accounting policies that comply with IFRSs.
- preparing (but not presenting) an opening balance sheet at the date of transition to IFRSs as a basis for subsequent accounting. The date of transition to IFRSs is the beginning of the earliest comparative period. If the company's reporting date for its first IFRS financial statements is say 31 December 2005 and it intends to disclose one year's comparatives, then the date of transition is 1 January 2004.
- determining estimates of values for both the opening IFRS balance sheet and all other presented comparative balance sheets; and finally
- presenting IFRS financial statements (including the required disclosures relating to the transition).

  Note: some credit would be given for references to practical issues such as required changes to information systems and the recruitment of personnel with IFRS experience.

(ii) When a company adopts IFRSs for the first time it must use the IFRSs that are in force at the reporting date. These IFRSs should be applied throughout all of the periods presented – normally two years. This means that comparative financial statements must comply with the IFRSs in force at the reporting date even if they were not in issue at the date of the comparatives (or different from those that were in issue).
The general principle is that the adoption of IFRSs should be applied retrospectively i.e. as if the entity had always applied each IFRS. This is contrary to the specific transitional requirements contained in some individual IFRSs (they often allow prospective application). More specifically an entity must:

- recognise all assets and liabilities that fall to be recognised by IFRSs (e.g. IFRSs require deferred tax to be recognized on a 'full' provision basis)

- not recognise assets and liabilities if IFRSs do not permit their recognition (e.g. IFRSs do not permit 'general' provisions to be made and some proposed dividends are not treated as liabilities)
- reclassify certain items under IFRSs (e.g. convertible debt must be split between its equity and debt components under IFRSs, but in some jurisdictions it may have been classed entirely as debt)
- apply IFRS rules to measure the value of all recognised assets and liabilities. This may mean for example using a no discounted value to measure an item whereas under previous GAAP it may have been discounted
- give specified reconciliations for equity and reported profits between previous GAAP and IFRSs, together with details of any recognition or reversals of impairments when implementing first time reporting. The resulting adjustments arising from the above must be recognised directly in equity at the date of transition.

The Standard contains some specific exemptions and exceptions to the above in the areas of values of property, plant and equipment, employee benefits, translation differences for net investments in foreign operations and derivative instruments. In essence the exemptions and exceptions allow the use of alternative value measures in limited circumstances and where the cost or effort required in determining the value measurements under IFRSs would be excessive.

The exemptions are permitted but not required and can be applied in full or individually, whereas exceptions (to retrospective application) are mandatory.

A particularly important exemption is that the IFRS rules governing business combinations are not applied retrospectively. However any intangible that was recognised under previous GAAP that cannot be recognised under IFRSs should be reclassified as goodwill and the entity must test for impairment of goodwill at the date of transition.

(b)

As Transit intends first-time adoption for the year ended 31 December 2005 and to disclose one year's comparatives, the date of transition to IFRSs is 1 January 2004.

Transit – summarised balance sheet at 1 January 2004

	$000	$000
Property, plant and equipment (w (i))		800
Goodwill (450 + 300 (w (ii)))		750
Development costs (w (ii)) nil		-
		1550
Current assets		
Inventory (150 + 30 (w (i)))	180	
Receivables	250	
Bank	20	450
Total asset		2,000
Issued share capital		500
Retained earnings (w (v))		1320
Current liabilities		
Trade and other payables		320
Non-current liabilities		
Restructuring provision (w (iii))	nil	
Deferred tax (w (iv))	360	680
		2000

In addition the goodwill will be tested for impairment and if there is any indication of impairment to the other identifiable assets, they too must be tested for impairment.

Workings (all figures in $000)

(i) Property, plant and equipment and inventory are restated to their IFRS base valuations of $800,000 and $180,000 respectively.

(ii) Acquired intangible assets that do not qualify for recognition under IFRSs must be reclassified as goodwill after allowing for the effect of deferred tax. Thus an amount of $300 (400 – 100 re deferred tax) is transferred to goodwill and $100 debited to deferred tax.

(iii) The restructuring provision does not qualify for recognition under IFRSs.
(i) Summarising the effect on deferred tax:

Per question	300
Re development costs	(100)
	200
Required balance	(360)
Charge to retained earnings	(160)

(v) Summarising the effect on retained earnings:

per question	900
property, plant and equipment	(200)
Inventory	30
elimination of restructuring provision	250
deferred tax	(160)
	820

4.10 SMALL AND MEDIUM-SIZED ENTITY FINANCIAL REPORTING FRAMEWORK

Scope (www.googlo.co.ke –small and medium sized entity financial reporting framework)

1. The Small and Medium-sized Entity Financial Reporting Framework (SME-FRF) sets out the conceptual basis (paragraphs 2-15) and qualifying criteria (paragraphs 16-26) for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS).

Users

2. Users of financial statements generally include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and, in some cases, the public. For SMEs, the most significant users are likely to be owners, government and creditors, who may have the power to obtain information additional to that contained in the financial statements. Management is also interested in the information contained in the financial statements, even though it has access to additional management and financial information.

Objective

3. The objective of financial statements is to provide information about the financial position and performance of an entity that is useful to users of such information. Financial statements show the results of management's stewardship of and accountability for the resources entrusted to it.

Underlying Assumptions

4. Financial statements are prepared on the accrual basis of accounting. They are normally prepared on the assumption that an entity is a going concern and will continue to operate for at least the foreseeable future.

Qualitative Characteristics

5. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal characteristics are:

(a) Understandability: It is essential that information provided in financial statements is readily understandable by users.

(b) Relevance: To be useful, information must be relevant to the needs of users. The relevance of information is affected by its nature and materiality.

(c) Reliability: Information is reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it is said to represent. In assessing reliability, substance over form, prudence, neutrality and completeness are also considered.

(d) Comparability: Users must be able to compare the financial statements of an entity over time in order to identify trends in the entity's financial position and performance.

6. Constraints: The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Users of financial statements should be aware of this constraint.

7. In practice, trade-offs between qualitative characteristics are often necessary. Determining the relative importance of the characteristics in different cases is a matter of professional judgment.

Elements

8. An "asset" is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

9. A "liability" is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

10. "Equity" is the residual interest in the assets of the entity after all its liabilities have been deducted.

11. "Income" encompasses both revenue and gains. It includes increases in economic benefits during the accounting period in the form of inflows or enhancements of assets as well as decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

12. "Expenses" encompass losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses are decreases in economic benefits.

Recognition

13. An item that meets the definition of an element should be recognised if (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

Measurement

14. The measurement base most commonly adopted by entities in preparing their financial statements is historical cost. This may be combined with other measurement bases for certain specific items, as referred to in the SME-FRS (for example, Section 15 The Effects of Changes in Foreign Exchange Rates).

15. Under the historical cost convention:
(a) assets are recorded at the amount of cash or cash equivalents paid or the fair value

of the consideration given to acquire them at the time of their acquisition; and

(b) Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
Assets should not be revalued nor should future cash flows be discounted in the measurement of assets and liabilities except when required or permitted by the SME-FRS.

Qualifying Entities

16. A company incorporated under the Companies Ordinance qualifies for reporting under the SME-FRF if it satisfies the criteria set out in section 141D of that Ordinance. Compliance with the SME-FRF and SME-FRS is necessary in order for financial statements to give a "true and correct view" when a Hong Kong incorporated company prepares its financial statements in accordance with section 141D of the Companies Ordinance.

17. An entity, other than a company incorporated under the Companies Ordinance, subject to any specific requirements imposed by the law of the entity's place of incorporation and subject to its constitution, qualifies for reporting under the SME-FRF when the entity does not have public accountability (paragraphs 22 – 23), and:

(a) All of its owners agree to prepare the financial statements in accordance with the SME-FRS; and

(b) The entity is considered to be an SME in terms of its size under paragraph 24.

18. An entity which is a subsidiary or an intermediate holding company of an entity qualifies for reporting under the SME-FRF for its own financial statements if it also satisfies the conditions set out in paragraph 17.

19. Unless the law requires otherwise, it is presumed that, once an agreement is made by all owners to prepare the financial statements in accordance with the SME-FRS, the agreement will remain valid until there is a change in the ownership or the agreement is revoked by an owner or an entity no longer qualifies for reporting under the SME-FRF.

20. When an entity has not been considered to be an SME in terms of its size under paragraph 24 and subsequently becomes an SME, the entity will not qualify for reporting under the SME-FRF in terms of paragraph 17(b) until the entity has been determined to be an SME for two consecutive reporting periods.

21. Where an entity has previously qualified for reporting under the SME-FRF in terms of paragraph 17, the entity will no longer qualify for reporting under the SME-FRF in terms of paragraph 17(b) until the entity is no longer an SME for two consecutive reporting periods.

Public Accountability

22. An entity has public accountability for the purposes of the SME-FRF if:

(a) at any time during the current or preceding reporting period, the entity (whether in the public or private sector) is an issuer of securities, that is, its equity or debt securities are publicly traded or it is in the process of issuing publicly traded equity or debt securities;
(b) the entity is an institution authorised under the Banking Ordinance;
(c) the entity is an insurer authorised under the Insurance Companies Ordinance; or
(d) the entity is a corporation which is granted a license under the Securities and Futures Ordinance to carry on business in a regulated activity in Hong Kong.

23. An entity does not have public accountability, for the purposes of the SME-FRF, solely by reason of receiving public funds from another entity that has the power to tax, rate or levy to obtain public funds.

Size

24. An entity is considered to be an SME if it does not exceed any two of the following:

(a) Total annual revenue of HK$50 million.
(b) Total assets of HK$50 million at the balance sheet date.
(c) 50 employees.

25. For the purposes of paragraph 24, the total revenue and total assets are determined after the application of the SME-FRS and, in the case where the reporting period is shorter or longer than a year, the total revenue is determined on an annualised basis.

26. For the purposes of paragraph 24, the number of employees is the average number of persons employed by the entity during the reporting period (irrespective of whether in full-time or part-time employment) determined on a monthly basis as follows:
(a) Determine the number of employees as at the end of each calendar month.
(b) Add together all the monthly numbers in (a).
(c) Divide the number in (b) by the number of months in the reporting period.

Transitional Provisions

27. The transition to the SME-FRF and SME-FRS is accounted for as follows:

(a) All items recognised previously under a different GAAP (for example, deferred tax liability) which do not meet the recognition criteria under the SME-FRF and SME-FRS are to be derecognised and dealt with as a change of accounting policy under the SME-FRS.
(b) All items not recognised previously under a different GAAP which do meet the recognition criteria under the SME-FRF and SME-FRS are to be recognised in accordance with the relevant section of the SME-FRS and dealt with as a change of accounting policy under the SME-FRS.
(c) All items recognised previously under a different GAAP, which do meet the recognition criteria under the SME-FRF and SME-FRS, but which were previously measured

on a basis inconsistent with the SME-FRF and SME-FRS are to be re-measured in accordance with the relevant section of the SME-FRS and dealt with as a change of accounting policy under the SME-FRS.

Effective Date

28. The SME-FRF becomes effective for a Qualifying Entity's financial statements that cover a period beginning on or after 1 January 2005. Earlier application is permitted.

Definitions

The following terms are used in the SME-FRS with the meanings specified:

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

An active market is a market in which all the following conditions exist:

(a) The items traded within the market are homogeneous;

(b) Willing buyers and sellers can normally be found at any time; and

(c) Prices are available to the public.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An asset is a resource:

(a) Controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

An associate is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds.

Carrying amount is the amount at which an asset or a liability is recognised in the balance sheet after the deduction of (if applicable) any accumulated depreciation (amortisation) and accumulated impairment losses thereon, or any write-down to net realisable value.

Cash comprises cash on hand and demand deposits.

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

Cash flows are inflows and outflows of cash and cash equivalents.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

(a) The individual's spouse and children;
(b) Children of the individual's spouse; and
(c) Dependants of the individual or the individual's spouse.

The closing rate is the spot exchange rate at the balance sheet date.

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. Construction contracts include: contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

A constructive obligation is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

A contingent liability is:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) A present obligation that arises from past events but is not recognised because:
  (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  (ii) The amount of the obligation cannot be measured with sufficient reliability.

Contingent rent is that portion of the lease payments which is not fixed in amount but is based on a factor other than the passage of time (e.g. percentage of sales, amount of usage, price indices, and market rates of interest).

Control (of an asset) is the power to obtain the future economic benefits that flow from the asset.

Control (of an entity) is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition, production or construction.

A cost-plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Depreciable amount is the cost of an asset less its residual value.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

Economic life is either:

(a) The period over which an asset is expected to be economically usable by one or more users; or

(b) The number of production or similar units expected to be obtained from the asset by one or more users.

Events after the balance sheet date are events, both favourable and unfavorable, that occur between the balance sheet date and the date when the financial statements are authorised for issue. Two types of events can be identified:

(a) Those providing evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and

(b) Those indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

Exchange difference is the difference resulting from translating a given number of units of one currency to another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

Foreign currency is a currency other than the reporting currency of an entity.

Government refers to government, government agencies and similar bodies, whether local, national or international.

Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed on them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets.

Guaranteed residual value is:

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) in the case of the lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Historical cost is:

(a) in the case of assets, the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition; and

(b) in the case of liabilities, the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Historical cost convention is the measurement basis whereby:

(a) Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition; and

(b) Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business; and whereby:

Assets should not be revalued nor should future cash flows be discounted in the measurement of assets and liabilities except when required or permitted by the SME-FRS.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

The inception of the lease is the earlier of the date of the lease agreement or the date of commitment by the parties to the principal provisions of the lease.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

An intangible asset is an identifiable non-monetary asset without physical substance.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

(a) the minimum lease payments; and

(b) the unguaranteed residual value

to be equal to the fair value of the leased asset.

Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Investment (in a security) is a financial asset (such as a bond or share or other negotiable instrument evidencing debt or ownership) held by an entity for trading, the accretion of wealth through distribution (such as interest and dividends), for capital appreciation or for other benefits to the investing entity such as those obtained through trading relationships. Current investments are those that would satisfy the criteria for being classified as current in accordance with paragraph 1.16 of the SME-FRS.

Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

A legal obligation is an obligation that derives from:

(a) A contract (through its explicit or implicit terms);
(b) Legislation; or
(c) Other operation of law.

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, in the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee. However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable, and if, at the inception of the lease, it is reasonably certain that the option will be exercised, then the minimum lease payments comprise the minimum payments payable over the lease term and the payment required to exercise this purchase option.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

A non-cancellable lease is a lease that is cancellable only:

(a) Upon the occurrence of some remote contingency;

(b) With the permission of the lessor;

(c) If the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

An operating lease is a lease other than a finance lease.

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were authorised for issue; and

(b) Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Property, plant and equipment are tangible assets that:

(a) Are held by an entity for use in the production or supply of goods or services, for rental to others, for investment potential, or for administrative purposes; and

(b) Are expected to be used during more than one period.

A provision is a liability of uncertain timing or amount.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Recoverable amount is the greater of an asset's net selling price and future net cash flow expected from the continued use of that asset.

Related party: A party is related to an entity if:

(a) Directly, or indirectly through one or more intermediaries, the party:

(i) Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
(ii) Has an interest in the entity that gives it significant influence over the entity; or
(iii) Has joint control over the entity;

(b) The party is an associate of the entity;

(c) The party is a joint venture in which the entity is a venturer;

(d) The party is a member of the key management personnel of the entity or its parent;

(e) The party is a close member of the family of any individual referred to in (a) or (d); or

(f) The party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e).

A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Residual value is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control or joint control over those policies.

A subsidiary is an entity that is controlled by another entity.

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, on which income taxes are payable (recoverable).

Useful life is:

(a) The period of time over which an asset is expected to be available for use by an entity; or

(b) The number of production or similar units expected to be obtained from the asset by an entity.

4.11 CASHFLOW STATEMENTS (IAS 7)

FAST FORWARD: A Cashflow Statement simply records monies passing into and out of the bank, and is not blurred by estimates of accruals, e.t.c.

A trading and profit account is the usual method of describing what has happened in a business during the past year, and it incorporates many adjustments in order to show a truer and fair view of the profit. These adjustments have a number of disadvantages:

- They are often estimates, and the profit is consequently an estimate;

- The underlying cash flow becomes blurred by the adjustments and it becomes difficult to focus on the liquidity position of the organisation.

It is generally felt in many quarters—especially in USA, that these very adjustments mask other happenings of the year, notably the changes in the liquidity of the business. Depending on the circumstances of the business, and the particular needs of various users, it may be that a report which focuses on liquidity will be of more use - cash flow statement.

The cash flow statements should assist the users to:

- Assess the enterprise's ability to generate positive future cash flows;

- Assess the enterprise's ability to meet its obligations, pay dividends and meet its needs for external reporting;

- Assess the reasons for differences between net income and related cash receipts and payments; and

- Assess the effects on the enterprise's financial position of both cash and non-cash investing and financing transactions during the period.

This statement is mostly recommended because of its objectivity and verifiable nature.

Note that the cash flow statement is somehow different from the statements of source and application of funds. The essential difference is the cashflow statements are concentrating strictly on monies passing into and out of the bank account. In contrast, statements of source and application of funds conventionally focuses on the movement in working capital; i.e. they incorporate not only movements in stocks, debtors and creditors, but also accruals and prepayments which we identified as being a prime cause of the subjective nature of the trading and profit and loss account. Statements of source and application of funds certainly adjust for "items not involving movements of funds" such as depreciation but they do not accrue the full objective simplicity of cashflow statements.

4.11.1 REASONS WHY PROFITS AND THE FLOW OF FUNDS MIGHT DIFFER

- A company might have to buy fixed asserts, and the purchase costs of view fixed assets will differ from the depreciation charge in the year. (Depreciation, in fact does not represent a flow of funds at all.)

- Profits are calculated on the accruals concept. This means that a company might:-

  - Spend money on the purchase of stocks which are unsold during the period, and their not charged against profits;
  - Sell goods on credit, thereby making a profit on sales without receiving the cash from the debtors before the end of the accounting period;
  - Incur development expense which is capitalized and not charged against profits until later periods;
  - Charge taxation and dividends payable against profits, whereas the cash flows are affected by taxation and dividends actually paid.

- A company might be able to obtain funds from sources other than "Profits" - eg by issuing new shares or raising a loan. On the other hand, the company might have to find the cash to redeem some preference shares or debentures or to repay a loan.

Relationship between Balance Sheet changes and Cashflows:

- Increases (decreases) in assets represent net cash outflows (inflows) if an asset increases, the firm must have paid cash in exchange.
  For example, when accounts receivable increase, the period's sales revenues must have exceeded cash collections. Thus the increase in receivables must be deducted from the accrued sales revenues to derive the cash collected from customers during the period.

- Increases (decreases) in liabilities represent net cash inflows (outflows) when a liability increases, a firm must have received cash in exchange.

For instance, when interest payable increases, that means the firm did not pay all the interest expense accrued during the period hence, the increase in interest payable must be deducted from the interest expense to compute the amount of interest paid during the period.

The cash flow for inputs is not affected by the inventory valuation (FIFO, LIFO) method used by the firm, facilitating comparison for firms.

Components of financing cash flow include inflows from additional borrowing and equity financing and outflows for repayment of debt, dividend payments, and equity repurchases.

Debt financing for the period is the sum of the changes in short and long-term debt accounts.

Differences between Cash-Flow Statement (CFS) and Funds Flow Statement (FFS)

- Treatment of changes in operating accounts (working capital). FFS equals net income adjusted only for the non-cash income statement items. No adjustment is made for the changes in the current operating accounts.

- Treatment of short-term debt. FFS retains short term debt as a component of working capital and is not removed to CFF.

- FFO is not a true measure of cash generated from operating activities.

- FFO does not add information value to net income, but CFO does.

4.4.2 METHODS OF PREPARING CASHFLOW STATEMENTS

The indirect method:

This method starts with the period's net income and makes two adjustments to arrive at the Cash Flow from Operations (CFO):

- All "non-cash" expense (revenue) components of the income statement are added (subtracted)

- Changes in operating account are added/subtracted as follows:

  - o Increases (decreases) in the balances of operating asset accounts are subtracted (added).
  - o Increases (decreases) in the balances of operating liability accounts are added (subtracted).

The discrepancies between the changes in accounts reported on the balance sheet and those reported in the cash flow statement are due to two factors

- ⊙ Acquisitions and divestitures.
- ⊙ Foreign subsidiaries.

Changes in the level of investments in short-term financing instruments are reported NET one of the few exceptions to he "gross" reporting requirements of SFAS 95. Under that standard, changes in b/s assets and liabilities that turn over frequently (another example is credit receivable) may be reported net.

Investments that are long-term, less liquid and riskier (e.g – stocks or long-term bonds) should be treated differently.

Drawback of indirect Method:

Because of the indirect format, it is not possible to compare operating cash inflows and outflows by function with the revenue and expense activities that generated them, as is possible from cash flow statement prepared using the direct method.

In the absence of acquisitions, divestitures and significant foreign operations, the indirect method simply recasts the income statement and the balance sheet, providing little new or no insight into a firm's cash-generating ability.

Direct Method

This method uses a transactional analysis in preparing Cashflow Statements.

Transactional analysis is a technique that can be used to create a cashflow statement for firms that do not prepare such statements in accordance with IAS 7, FRS 1(UK) or SFAS 95(USA).

It can also be used to convert the indirect method cashflow to the direct method.

One objective of the transactional analysis is to understand the relationship between the accrual of revenues, expenses, assets and liabilities and their cashflow consequences. Another goal is to classify cashflows among operating, investing and financing activities.

4.4.3 ANALYSIS OF CASH FLOW INFORMATION

The CSF is intended to help predict the firm's ability to sustain (and increase) cash from current operations. In so doing, the statement provides more objective information about:

- A firm's ability to generate cash flows from operations.
- Trends in cash flow components and components and cash consequences of investing and financing decisions.
- Management decisions regarding such critical areas as financial policy (leverage), dividend policy, and investment for growth.

Free Cash flows

Is the Cash from operations less the amount of capital expenditures required to maintain the firm's present productive capacity?

Discretionary measures include:

- Growth oriented capital expenses and acquisitions.
- Debt reduction
- Stockholder payments (dividends and stock repurchase).

The larger the firm's FCF, the healthier it is because it has more cash available for growth, debt payment, and dividends.

In valuation models, required outflows are defined as operating cash flows less capital expenditures to replace current operating capacity "as well as capital expenditure necessary to finance the firm's growth opportunities." Growth opportunities are defined as those in which the firm can make "above normal" returns. FCF is generally measured as CFO less capital expenditures.

Relationship of income and cash flows:

- Accrual accounting can be affected by management's choice of accounting policies and estimates. It fails to provide adequate information about the liquidity of the firm and long-term solvency.
- Cash flow is less likely to be affected by variations in accounting principles and estimates, making it more useful than reported income in assessing liquidity and solvency.
- FCF patterns have to be monitored carefully for growth coys to ensure that they are not growing too fast, which can cause liquidity problems. Lack of sales growth, coupled with increases in working capital growth, reduces CFO, and reflects slow receivable collections and inventory build-up.
- Cash flow statements should be used together with information from the Profit and Loss, Balance Sheet and footnotes to assess the cash-generating ability of the firm. This assessment should consider the firm's liquidity, the viability of income as a predictor of future cash flows, and the effect of timing and recognition differences.

- Accrual a/c is generally presumed to be a good indicator of future cashflow. That predictive ability is subject to a number of implicit assumptions, one of which is the going concern.

>>> Examples

- The classification of inventories as assets rather than expenses implicitly assumes that they will be sold in the normal course of business.

- The accrual of revenue from credit sales and the valuation of receivables assume that the firm will continue to operate normally; failing firms may find that customers are unwilling to pay.

- When the going concern assumption is subject to doubt, revenue recognition and asset valuation can no longer be taken for granted. CFS acts as a "check" on the assumptions inherent in the Profit & Loss account.

- To find out why income can fail as a predictor of cash-generating ability (uncollected receivables or unsold inventories) requires a comparison of amounts recorded as sales and cost of goods sold on the Profit and Loss with the pattern of cash collections from customers and cash paid for inventories on the CFS.

A direct method CFS is helpful in this regard.

- The periodic net income differs because account methods and assumptions of mangers differ, not because their economic activities differ.

- The CFS allows the analyst to distinguish between the actual events that have occurred and the account assumptions that have been used to report these events.

Nonetheless, assumptions made by management may provide useful information.

Problems affecting Cash Flow Classification Issues

- Cash flows involving Property, Plant and Equipment.

- Differences due to some accounting methods.

- Interest and dividends received.

- Interest paid.

- Non cash transactions.

Problems

1. Classification of Cash Flows for Property, Plant and Equipment

Example

	Kshs.
Net income	30,000
Add non cash items: depreciation	5,000
	35,000
Add change in operating accounts – decrease in inventory	15,000
= CFO	50,000

- The CFS adds both depreciation expense (a non-cash expense) and the decrease in inventory (change in operating accounts) to net income to arrive at CFO. Their differing classifications suggest that the reason for these add backs are not identical. On the other hand, both adjustments reflect cash outflows that occurred in Prior Periods but are recognized in income in the current period.
  Depreciation allocates the cost of fixed assets to the current period, the period in which they are used. Similarly, the cost of goods sold allocates the cost of inventory to the current period, when the inventory is actually sold.

- The difference between the two adjustments is the classification of the initial cash outlays. In one sense, both initial outlays were for investment. In one case, the firm invested in fixed assets; in the other, it invested in inventories. The latter, however is classified as an operating cash outflow, deducted from CFO in the period of the initial outlay and added back to income when expensed to avoid double counting.

The original investment in fixed assets was reported as an investment cash outflow and its allocation (depreciation expense) is added back to income because it is never classified as an operating flow, but always as an investment flow. For inventory, no adjustment to current period cash flows is required. But the current period allocation of the investment in plant assets (depreciation expense) must be added back as the outflow has been recorded as an investing cash outflow – avoiding double counting.

Implication of this classification issue

CFO does not include a charge for use of the firm's operating capacity. Cash required replacing the productive capacity or physical plant used during operations is not included in CFO. A firm reporting positive CFO may not thrive unless the CFO (generated and retained) is sufficient to replace the productive capacity used to generate the operating cash flow.

Identical firms with equal capital intensity will report different CFO's when one firm leases plant assets and the other owns its assets. The firm that leases reports lower CFO because lease rentals are operating expenditures (operating cash flows), whereas the other firm's expenditure are reported as investment cash flows.

Cash payments for inventory may also be excluded from CFO. When an acquired firm has inventories, the cash paid for those inventories is included in investing cash flow. However, the proceeds from the subsequent sale of such “purchased” inventory are included in CFO, distorting reported CFO because its purchase cost is never reported in CFO.

Another problem is that “investment” is not precisely defined e.g:-

Hertz classifies its investment in rental cars as inventory, and purchases are included in CFO. In this case, CFO is understated relative to a firm that classifies its operating assets as property. Media companies consider Programming Purchases as long-term fixed assets. Although amortization impacts reported earnings, purchase costs are never reported in CFO. Yet financial markets seem to value such firms based on multiples of CFO Per share rather than EPS.

2. Effects of Differences in Accounting Methods

CFO is not affected by the timing differences generated by revenue and expense recognition methods.

CFO is less affected by differing accounting policies. However, CFO is affected by reporting methods that after the classification of cash flows among operating, investing and financing categories. If one accounting method results in the classification of a cash flow as investing and an alternative results in its classification as operating, then the reported CFO’s will differ.

Moreover, unlike revenue and expense differences in account policies that reverse over time, the differences in CFO classification caused by reporting methods are permanent and do not reverse.

The classification of expenditures such as computer software leads to the classification of cash outflows as investing cash flows. However they are reported as operating cash flows when expensed immediately. Lease classification also affects cash flow components for both le lessors and lessees

3. Interest and Dividends Received

Interest income and dividends received from investments in other firms are classified under SFAS 95 as operating cash flows. As a result, the return <u>on</u> capital is separated from the return of capital combining these returns to reported cash flow to and from investees facilitates analysis. Moreover, the reclassification of after-tax dividend and interest from operating to investing cash flows has the advantage of reporting operating cash flows that reflect only the operating activities of the firm’s core business.

<u>NB</u>

Only the nominal (cash) return (dividend or interest received) is reported as an operating cash flow; the real (total) return (which includes capital gain or loss) is split between operating and investing cash flow.

However, some investments and joint ventures are operating in nature. Such investments may assist in current and future operations, require significant financing commitments, and provide some control over the cash flows generated by the investee.

4. Interest paid

Is classified as operating cash flow under SFAS 95. Such payment is the result of capital structure and leverage decisions and they reflect financing rather than operating risk. The reported CFO's of two firms with different capital structures are not comparable because returns to creditors (interest) are included in CFO, whereas returns to shareholders (dividends) are reported as financing cash flows.

For analytic purposed, therefore, interest payments (after tax to reflect the cash flow benefits of tax deductibility) should be reclassified as financing cash flows.

The resulting operating cash flow is independent of the firm's capitalization, facilitating the comparison of firms with different capital structures.

5. Non cash transactions

Some investing and financing activities do not require direct outlays of cash eg. a building may be acquired on mortgage. Such transactions are not treated as financing or investing but as footnotes.

For analytical purposes, however, this transaction is identical to the issuance of a bond to a third party, using the proceeds to acquire the building. The "non-cash" transaction reflects both a financing and investing activity and should be included in each category – Both entries cancel out each other.

The usefulness of cash flow statements may be summarized as follows:

- Profit is not necessarily a measure of solvency and may mislead as to the underlying cashflows, which if adverse may affect the ability of the firm to survive.

- Profit is a measure based on the concept of accrual accounting and matching. When these concepts are applied the effect may be to smooth out peaks and troughs in the business cycle, which when applied over-indulgently has been referred to as creative accounting. The reporting of the raw data (cash flow) may be a useful adjunct to accrual-based accounts.

- Cash flow may be a better guide to the ability of a firm to pay dividends than profit since dividends are paid in cash.

- It may be argued that forecast data is more useful than historical data and that cash flow forecasts are better based on cash flow statements rather than on profit and loss accounts.

Chakula Kitamu Ltd
Cash flow Statement for the year ended 31 December 1997

	Sh. '000'	Sh. '000'
Cash flow from operating activities		
Group Profit before tax & extra-ordinary items		2,718,000
Adjustments		
Depreciation	560,000	
Share of profit in associated Coy	(80,000)	480,000
		3,198,000
Working Capital changes		
Increase in stock	(950,000)	
Decrease in Debtors	392,000	
Increase in Bills Receivable	(15,000)	
Increase in creditors	110,000	
Increase in sundry recoverable on tax	(95,000)	(558,000)
		2,640,000
Taxation paid (wk 1)		(1,471,000)
		1,169,000
Extra ordinary items		(33,000)
Net cash flow from operations		1,136,000
Cash flow from investing activities		
Purchase of fixed assets (wk 2)	(777,000)	
Purchase of subsidiary	(200,000)	
Proceeds from the sale of fixed assets	80,000	
Dividend received from associated Coy (W3)	15,000	
Loan advance	980,000	
Net cash inflow from investing activities		98,000
Cash flow from financing activities		
Redemption of debenture(390,000 – 412,000)	(22,000)	
Dividend paid	(900,000)	
Net cash out flow on financing activities		(922,000)
Net increase in cash and cash equivalents		312,000
Cash and cash equivalents –at beginning		340,000
- at end		652,000

Working 1

Taxation A/c

	Shs '000'			Shs '000'
Bank	**1,471,000**	**Bal b/d**	6	1,370,000
Deferred tax	**680,000**	**Deferred tax**		**649,000**
Bal c/d	**1,310,000**	**P&L**		**1,442,000**
	3,461,000			3,461,000

Working 2

Fixed Assets A/c

Bal b/d	4,548,000	Depreciation	560,000
Subsidiary	460,000	Disposal	80,000
Bank (purchases)	777,000	Bal c/d	5,145,000
	5,785,000		5,785,000

Div

Bank	550	Bal b/d	650
Bal c/	550	P&L	650

Bal b/d	**400,000**	**P&L (tax)**	**30,000**
P&L (profit)	**80,000**	**Dividend**	**15,000**
		Bal c/d	**43,500**
	480,000		**480,000**

Working 3

>>> EXAMPLE 2 (ACQUSITION OF A SUBSIDIARY)

The following draft financial statement relate to Baraka Group Ltd.:

Group balance sheet as at 31 May 2001

		2001		2000
		Sh. million'		Sh. million'
Assets:				
Intangible assets (goodwill)		90		83
Tangible assets		1,239		1,010
Investments		780		270
		2,109		1,363
Current assets:				
Inventories		750		588
Trade receivables		660		530
Cash and cash equivalents		45		140
		1,455		1,258
Total assets		3,564		2,621
Equity and Liabilities:				
Capital and reserves				
Called-up capital-ordinary shares of Sh.10		100		70
Share premium account		85		15
Revaluation reserves		30		10
Accumulated profits		200		103
		415		198
Minority interest		250		150
Non-current liabilities				
7% redeemable preference shares	136		130	
interest bearing borrowings	1,262		930	
		1,398		1,060
Current liabilities:		1,501		1,213
Total equity and liabilities		3,564		2,621

Group income statement for the year ended 31 May 2001

	Sh.million	**Sh.milliom**
Revenue		7,310
Cost of sales		(5,920)
Gross profit		1,390
Distribution and administrative expenses		(772)
Profit from operations		618
Income from associates		98
Profit on sale of tangible non-current assets		15
Interest receivable	34	
Interest payable	(37)	(3)
Profit before taxation		728
Income tax expense(including tax on income from associates of Sh.15 million)		(213)
Profit after taxation		515
Minority interests		(97)
Net profit from ordinary activities		418

Additional information:

1. Baraka Group Ltd. acquired an 80% holding in Neema Ltd. on 1 June 2000. The fair value of the assets of Neema Ltd. on 1 June 2000 were as follows:

	Sh. 'million'
Non-current assets (tangible)	60
Inventories	30
Trade receivables	25
Cash and cash equivalents	35
Trade payables	(20)
Taxation	(30)
	100

The purchase consideration was Sh.97 million and comprised 2 million ordinary shares of Sh.10 each in Baraka Group Ltd valued at Sh.40 per share and Sh.17 million in cash.

The group amortises goodwill over 10 years.

2. The movement in tangible non-current assets for the year ended 31 May 2001, comprised the following amounts at net-book value:

	Sh. 'million'
Balance as at 1 June 2000	1,010
Additions (including Neema Ltd.)	278
Revaluation of properties	20
Disposals	(30)
Depreciation	(39)
Balance as at 31 May 2001	1,239

3. Interest receivable included in trade receivables was Sh.15 million as at 31 May 2000 and Sh.17 million as at 31 May 2001.

4. Included in non-current liabilities is a bill of exchange for Sh.100 million (raised on 30 June 2000) which was given to a supplier on the purchase of non-current tangible assets and which is payable on 1 July 2002.

5. There have been no sales of non-current investment in the year. The investments included under non-current assets comprised the following items:

	2001 Sh. Million	2000 Sh. Million
Investment in associated company	300	220
Trade investment (including foreign equity investment of Sh.400 million as at 31 May 2001)	480	50
	780	270

6. The preference share dividends are always paid in full on 1 July each year, and are included in interest payable in the income statement. Additionally, a charge of Sh.6 million has been made in the interest payable figures to provide for a premium payable on the preference shares on redemption.

7. Current liabilities comprised the following items:

	2001 Sh. 'million'	2000 Sh.'million'
Trade payables (including interest payable, Sh. 9 million in 2001, nil in year 2000)	1,193	913
Taxation	203	200
Dividends (dividends charges in the income statement for the year 2001 amounted to Sh.126 million)	105	100
	1,501	1,213

8. Baraka Group Ltd allotted 1 million

9. There was an exchange loss on re-translation ordinary shares of Sh.10 at a price of Sh.20 upon the exercise of directors' option during the year. of foreign equity investment of Sh.205 million and a gain on the loan to finance the foreign equity investment of Sh.10 million. A loan of Sh.300 million was taken out in 2000/2001 to finance a foreign equity investment of Sh.400 million in Paka Ltd.

10. Baraka Lts acquired a debenture note of 10% at Shs 121 million.

Required:

Group cash flow statement in accordance with IAS 7 as at 31 May 2001 (20 marks)

Solution

Baraka Group

Consolidated Cash flow Statement for the year to 31 May 2001

Cash flow from operating activities:	**Sh. 'million'**	**Sh. 'million**
Net profit before tax		728
Adjustments for:		
Preference share appropriation	6	
Goodwill amortization (WK1)	10	
Depreciation	39	
Interest income (net)	(3)	
Profit on disposal of tangible noncurrent assets	(15)	
Profit from associated company	(98)	(61)
Operating profit before working capital charges		667
Increase trade receivable (660 -530 – 25 – 17 + 15)	103	
Increase in inventories (750 – 588 – 30)	(132)	
Increase in trade payables (1, 193-913-20-9)	251	16
Cash generated from operations		683
Interest paid (37 – 6 – 9)	(22)	
Income taxes paid (200 + 198 + 30 – 203)	(225)	(247)
Net cash from operating activities		436

Cash flows from investing activities		
Acquisition of subsidiary (net cash received = 17 -35)	18	
Investment in Associate company	80	
Interest received (15 + 34 – 17)	32	
Dividend from associated company (WK2)	3	
Purchase of tangible non-current assets (278 – 60 – 100)	(118)	
Sale of tangible non-current assets (30 + 15)	45	
Purchase of trade investments –	(635)	
Net cash used in investing activities		(655)
Cash flows from financing activities		
Proceeds of issuance of share capital (directors options)	20	
Proceeds from long term borrowing (1,262 – 930-100+10)	242	
10 % Debenture	(121)	
Dividends paid to minority interests (150+97-250+20)	(17)	
Net cash from financing activities		124
Net decrease in cash and cash equivalents		(95)
Cash and cash equivalents at beginning of period		140
Cash and cash equivalents at end of period.		45

STUDY TEXT

WORKINGS:

		Sh 'million'	Sh 'million'
1.	Purchase of subsidiary:		
	Net assets acquired	100	
	Group share of net assets (80%)	80	
	Purchase consideration (shares + cash)	97	
	Goodwill	17	
	Goodwill account: Opening balance		83
	Goodwill on Neema		17
			100
	Amortization (10 years)		(10)
	Closing balance		90
2.	Associated company:		
	Balance as at 1 June 2000		220
	Income for the period (98 15) net of tax		83
	Dividends received –Cash flow		(3)
	Balance as at 31 May 2001		300

		Sh 'million'	Sh 'million'	Cash flow
3.	Investments and non-current liabilities:			
	(a) Trade investments – balance 31 May 2000	50		
	Foreign equity investment	605		605
	Exchange difference	(205)	450	
	Purchase in year – other		30	30
	Trade investments balance 31 May 2001		480	635
	(b) Non-current liabilities – Interest bearing borrowing:			
	Balance – 31 may 2001		930	
	Loan taken out to finance equity Investment	310		310
	Exchange difference	(10)		
			300	
	Bill of exchange		100	
	Cash paid		(68)	(68)
	Balance at 31 may 2001		1,262	242

a. Note as the purchase of tangible non-current assets is being financed by the supplier in part, and the bill of exchange of Sh.100 million has not been paid, then the purchase of tangible non-current assets in terms of its cash effect is reduced.

4.12 SEGMENTAL REPORTS (IAS 14)

Many businesses operate in different geographical locations and also offer several products or services. A segmental report provides information about the performance of the different units of business to enable users have a wider perspective of the company and allow for even more informed decision making. For example users can be able to understand the risk and return profile of each segment of the business.

IAS 14 is a detailed standard and has numerous definitions that are very important. It is also a popular topic with the examiner.

The objective of IAS 14 (Revised 1997) is to establish principles for reporting financial information by line of business and by geographical area. It applies to enterprises whose equity or debt securities are publicly traded and to enterprises in the process of issuing securities to the public. In addition, any enterprise voluntarily providing segment information should comply with the requirements of the Standard.

Applicability

IAS 14 must be applied by enterprises whose debt or equity securities are publicly traded and those in the process of issuing such securities in public securities markets.

If an enterprise that is not publicly traded chooses to report segment information and claims that its financial statements conform to IAS, then it must follow IAS 14 in full.

Segment information need not be presented in the separate financial statements of a (a) parent, (b) subsidiary, (c) equity method associate, or (d) equity method joint venture that are presented in the same report as the consolidated statements.

Important definitions

Business segment: A component of an enterprise that:

(a) Provides a single product or service or a group of related products and services and

(b) That is subject to risks and returns that are different from those of other business segments.

Geographical segment: A component of an enterprise that:

(a) Provides products and services within a particular economic environment and
(b) That is subject to risks and returns that are different from those of components operating in other economic environments.

Reportable segment: A business segment or geographical segment for which IAS 14 requires segment information to be reported.

Segment revenue: Revenue, including inter-segment revenue that is directly attributable or reasonably allocable to a segment. This includes interest and dividend income and related securities gains only if the segment is a financial segment (bank, insurance company, etc.).

Segment expenses: Expenses, including expenses relating to inter-segment transactions, that:

(a) Result from operating activities and

(b) Are directly attributable or reasonably allocable to a segment. This includes interest expense and related securities losses only if the segment is a financial segment (bank, insurance company, etc.). Segment expenses never include:
- extraordinary items;
- losses on investments accounted for by the equity method;
- income taxes;
- general corporate administrative and head-office expenses.

Segment result: Segment revenue minus segment expenses, before deducting minority interest.

Segment assets and segment liabilities: Are operating assets (liabilities) that are directly attributable or reasonably allocable to a segment.

Identifying a Business segment and a geographical Segment

An enterprise must look to its organizational structure and internal reporting system to identify reportable segments. In particular, IAS 14 presumes that segmentation in internal financial reports prepared for the board of directors and chief executive officer should normally determine segments for external financial reporting purposes. Only if internal segments aren't along either product/service or geographical lines is further disaggregation appropriate. This is a "management approach" to segment definition. The same approach was recently adopted in Canada and the United States.

Geographical segments may be based either on where the enterprise's assets are located or on where its customers are located. Whichever basis is used, several items of data must be presented on the other basis if significantly different.

Primary and Secondary Segments

For most enterprises one basis of segmentation is primary and the other is secondary, with considerably less disclosure required for secondary segments. The enterprise should determine whether business or geographical segments are to be used for its primary segment reporting format based on whether the enterprise's risks and returns are affected predominantly by the products and services it produces or by the fact that it operates in different geographical areas. The basis for identification of the predominant source and nature of risks and differing rates of return facing the enterprise will usually be the enterprise's internal organisational and management structure and its system of internal financial reporting to senior management.

Segments to be reported

The enterprise's reportable segments are its business and geographical segments for which a majority of their revenue is earned from sales to external customers and for which:

(i) revenue from sales to external customers and from transactions with other segments is 10% or more of the total revenue, external and internal, of all segments; or

(ii) segment result, whether profit or loss, is 10% or more the combined result of all segments in profit or the combined result of all segments in loss, whichever is greater in absolute amount; or assets are 10% or more of the total assets of all segments.

Segments deemed too small for separate reporting may be combined with each other, if related, but they may not be combined with other significant segments for which information is reported internally. Alternatively, they may be separately reported. If neither combined nor separately reported, they must be included as an unallocated reconciling item.

If total external revenue attributable to reportable segments identified using the 10% thresholds outlined above is less than 75% of the total consolidated or enterprise revenue, additional segments should be identified as reportable segments until at least 75% of total consolidated or enterprise revenue is included in reportable segments.

Vertically integrated segments (those that earn a majority of their revenue from inter-segment transactions) may be, but need not be, reportable segments. If not separately reported, the selling segment is combined with the buying segment.

IAS 14.42-43 contains special rules for identifying reportable segments in the years in which a segment reaches or loses 10% significance.

Accounting policies to be followed by segments

Segment accounting policies must be the same as those used in the consolidated financial statements.

If assets used jointly by two or more segments are allocated to segments, the related revenue and expenses must also be allocated.

Information to be disclosed

IAS 14 has detailed guidance as to which items of revenue and expense are included in segment revenue and segment expense. All companies will report a standardised measure of segment result -- basically operating profit before interest, taxes, and head office expenses. For an enterprise's primary segments, revised IAS 14 requires disclosure of:

- Sales revenue (distinguishing between external and intersegment);
- Result;
- Assets;

- The basis of intersegment pricing;
- Liabilities;
- Capital additions;
- Depreciation;
- Non-cash expenses other than depreciation; and
- Equity method income.

Segment revenue includes "sales" from one segment to another. Under IAS 14, these intersegment transfers must be measured on the basis that the enterprise actually used to price the transfers.

For secondary segments, disclose:

- Revenue;
- Assets; and
- Capital additions.

Other disclosure matters addressed in IAS 14:

Disclosure is required of external revenue for a segment that is not deemed a reportable segment because a majority of its sales are inter-segment sales but nonetheless its external sales are 10% or more of consolidated revenue.

Special disclosures are required for changes in segment accounting policies.

Where there has been a change in the identification of segments, prior year information should be restated. If this is not practicable, segment data should be reported for both the old and new bases of segmentation in the year of change.

Disclosure is required of the types of products and services included in each reported business segment and of the composition of each reported geographical segment, both primary and secondary.

An enterprise must present a reconciliation between information reported for segments and consolidated information. At a minimum:

- Segment revenue should be reconciled to consolidated revenue
- Segment result should be reconciled to a comparable measure of consolidated operating profit or loss and consolidated net profit or loss
- Segment assets should be reconciled to enterprise assets
- Segment liabilities should be reconciled to enterprise liabilities.

>>> Example

Gawanya Ltd is preparing segmental report for inclusion in its financial accounts for the year ended 31 December 2001. The figures given below relate to Gawanya Ltd. And its subsidiaries but exclude information on associated companies

	Sh.'000'
Sales to customers outside the group by stationery division	11,759
Sales to customers outside the group by Kenyan companies	28,200
Sales not derived from stationery, tissue or packaging activities	3,290
Sales made to customers outside the group by tissue division.	18,390
Assets used by the Ugandan subsidiary companies	30,600
Assets not allocable to stationery, tissue or packaging activities	14,856
Assets used by the stationery division	31,750
Sales by the tissue division to other group members	3,658
Assets used by the packaging division	17,775
Assets used by the Kenyan companies	41,820
Sales not allocated to Kenya, Uganda or other areas	3,290
Sales by the stationery division to other group members	1,227
Sales made by the group to other areas of the world.	1,481
Expenses not allocated to Kenya, Uganda or other areas	4,073
Sales to customers outside the group by Ugandan companies	7,227
Expenses not allocated to stationery, tissue or packaging services	5,004
Sales by Ugandan companies to group members	2,117
Sales to customers outside the group for bureau service	5,200
Sales by Kenyan companies to other group members	2,430
Assets used by the tissue division	44,620
Assets used by the group in other areas.	21,660
Assets not allocated to Kenya, Uganda or other areas.	14,921
Segmental net profit by industry - Stationery	2,442
- Tissue	5,916
- Packaging	821
Segmental net profit by geographical area - Kenya	4,873
• Uganda	3,127
• Other areas	487
Consolidated net profit by industry	8,978
Consolidated net profit by geographical area	8,047

Required:

(a) An industry and geographical segmental report in accordance with IAS 14 (reporting Financial Information by Segment) for inclusion in the annual report to give the maximum information to the shareholders. (12 marks)

(b) Using Gawanya Ltd.'s figures as illustrations, discuss items for which you consider there is need for further information to assist the reader to interpret the segmental data. (3 marks)

(c) Identify the problems associated with segmental reporting. (5 marks)

4.12 RELATED PARTIES (IAS 24)

IAS 24 is about companies disclosing requirements about transactions with related companies or parties. It is one of the shortest standard and, therefore, not difficult to comprehend.

The objective of IAS 24 is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

Who Are Related Parties?

Parties are considered to be related if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.

A party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
(ii) has an interest in the entity that gives it significant influence over the entity; or
(iii) has joint control over the entity;

(b) the party is an associate (as defined in IAS 28 Investments in Associates) of the entity;

(c) the party is a joint venture in which the entity is a venturer (see IAS 31 Interests in Joint Ventures);

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.
Prior to the 2003 revision of IAS 24, state-controlled entities were exempted from the related party disclosures. That exemption has been removed in the 2003 revision. Therefore, profit-oriented state-controlled entities that use IFRS are no longer exempted from disclosing transactions with other state-controlled entities.

The following are deemed not to be related:

(i) two enterprises simply because they have a director or key manager in common; two venturers who share joint control over a joint venture;

(ii) providers of finance, trade unions, public utilities, government departments and agencies in the course of their normal dealings with an enterprise; and

(iii) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

What Are Related Party Transactions?

A related party transaction is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

Disclosure

Relationships between parents and subsidiaries. Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so must also be disclosed.

Management compensation. Disclose key management personnel compensation in total and for each of the following categories:

- Short-term employee benefits;
- Post-employment benefits;
- Other long-term benefits;
- Termination benefits; and
- Equity compensation benefits.

Key management personnel are those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including all directors (whether executive or otherwise).

Related party transactions. If there have been transactions between related parties, disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. These disclosures would be made separately for each category of related parties and would include:

- The amount of the transactions.
- The amount of outstanding balances, including terms and conditions and guarantees.
- Provisions for doubtful debts related to the amount of outstanding balances.
- Expense recognised during the period in respect of bad or doubtful debts due from related parties.

Examples of the Kinds of Transactions that Are Disclosed If They Are with a Related Party
• Purchases or sales of goods. • Purchases or sales of property and other assets. • Rendering or receiving of services. • Leases. • Transfers of research and development. • Transfers under license agreements. • Transfers under finance arrangements (including loans and equity contributions in cash or in kind). • Provision of guarantees or collateral. • Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

A statement that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made only if such terms can be substantiated.]

>>> Example

Purchaser	Seller	Amount	Basis of price charged	Outstanding at 30 November 2000
TPL	TTL	Sh.38 million	Comparable uncontrolled price	Sh.4 million
TPL	MDFL	Sh.32 million	Cost plus 100% other consumers	
			are charged cost plus 80%	Sh.3 million
TPL	MHSL	Sh.49 million	Comparable uncontrolled price	
			Plus 10%	Sh.5 million
TPL	BCL	Sh.2 million	Normal market price	Sh.2 million
MDFL	BCL	Sh.1 million	Normal market price	Nil
MHSL	MDFL	Sh.66 million	Comparable uncontrolled price plus 10%	Sh.6 million

Tourists Paradise Limited, TPL is a company quoted on the Nairobi Stock exchange. Its managing directors, Mr. Tamiba, own 52% of the share capital of the company. Mr. Tamiba is a director of Tourists Travels Limited (TTL), an 80% subsidiary of Tourists Paradise Limited, of Mombasa Deep-sea Fishing Limited (MDFL), a 40% associate of Tourists Paradise Limited, and of Mombasa Hotel Supplies Limited (MHSL). TPL owns and runs 6 tourist hotels along the coast, both north and South of Mombasa. TTL is a travel and transport company. All TPL's travel and transport needs are outsourced to TTL, MDFL, markets a wide variety of fish products parts of its output is exported and the rest is sold to a large number of hotels and restaurants both in the coastal region and inland. MHSL supplies many hotels in the coast region with an assortment of different products. Mr. Tamiba owns 40% of the share capital of MHSL, his wife owns 20%, the owners of the 4 other hotels in the coastal region each own 10% of the ordinary share capital. In addition to being a director of these companies, Mr. Tamiba is a director of Bamburi Cement Limited (BCL) from which company all the other companies named above buy cement at the normal market price. All 5 companies prepare their annual financial statements to 30 November each year.

Transactions between the companies in the year ended 30 November 2000 are as follows

Required:

(a) Define the terms "related party" and "related party transaction" as laid down in IAS 24: Related party Disclosures (2 marks)

(b) IAS 24 deals only with certain related party relationships. State the 5 related party relationships dealt with. (5 marks)

(c) Disclose the information required by IAS 24 in the consolidated financial statements of TPL, and in the individual financial statements of TTL, MDFL and MHSL. (10 marks)

(Total: 17 marks)

Solution

(a)

i). Related party – parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party making financial and operating decision.

ii). Related party transaction- A transfer of resources or obligations between related parties, regardless of whether a price is charged.

(b)

The standard deals only with the following relationships: -

(a) Enterprises that directly or indirectly through one or more intermediaries, control or are controlled by, or one under common control with the reporting enterprise. (This includes holding companies, subsidiaries and fellow subsidiaries).

(b) Associates

(c) Individuals owning, directly or indirectly an interest in the power of the reporting enterprise that gives them significant influence over the enterprise and close members of the family of any such individual.

(d) Key management personnel, i.e. those persons having authority and responsibility for planning, directly and controlling the activities of the reporting enterprise, including directors and officers of companies and close members of the families of such individuals.

(e) Enterprises to which a substantial interest in the rotting power is owned, directly or indirectly by any person described in (c) or (d) or over such a person is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprises and enterprises that have a member or key management in common with the reporting enterprises.

DISCLOSURES REQUIRED UNDER IAS 24

(c)

TPL and MHSL are both under the control of Mr. Tamibar the managing director of the company. TPL makes purchases from MDFL, an associate of TPL.

Transactions with the related parties.

Related party	Types of transaction	Amount	Pricing policy	Outstanding balance
MDFL	Purchase of goods	Sh.32 million	11% above normal selling price	Due to MDFL Sh.3 million
MHSL	Purchase of goods	Sh.49 million	10% above normal selling prize	Due to MHSL Sh.5 million

TTL is controlled by TPL, its holding company transactions with TPL

Type of transaction	Amount	Pricing policy	Outstanding balance
Sale of services	Sh.38 million	Firms length price	Receivable from TPL Sh.4 million

MDFL is an associate of TPL, TPL and MHSL are both under the control of Mr. Tamiba, a director

Transaction with related parties

Related party	Type of transaction	Amount	Pricing policy	Outstanding balance
TPL	Sale of goods	Sh.42 million	11% above normal selling price	Receivable from TPL Sh.3 million.
MHSL	Sale of goods	Sh.66 million	10% above normal selling price	Receivable from MHSL Sh.3 million

MHSL and TPL are both under the control of Mr. Tamiba, a director of MHSL, MDFL is an associate of TPL

Related party	Type of transaction	Amount	Pricing policy	Outstanding balance
TPL	Sale of goods	Sh.49 million	10% above normal selling price	Receivable from TPL Sh.3 million.
MDFL	Purchase of goods	Sh.66 million	10% above normal selling price	Due to MDFL. Sh.6 million

4.13 EARNINGS PER SHARE (IAS 33)

FAST FORWARD: When both parents and consolidated financial statements are presented, the information called for in respect of earnings per share need be presented only on the basis of consolidated financial statements.

INTRODUCTION

EPS is the amount of earnings for a period that is attributable to each ordinary/equity share. As per IAS 33 'Earnings per share', enterprises whose ordinary shares or potential ordinary shares are publicly traded and those enterprises that are in the process of issuing ordinary shares or potential ordinary shares in public securities market should calculate and disclose earnings per share.

Potential ordinary shares are securities, which are not presently equity shares but, which have the potential of causing additional equity shares to be issued in the future.

Examples include:

- Debt or equity instrument including preference shares that are convertible into ordinary shares
- Share warrants and options
- Employee plans that allow employees to receive ordinary shares as part of their remuneration and other share purchase plans and

- Shares which would be issued upon satisfaction of certain conditions resulting from contractual arrangements such as the purchase of a business or other asset

The term Earnings Per Share should be used without qualifying language (e.g. diluted) when no potential ordinary shares exist.

Earnings per share to be calculated are:

- Basic earnings per share
- Diluted earnings per share

Basic Earnings Per Share

Basic = Net profit/loss attributable to ordinary shares
Weighted average no. of ordinary shares outstanding (WANOS)
(issued during the period)

Where: net profit/loss attributable to ordinary shares =

Net profit/loss for the period	xx
Less: preference dividend	(xx)
	xx

Note:

- All items of income and expense which are recognised in a period including tax expense, extra ordinary items and minority interest are included in the determination of net profit (loss) for the period

- The amount of preference dividend that is deducted from the net profit for the period is
  - The amount of any preference dividend on non-cumulative preference shares declared in respect of the period and
  - The full amount of the required preference dividend for cumulative preference shares for the period whether or not the dividends have been declared.
  - The amount of preference dividend deducted for the period does not include the amount of any preference dividend for cumulative preference shares paid or declared during the current period in respect of previous periods. This is so because such dividends have already been considered in the prior periods earnings per share computation.
  - Weighted average number of ordinary shares outstanding (issued during the period) is: the number of ordinary shares outstanding at the beginning of the period adjusted by the number of shares issued during the period multiplied by a time weighting factor.
  - The time weighting factor is the number of days or months that the specific shares are outstanding as a proportion of the total number of days or months in the period.

>>> Example 1

Assume that a company had 2m ordinary shares outstanding as at 1.1.2001. On 31.5.2001, the company issued 800,000 new ordinary shares for cash.

Required

Calculate the weighted average number of shares outstanding during the period ended 31.12.2001.

Solution 1

Weighted average number of ordinary shares outstanding (issued during the period)

1 January – 31 May	2,000,000 X 5/12	=	833,333
1 June – 31 December	2,800,000 X 7/12	=	1,633,333
			2,466,666

>>> Example 2

The consolidated income statement of ABC ltd for the year ended 30 June 2002 is as follows:

	Sh '000'
Profit from ordinary activities after tax	456,500
Less: Minority interest	(17,500)
	439,000
Less: Extra ordinary loss	(50,000)
	389,000
Less: Preference dividend_	(7,500)
	381,500
Less: ordinary dividends	(17,500)
Retained earnings for the year	364,000

The company has 750m Sh.5 ordinary shares outstanding throughout the accounting period.

Required

Calculate the Earnings Per Share

Solution 2

$$\text{Earnings per share} = \frac{381{,}500}{750{,}000} = \text{Sh. } 0.509 \text{ or } 50.9 \text{ cents}$$

Notes to the accounts (Disclosure requirements)

The calculation of Earnings Per Share is based on earnings pf Sh. 381,500,000 and on the weighted average of 750,000,000 ordinary shares in issue during the period.

STUDY TEXT

Negative Earnings Per Share

Where a loss is incurred or where the amount earned for ordinary shares (after deducting preference dividend) is a negative figure, Earnings Per Share should be calculated in the usual way and the result described as a loss per share.

CHANGES IN EQUITY CAPITAL DURING THE CURRENT YEAR

Issue of new shares for cash at full market price ranking for dividend during the year

>>> Example 3

The issued and fully paid share capital of company ABC Ltd on 1st of January 01 comprised:

400,000 7% per shares of Sh.1 per share	400,000
3,000,000 ordinary shares of Sh.1 per share	3,000,000
	3,400,000

On 1 September 2001 a further 600,000 ordinary shares were issued and fully paid for in cash. The post tax net profit for the period to 31st December 2001 was Sh.197,600

Required

Compute the Earnings Per Share

Solution 3

1.

	Shs
Net profit attributable to ordinary shares	197,600
Post tax net profit for the period	(28,000)
Less: preference dividend	169,600

Weighted average number of ordinary shares outstanding

1 January – 31 August: 3,000,000 X 8/12	2,000,000
1 September – 31 December:	1,200,000
	3,200,000

Earnings per share = $\frac{169,600}{3,200,000}$ X = Sh. 0.053 or 5.3 cents

Notes to the accounts

The calculation of earnings Per Share is based on earnings of Sh.169,500 and on the weighted average of Sh.3.2 m ordinary shares in issues during the year.

2. **Issue of new shares as part of a capitalization scheme (bonus issue)**

In a capitalization or bonus issues, ordinary shares are issued to existing shareholders for no additional consideration. Therefore, the numbers of ordinary shares outstanding is increased without an increase in resources.

The number of ordinary shares outstanding before the bonus issues is adjusted as if the bonus issue has occurred at the beginning of the earlier reported period. The corresponding Earnings Per Share disclosed in respect of all earlier periods should be adjusted proportionately in respect of the capitalisation issue. In other words the earnings Per Share should be based on the increased number of shares ranking for dividend after the capitalisation issue.

>>> Example 4

The summarised profit and loss account of ABC ltd for the year ended 31 December 2001 is as follows:

	Sh. '000'
Profit after taxation	1,020
Less: Minority interest	(18)
	1,002
Add: Extra ordinary item	198
	1,200
Less: Preference dividend (including arrears)	(315)
	885
Less: Ordinary dividends	(750)
Retained earnings for the year	135
Retained earnings brought forward	665
Retained earnings carried forward	800

The company had as at 1.1.01 an issued share capital of 500,000 ordinary shares and Sh. 1,500,000 7% preference shares. The company made a bonus issue of 1 for 5 ordinary shares on 31.3.2001.

Required

Compute Earnings per share

STUDY TEXT

Solution 4

1. Net profit attributable to ordinary shares

Net profit for the period	1,200
Less: preference dividend (7% X 1,500)	105
	1,095

2. Weighted average number of shares

	Sh.
As at 1.1.2001	500,000
Add: Bonus 1/5 X 500,000	100,000
	600,000

Earnings per share $= \frac{1,095,000}{600,000}$ = Sh. 1,825

Assume that the earnings for 20X0 after deducting preference dividend was sh. 1,005,000 and that the ordinary shares outstanding throughout the period were 500,000.

Required

Compute the restated earnings per share taking into account the effect of the bonus issue

Solution

Earnings per share $= \frac{1,005}{600}$ = Sh. 1,615

Notes to the accounts

The calculation of earnings per share is based on earnings of sh. 1,095,000 (20X0: 1,005,000) and on the weighted average of 600,000 ordinary shares (20X0: 600,000) in issue during the year.

Ordinary shares issued as part of the purchase consideration of a business combination, which is accounted for as an acquisition

The ordinary shares issued are included in the weighted average number of shares as from the date of acquisition because the acquirer incorporates the results of the operations of the acquiree as from the date of acquisition.

Note

Ordinary shares issued as part of a business combination which gives rise to a merger are included in the calculation of the weighted average number of shares for all periods presented because the financial statements of the combined enterprise are prepared as if the combined enterprise had always existed.

>>> Example 5

The issued and fully paid share capital of the company

	Sh
On 1.1.01 comprised	
80,000 7% preference shares of sh. 1 per share	80,000
4,200,000 ordinary shares of sh.1 per share	4,200,000
	4,280,000

On 1.8.01 the company issued 20,000 7% preference shares and 600,000 ordinary shares as consideration of an 80% controlling interest in another company, which had become a subsidiary on 1.1.01. The post tax net profit for the year to 31.12.01 was shs. 273,200 for the group of which sh. 7,400 was attributable to minority interest in the subsidiary. The profit had been consolidated for the whole year. All shares in issue at 31.12.01 ranked for dividend.

Required

Compute earnings per share

Solution 5

1. Net profit attributable to ordinary shares

	Shs	Shs
Net profit attributable to ordinary shares	273,200	273,200
Less: minority interest	(7,400)	265,800
Less: preference dividend 100,000 X 0.07	(7,000)	258,800
As at 1.1.01	4,200,000	
Issued on 1.8.01 (Assumed to be issued as at date of acquisition)	600,000	4,800,000

Earnings per share $\frac{258,800}{4,800,000}$ = Sh. 0.054 or 5.4 cents

Note to the account

The calculation of earnings per share is based on earnings of sh. 258,800 and on the weighted average of 4,800,000 ordinary shares in issue during the year.

4.13.1 ISSUE OF SHARES THROUGH A RIGHTS ISSUE

In a rights issue, the exercise price is often less than the fair value of the shares. Thus, the concessionary price at which the shares are issued reflects a bonus element in the rights issue.

The rights issue is therefore regarded as an issue for cash at full market price and partly a bonus issue on the combined number of original and assumed rights shares.

>>> Example 6

A company has 4m ordinary shares of sh. 1 in issue. The market value of which were sh. 3.5 per share. It then decided a 1 for 4 rights issue at the concessionary price of sh. 2.8 per share.

Required

Determine the bonus element in rights issue.

Solution 6

Number of shares to be acquired through the rights issue

$$= \frac{4,000,000}{1,000,000} = 4$$

Less: Shares to be issued at full market price

$$\frac{1,000,000 \times 2.8}{(800,000)} = 3.5$$

Bonus shares 200,000

$$\text{Therefore Bonus} = \frac{200,000}{(4,000,000 + 800,000)}$$

i.e. 1 for 24 (for every 24 shares 1 share is free)

In calculating the current earnings per share figure the weighted average number of shares is computed as follows:

(Number of shares before the rights issue) X period X $\frac{\text{Actual cum-rights price}}{\text{Theoretical ex-rights price}}$ =	xx
Add: (number of shares after the rights issue) X period	xx
Weighted average number of shares	xx

The previous year's earnings per share will be adjusted/computed as follows:

$$\text{Earnings per share} \times \frac{\text{Theoretical ex-rights price}}{\text{Actual cum-rights price}}$$

Where:

The actual cum-rights price is the fair value of the shares prior to the exercise of rights

Theoretical ex-rights is given by:

$$\frac{(\text{No. of ord. Shares outstanding prior to the rights issue} \times \text{fair value of shares}) + (\text{No. of shares issued through rights issue} \times \text{rights price})}{\text{No. of ord. Shares outstanding prior to the rights issue} + \text{No. of shares issued through a rights issue}}$$

>>> Example 7

The issued and fully paid capital of ABC Company on January 01 comprised:

100,000 7% preference shares of Sh 10 per share

4,000,000 ordinary shares of sh. 10 per share

On 1st October 2001, the company decided a 1 for 4 rights issue of ordinary shares at sh.14 per share. The market price of ordinary shares on the last day of quotation on a cum-rights basis was sh.24 per share.

Required

(i) Compute the earnings per share of the current year where the post tax net profit for the year to 31 December 01 was sh. 1,155,400

(ii) Adjust the previous years earnings per share where the earnings per share for the previous year was 28 cents.

Solution 7

1. Earnings

	Shs
Net profit after tax	1,155,400
Less: preference dividend	
(7% X 1,000,000)	(70,000)
	1,085,400

2. Theoretical Ex-rights price

$$\frac{4{,}000{,}000\ (24) + 1{,}000{,}000\ (14)}{4{,}000{,}000 + 1{,}000{,}000} = \text{Ksh. } 22$$

3. Weighted average number of shares

January 1 – September 30	4,000,000 X 9/12 X 24/22	3,272,727
October 1 – December 31	5,000,000 X 3/12	1,250,000
		4,522,727

Earnings per share 2001

$$= \frac{1{,}085{,}400}{4{,}522{,}727} = 0.24 \text{ or 24 cents}$$

Earnings per share 20X0 = 28 X 22/24 = 25.6 or 26 cents

Bonus element in the rights issue

Number of shares to be acquired through a rights issue =	1,000,000
Less: number of shares issued at full market price (1,000,000 X 14/24)	583,333
	416,667

Bonus = $\frac{416,667}{4,000,000 + 583,333} = \frac{1}{11}$

(i.e. for every 11 shares 1 share is bonus/free)

January 1 – September 30 WANOS (4,000,000 X 9/12)	3,000,000
Add: bonus 3,000,000/11	272,727
	3,272,727

4.13.2 DILUTED EARNINGS PER SHARE

At the balance sheet date a company may have entered previously into commitments, which would result in the issue at some future date of further ordinary shares. Such an issue could adversely affect the interest of existing shareholders in terms of reduction or dilution in earnings per share.

For this reason International Accounting Standard 33 requires that a listed company should be required to publish its diluted EPS in addition to its Basic EPS, if it has dilutive potential ordinary shares. A potential ordinary share is treated as dilutive when and only when their conversion to ordinary shares would decrease EPS.

Potential ordinary shares are anti-dilutive when their conversion to ordinary shares would increase EPS. The effects of anti-dilutive potential ordinary shares are ignored in calculating diluted EPS.

When a separate class of equity shares being issued do not rank for dividend in the current year diluted EPS should be calculated on the assumption that this class of shares ranked for dividend from the start of the year or such a later date as they were issued or assumed to be issued.

>>> Example 8

The issued and fully paid share capital of a company on 31.12.00 comprised:

- 800,000 ordinary class A shares of Ksh. 25 each
- On 1.1.01 the company issued 2000,000 ordinary shares of Sh.30 each which do not rank for dividend until December 31 2002.
- The post tax net profit for the year ended to 31 December 01 was 2,480,000.

Required

1. Calculate basic EPS
2. Calculate diluted EPS

Solution 7

$$\text{Basic EPS} = \frac{2{,}480{,}000}{800{,}000} = \text{Sh. } 3.1$$

$$\text{Diluted EPS} = \frac{2{,}480{,}000}{1{,}000{,}000} = \text{Sh. } 2.48$$

4.13.3 CONVERTIBLE SECURITIES

The terms of issue of convertible securities specify the date and the number of equity shares to be issued. If the conversion rate varies according to the date of occurrence, it should be assumed for the purpose of calculating diluted EPS that the conversion takes place at the most advantageous conversion rate from the standpoint of the holder of the potential ordinary shares. For the purpose of calculating diluted EPS, the net profit (loss) attributable to ordinary shareholders as calculated in basic earnings should be adjusted by the after tax effect of;

- Any dividends on diluted potential ordinary shares, which have been deducted in arriving at the net profit attributable to ordinary shareholders.
- Interest recognised in the period for the dilutive potential ordinary shares and,
- Any other changes in income or expense that would result from the conversion of the diluted potential ordinary shares.

>>> Example 8

The issued and fully paid share capital of a company on 31.12.01 was:

- 400,000 7% preference shares of Sh.1 per share
- 4,000,000 ordinary shares of Sh.1 per share

The post tax net profit for the year ended 31.12.01 was Sh. 372,000

On 1st October 1999, the company had issued Sh.1.2. m 6% convertible loan stock, 2002/2005 convertible per Sh 100 of loan stock into ordinary shares of Shs. 1 per share as follows:

30th September 2002	120
30th September 2003	115
30th September 2004	110
30th September 2005	108

The tax rate for 2001 was 35%.

Required

1. Compute the basic earnings per share
2. Diluted earnings per share

Solution 8

Basic earnings per share

Basic earnings

	Shs
Post net profit	372,000
Less: preference dividends (7% X 400,000)	(28,000)
	344,000

Equity shares in issue ⑧ 4,000,000

Basic earnings per share = $\frac{344,000}{4,000,000}$ 0.086 = 8.6 cents

Diluted earnings per share

	Shs
Basic earnings	344,000
Add: Interest on 6% convertible loan stock Adjusted for after tax effects(6% X 1,200,000 X 0.65)	46,800
	390,800

Equity shares in issue

	Shs
For basic earnings per share	4,000,000
Convertible loan stock equivalent 1,200,000 X 120 /100	1,440,000
	5,440,000

Diluted earnings per share = $\frac{390,800}{5,440,000}$ = 7.2 cents

Partial Conversion

If a partial conversion of loan stock has taken place during the year, basic EPS is calculated on the weighted average number of shares in issue during the year. Diluted EPS is calculated on the adjusted earnings and on the total number of shares in issue at the yearend plus the maximum number of ordinary shares issuable under the conversion terms.

>>> Example 9

Details as in example 8 with the exception of details relating to financial year 2002.

On 30th September 2002, the company converted Sh. 400,000 of 6% convertible loan stock into 480,000 ordinary shares which ranked for dividend in the year 2002.

Required

(i) Calculate the basic EPS
(ii) Calculate the diluted EPS

Solution 9

Basic EPS

Basic earnings

	Shs
Net profit after tax	372,000
Less: preference dividends	(28,000)
	344,000

1 January – September 30	=	4,000,000 X 9/12	=	3,000,000
1 October –December 31	=	4,480,000 X 3/12	=	1,120,000
				4,120,000

Basic EPS = $\frac{344{,}000}{4{,}120{,}000}$ = 0.083 or 8.3 cents

Diluted EPS

Diluted earnings

Basic earnings	Sh. 344,000
Add back 6% interest:	
In respect of converted loan stock	
6% X 400,000 X 9/12 X 0.65	11,700
In respect of unconverted loan stock	
6% X 800,000 X 0.65	31,200
	386,900

Equity shares in issue

Outstanding throughout the year	4,480,000
6% convertible loan stock equivalent	
800,000 X 115/100	920,000
	5,400,000

Diluted EPS = $\frac{386,900}{5,400,000}$ = 7.2 cents

Where final conversion takes place

>>> Example 10

Details as example 9 with the exception that on 30th September 2003, the remainder of 6% convertible loan stock was converted into 920,000 ordinary shares which ranked for dividend in 2003.

Required

Compute the basic earnings per share

Solution 10

Basic EPS

January 1 – September 30	4,480,000 X 9/12	=	3,360,000
October 1 – December 31	5,400,000 X 3/12	=	1,350,000
			4,710,000

Basic EPS = $\frac{344,000}{4,710,000}$ = 7.3 cents

Assume that the converted shares did not rank for dividend, calculate diluted EPS

Basic EPS

Basic earnings	
Net profit after tax	372,000
Less: preference dividend	(28,000)
	344,000

WANOS

Equity shares in issue = 4,480,000

Since the shares are not ranking for dividend the basic EPS would have been

$\frac{344,000}{4,480,000}$ = 7.7 cents

Diluted EPS

Basic earnings	344,000
Add: 6% interest on converted loan stock	
6% X 800,000 X 9/12 X 0.65	23,400
	367,400

Equity shares in issue as at year end = 5,400,000

Diluted EPS = $\frac{367,400}{5,400,000}$ = 6.8 cents

4.13.4 Options/Warrants to Subscribe For Ordinary Shares

Options and other share purchase arrangements are dilutive when they would result in the issue of ordinary shares for less than their fair value. The amount of the dilution is fair value less the issue price.

Therefore, in order to calculate diluted EPS, each of such arrangement is treated as comprising of:

a) A contract to issue a certain number of ordinary shares at their average fair value during the period. The shares so to be issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. Therefore, they are ignored in the computation for diluted earnings per share.

b) A contract to issue the remaining ordinary shares for no consideration. Such ordinary shares generate no proceeds and have no effect on the net profit attributable to ordinary shares outstanding. Therefore, such shares are dilutive and are added to the number of ordinary shares outstanding in the computation of diluted EPS.

>>> Example 12

The net profit for 2001	Sh. 1,200,000
Weighted average number of ordinary shares outstanding during 2001	500,000
Average fair value of 1 ordinary share during 2001	Sh. 20
Weighted average number of shares under option during 2001	100,000 shares
Exercise price for shares under option during 2001	Sh. 15

Required

Compute the basic earnings per share and diluted earnings per share.

Solution 12

Basic EPS = $\frac{1,200,000}{500,000}$ = 2.4

Diluted EPS

Number of shares issued for no consideration	=	
Total number of shares to be issued		100,000
Less: Number of shares issued at full market price		
100,000 X 15/20		(75,000)
		25,000

$$\text{Diluted EPS} = \frac{1,200,000}{(500,000 + 25,000)} = \text{Sh. } 2.29$$

Determining the order in which to include dilutive securities in the calculation of the weighted average number of shares

In considering whether potential ordinary shares are dilutive or anti-dilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate. The sequence in which potential ordinary shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic EPS, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive.

CHAPTER SUMMARY

Free Cash flows: Is the Cash from operations less the amount of capital expenditures required to maintain the firm's present productive capacity.

Rights issue is regarded as an issue for cash at full market price and partly a bonus issue on the combined number of original and assumed rights shares.

Parties are considered to be **related** if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.

A **related party transaction** is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

Business segment: A component of an enterprise that:

(a) provides a single product or service or a group of related products and services and

(b) that is subject to risks and returns that are different from those of other business segments.

Geographical segment: A component of an enterprise that:

(a) provides products and services within a particular economic environment and

(b) that is subject to risks and returns that are different from those of components operating in other economic environments.

Reportable segment: A business segment or geographical segment for which IAS 14 requires segment information to be reported.

Segment revenue: Revenue, including inter-segment revenue that is directly attributable or reasonably allocable to a segment. This includes interest and dividend income and related securities gains only if the segment is a financial segment (bank, insurance company, etc.).

Segment expenses: Expenses, including expenses relating to inter-segment transactions, that:

(a) result from operating activities and

(b) are directly attributable or reasonably allocable to a segment. This includes interest expense and related securities losses only if the segment is a financial segment (bank, insurance company, etc.). Segment expenses never include:
  a. extraordinary items;
  b. losses on investments accounted for by the equity method;
  c. income taxes;
  d. general corporate administrative and head-office expenses.

Segment result: Segment revenue minus segment expenses, before deducting minority interest.

Segment assets and segment liabilities: Those operating assets (liabilities) that is directly attributable or reasonably allocable to a segment.

CHAPTER QUIZ

1. What is the purpose of a cashflow statement?

2. Why would profits and the flow of funds differ?

3. When is a party said to be related to an entity?

ANSWERS TO QUIZ QUESTIONS

1. Cash flow statements should assist the users to:

- Assess the enterprise's ability to generate positive future cash flows;
- Assess the enterprise's ability to meet its obligations, pay dividends and meet its needs for external reporting;
- Assess the reasons for differences between net income and related cash receipts and payments; and
- Assess the effects on the enterprise's financial position of both cash and non-cash investing and financing transactions during the period.

2. Reasons why profits and the flow of funds might differ:

- A company might have to buy fixed asserts, and the purchase costs of view fixed assets will differ from the depreciation charge in the year. (Depreciation, in fact does not represent a flow of funds at all.)
- Profits are calculated on the accruals concept. This means that a company might:-
  - o Spend money on the purchase of stocks which are unsold during the period, and their not charged against profits;
  - o Sell goods on credit, thereby making a profit on sales without receiving the cash from the debtors before the end of the accounting period;
  - o Incur development expense which is capitalized and not charged against profits until later periods;
  - o Charge taxation and dividends payable against profits, whereas the cash flows are affected by taxation and dividends actually paid.

  A company might be able to obtain funds from sources other than “Profits” - eg by issuing new shares or raising a loan. On the other hand, the company might have to find the cash to redeem some preference shares or debentures or to repay a loan.

3. A party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
(ii) has an interest in the entity that gives it significant influence over the entity; or
(iii) has joint control over the entity;

(b) the party is an associate (as defined in IAS 28 Investments in Associates) of the entity;

(c) the party is a joint venture in which the entity is a venturer (see IAS 31 Interests in Joint Ventures);

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

PAST PAPER ANALYSIS

Cashflow statements was tested in the following examinations:

12/'07

12/'06

12/'05

06/'05

06/'04

06/'03

06/'02

Segmental reports was tested in the following examinations:

12/'06

12/'05

12/'04

12/'03

06/'02

07/'00

Earnings per share was tested in the following examinations :

06/'07

06/'06

06/'04

12/'02

07/'00

Related parties was tested in the following examinations:

06/'05

06/'01

EXAM QUESTIONS

QUESTION ONE (disposal of a subsidiary)

Great Mountain Estates Limited is the holding company for a group of tea growing subsidiary companies. In the year to 31 March 2003, it sold one of its subsidiaries so that the group's area of operations could be confined to a single area of the country. The directors have made this decision as part of cost cutting exercise. The proceeds of the sale of the subsidiary were used to repay debt. In spite of the reduction in interest rates in the country, the directors are of the view that the interest cost of loans is excessive.

Consolidated Profit and Loss Account for the year ended 31 March 2003			Consolidated Balance Sheet as at 31 March		
	Sh. ' million'	**Sh. 'milli on'**		**2003 Sh. million'**	**2003 Sh million'**
Sales			Capital employed		
Cost of sales			Share capital	400	
Gross profit		596	Share premium	112	300
Other operating		(417)	Retained earnings	64	84
income		179	Shareholder's funds	576	95
Distribution		12	Minority interest	13	479
costs		(48)	Non-current	589	21
Administrative		(154)	liabilities	29	500
expenses		(19)	Bank loans	18	52
Other operating		(30)	Deferred tax	18	17
expenses		(35)	liabilities	-	19
Operating loss		19	Provisions for	65	2
Finance cost:		(46)	liabilities and	654	90
Interest expense	(2)		charges		590
Profit on	13		Finance lease		
disposal of			liabilities		
subsidiary					
Loss before tax		11		705	
Tax:		(35)	Represented by:	(161)	769
Current		4	Non-current asset:	544	(135)
Deferred tax		(31)	Property, plant and		634
			equipment cost:	40	
Net Loss			Depreciation	(24)	50
Minority interest				16	(50)
Net loss				16	25
attributable to			Intangible assets:	576	2
shareholders.			Goodwill cost		661
				158	
			Amortization	103	225
				11	134
			Deferred tax assets	3	9
				275	5
			Current assets:		373
			Inventories	112	
			Trade and other	-	188
			receivables	2	2
			Tax recoverable	83	8
			Cash and cash	197	246
			equivalents	78	444
				654	(71
			Current liabilities		590
			Trade and other payables		
			Current tax		
			Finance lease liabilities		
			Bank overdrafts		
			Net current assets/(liabilities)		

Additional information:

The assets and liabilities in the subsidiary (which was sold on 31 December 2002) were as follows:

	Sh. million
Property, plant, equipment cost	118
Depreciation	(31)
	87
Inventories	27
Trade and other receivables	41
	Sh. million
Cash and bank balances	3
Bank overdraft	(61)
Trade and other payables	(38)
Bank loans	(18)
Current tax payable	(1)
	40

Great Mountain Estates Limited had purchased 90% of the ordinary share capital of this subsidiary on 1 April 1997 for Sh.28 million when the fair value and the carrying value of the net assets were Sh.20 million. The bank overdraft is dealt with as part of the cash equivalents.

The other companies in the group sold property, plant and equipment which had cost Sh.11 million for Sh.9 million.

The figures for provisions for liabilities and charges are made up entirely of amounts due in respect of staff retirement gratuities.

There was an issue of ordinary shares at a premium of 30%, issue costs were charged against the share premium.

The loss before tax is arrived at after charging the following items:

	Sh. million
Depreciation of property, plant and equipment	65
Amortization of goodwill	4
Staff costs (2,433 members of staff at year end)	227
Auditors' remuneration	3
Directors' remuneration	2

The interest expense charged in the profit and loss account is made up of Sh.2 million on finance leases and Sh.33 million on bank loans and overdrafts. At 31 March 2003, included in trade and other payables is accrued interest of Sh.1 million on 31 March 2002 the figure had been Sh.5 million.

Share issue costs are shown as cashflows from financing activities.

There were no purchases of property, plant and equipment using new finance leases.

Required:

Prepare the consolidated cashflow statement for the year ended 31 March 2003 using the indirect method in IAS 7. Great Mountain Estates Limited shows interest paid as an operating activity and wants the cashflow from operating activities to start with the loss before tax. Do not include the detailed disclosure requirements in respect of the disposal of the subsidiary, but you should show the total disposal consideration and the amount of cash and cash equivalents in the subsidiary disposed of. A reconciliation of the cash equivalents in the cashflow statement with the equivalent items reported in the balance sheet should be disclosed. (25 marks)

STUDY TEXT

CASE STUDY

Case study – Advising using Cash Flow Statements

This is the solution to the case study found at the end of:

- Chapter 10 *Cash Flow*

Dezzie's: cash flow statement for the year ending 31 March 20X4

	£	£
Operating profit		78 578
Add back: depreciation on buildings	2000	
Depreciation on fixtures and fittings	1829	
Depreciation on delivery vehicles	4763	
Profit on sale of delivery vehicle	(520)	
		8 072
		86 650
Changes in working capital		
Stock (6 186 – 5 630) (cash outflow)	(556)	
Debtors (5 914 – 7 419) (cash inflow)	1505	
Creditors (8 510 – 6 340) (cash inflow)	2170	
Net change in working capital		3119
Net cash inflow from operating activities		89 769
Interest		
Interest received (cash inflow)	280	
Interest paid (cash outflow)	(4 617)	(4 337)
Capital expenditure (103 000 + 2039 + 15 183) (120 (cash outflow) 222)		
Sale of delivery vehicle – sale proceeds	2120	
		(118
		102
Proprietor's drawings (cash outflow)		(53000)
Mortgage loan (cash inflow)		73750
Net cash outflow		(11920)
Change in cash balance:		
Cash at 1 April 20X3		15 160
Cash at 31 March 20X4		3240
Decrease in cash – net cash outflow		(11 920)

Advice to Delroy Desmond

Delroy's business has suffered a net outflow of cash in the course of the year. The cash flow statement shows where the outflows have occurred. The principal items of outflow are, of course, the expenditure on new fixed assets. Delroy obtained a mortgage loan for some of the major expenditure on new premises, but financed part of it (£103 000 – 73 750 = £29 250) from the business's own resources. In addition, over £15 000 was spent on acquiring new delivery vehicles and a further £2000 on fixtures and fittings. The second largest item of cash outflow is Delroy's own drawings, which have increased substantially (£42 500 increasing to £53 000).

However, Delroy's business is profitable (net profit margin for the year ending 31 March 20X4 is 21.8%), and it has generated net cash inflows from operating activities of £89 769.

Delroy accepts the consultant's analysis of the operating problems the business faces. The accounting information suggests that Delroy is happy to make investments in bricks and mortar, but is quite prepared to skimp on the furnishing of his restaurants. We can see from the figures that the fixtures and fittings are quite old (this shows up in the relatively high figures for accumulated depreciation), and that only around £2000 was spent on new fixtures and fittings. Customers have obviously noticed Delroy's cheapskate approach to these matters, and are not happy about the appearance of the restaurants.

It appears that Delroy will be obliged to invest more money in restaurant fit out, new tables and so on, in order to keep the customers happy. He should be advised to do a thorough appraisal of the restaurant fittings and decoration, possibly in conjunction with an interior design expert (given that Delroy obviously has a blind spot in all matters relating to the appearance of his restaurants).

Over £15 000 has been spent on new delivery vehicles; this investment may address some of the problems noted by the customers of bikes breaking down and long waits for delivery. However, there could also be a problem with staffing, and it certainly appears to be the case that Delroy's managers are less effective than they should be. Delroy will have to arrange to employ higher paid staff. The obvious implication for cash and profits is that staffing expenses will increase. Also, he may have to spend extra cash on making existing staff redundant and could face legal problems if the staff consider themselves to have been unfairly dismissed.

However, if Delroy can sort out his staffing problems there are potential gains to be made in:

- Increased customer satisfaction (leading to word-of-mouth recommendations, and an increased rate of return visits)
- Better control of the delivery service, resulting in fewer complaints
- Improved quality of service within the restaurants

All of these factors could lead to increased turnover, and/or reduced costs.

Delroy's restaurants are profitable and bring in substantial sums of cash. The second restaurant has been open for only part of the year (we do not know from the details how long it has been open), and it could be expected to produce higher turnover and profits in the year ending 31 March 20X5. Delroy should prepare forecasts for at least the next following year, to show how much cash is likely to be available for spending on restaurant improvement and additional/replacement staffing.

Business Accounting and Finance 2nd Edition

Thomson Learning

Source: www.google.co.ke-case studies on cashflow statements.

CHAPTER FIVE

STUDY TEXT

EFFECTS OF INFLATION

CHAPTER FIVE

EFFECTS OF INFLATION

▶ OBJECTIVES

After this chapter, the student will have knowledge of:

- Capital maintenance and accounting models
- Inflation accounting and approaches to inflation accounting
- Adjustments to current cost accounting

▶ INTRODUCTION

Accounting for inflation has been covered in this text because it appears in the syllabus. The main standard is IAS 15 'Price level changes' which was withdrawn in 2004. In future, candidates may not be required to prepare inflation adjusted accounts. The important standard here is IAS 29 'Hyperinflationary economies' for which we shall only mention the summary accounting requirements. Ensure that you understand the effects of inflation on financial statements.

▶ DEFINITION OF KEY TERMS

Depreciation adjustment is the additional depreciation arising due to increase in prices of goods.

Monetary working capital adjustment represents the amount of additional (or reduced) finance needed for the monetary working capital as a result of changes in the input prices of goods and services used and financed by the business.

Cost of sales adjustment (COSA) is the additional cost of sales arising due to inflation.

Gearing Adjustment

This is the gain due to the shareholders as a result of financing the assets through loans.

▶ EXAM CONTEXT

In past examinations, the examiner has tested the students' knowledge on the following topics:

- Current purchasing power (CPP) accounting
- Current Cost Accounting (CCA)

The student should therefore understand these topics.

▶ INDUSTRY CONTEXT

This topic assists organizations to know how to treat inflation.

It explains how to prepare financial statements and to reflect the impact of inflation in the financial statements.

5.1 NEED FOR INFLATION ACCOUNTING

- The major reason why inflation accounting or accounting for price level changes has been a hot topic in the academic literature is because of the deficiencies of the historical cost accounting (HCA) approach.

- HCA is a well established method of accounting all over the world because it is able to meet the legal requirements of financial reporting i.e fulfilling the stewardship function assigned to financial reports. HCA has been able to provide information about the financial position, performance and changes in financial position of an enterprise to a wide range of users especially during periods of stable prices.

- However, most economics in the world are characterized with environments of non-stable prices —inflation. Under such circumstances, it is unlikely that HCA can be able to satisfy the informational demands of users whose academic needs are dependent on estimates of future cashflows. HCA is likely to fail because:

(a) The balance sheet figures for assets, based on cost at time of acquisition are unlikely to reflect present day values since they lack additivity. The balance sheet includes a conglomerate of costs incurred on different dates which will not enable users to "realistically predict future cashflows" related to those assets.

(b) If profit (income) is dependent on measure of capital at different dates, then profit measurement can be considered to be the result of comparing two fairly meaningless totals. In addition the profit that results is usually considered to be overstated and any ratio, including return on capital employed, will also be overstated.

(c) Historic cost profit give a misleading impression of the ability of a company to continue to operate at the same level of operation and/or maintain capital in `real terms' - problem of capital maintenance.

(d) A series of historic cost accounts can give a misleading impression of the financial trends of a company.

5.2 CAPITAL MAINTENANCE

FAST FORWARD: There is a relationship between profit and capital.

Conventionally, profit is calculated by setting expenses against revenues in a formal statement known as a profit and loss account. An alternative view of profit is to see it, in the absence of fresh capital inputs or drawings, as the increase in the net worth of a business.

Thus the relationship between profit (income) and capital can best be expressed by the following equation:

$$I = D + (K_2 - K_1)$$

Where I	=	Income for the period
D	=	Dividends or distribution
K_2	=	Capital at the end of the period
K_1	=	Capital at the beginning of the period

If $K_2 = K_1$, $I = D$, i.e. all the income has been distributed
$K_2 > K_1$, $I > D$, i.e. retained profits which form part of the capital at the beginning of next year
$K_2 < K_1$, $I < D$ i.e. dividends have been paid out of capital or reserves brought forward

As can be seen from the above equations, income is only recognised after the capital at the beginning of the year is maintained at the end of the year. Thus, capital maintenance is thus a minimum concept. Capital represents the absolute minimum funding that must be retained to provide security for creditors, and to keep the business at least at the level of activity that was originally determined by the owner(s).

In order to keep track of essential capital, accountants have traditionally made a clear distinction between capital and revenue funds.

The value of income will also depend on the manner in which the capital is measured. A number of models are available to measure income. These can be broadly categorised into two:

(a) Economic income model

(b) Accounting models

Economic Income Model

It can be measured using the following equation

$$I = C + (K_2 - K_1)$$

Where I	=	Income for the period
C	=	Realised cashflow in the period
K_2	=	Capital at the year-end measured in terms of present value of future cashflows.
K_1	=	Capital at the beginning of the year measured in terms of present value of future cashflows.

This equation is based on Hick's model of ideal income and he defines the income as being "the amount a man can spend and still be as well off at the end of the period as he was at the beginning.

This approach to measurement of income sidesteps all the problems associated with yearend adjustment to profit. The estimations of accruals and prepayments, the assumptions about fixed assets lives etc that are embodied in the traditional profit and loss account are entirely avoided.

However, the main disadvantage is probably that the calculation of well-offness, or capital, is similarly subject to estimates and professional judgments. Remember the value of capital at the beginning and the end of the period is defined as the discounted present value of the future income stream. This income is measured from changes in capital, by contract to the accrual concept where capital is the residual after measuring income.

Future cash flows are discounted at the entity's cost of capital and the maximum one can spend to maintain the "welloffness" is I and not C. An essential feature of the model is that the definition of income takes account of consumption and saving and dis-saving. The sums saved should be reinvested and should earn interest, which will ensure capital maintenance and a constant income.

5.3 ACCOUNTING MODELS

This includes:

(a) Classical school - Historical cost accounting the capital is maintained by money terms. If the entity has a historical cost of Shs 1,000 at the beginning of the year and Shs 1,000 at the end of the year (assuming no distributions and no injections or withdrawal of capital):

Income = Sh 1,500 - Sh 1,000 = Shs 500

This is the traditional approach to profit measurement.

(b) Neo-classical
This includes the Historical cost accounting adjusted for changes in general purchasing power. This model makes sure that the purchasing power of the capital is maintained.

(c) Modern School - Current Value Accounting
This model tries to maintain the operating capability of the entity. The operating capability of the business entity is its ability to replace assets as they are consumed or worn out or its ability to produce the same volume or value of goods i.e. the next year as in the current year.

5.4 APPROACHES TO INFLATION ACCOUNTING

- HCA does not reflect the impact of changing prices on the net assets and earnings of a company, but to date no agreement has been reached on a system that will do that and provide users with the information they require to make decisions in an environment of moving price levels.

- However, there are two main approaches to inflation accounting. These are:

  (a) Current purchasing power accounting system and

  (b) Current value systems

5.5 CURRENT PURCHASING POWER (CPP) ACCOUNTING

FAST FORWARD: Current Purchasing Power (CPP) Accounting requires that historical cost based amounts be translated to the current purchasing power equivalent using the general price level index.

- It is also referred to as the General Price Level Approach.
- The CPP accounts attempts to maintain the shareholders' capital in terms of the general or consumer purchasing power. This is known as the proprietorship concept of capital maintenance.
- According to the CPP, all items in the profit and loss account are expressed in terms of current (year-end) purchasing power, while the same will be true in the balance sheet. Thus all items in the balance sheet will have to be converted in terms of year-end purchasing power except the so called monetary items (assets and liabilities) which are automatically expressed in such terms.

>>> Example - CPP Accounts

Nyumba Ltd engages in real estate business owning only one property. The company's main income is rental income.

The balance sheet of the company as at the end of the year 1 and year 2 is as follows:

	Year 1	**Year 2**
	KShs	KShs
Assets		
Building (net)	150,000	105,000
Cash	45,000	90,000
	95,000	195,000

The comparative income statements for both year 1 and year 2 are given below:

	Year 1 Kshs	Year 2 Kshs
Revenue	82,500	90,755
Expense		
Depreciation	(45,000)	(45,000)
Net Income	37,500	45,755

Additional Information

- The company was formed on January 1st, Year 1 through a cash investment of KSh 195,000.
- The building was acquired on January 1st Year 1 at a cost of 195,000. Expected useful life is 4 1/3 years.
- All revenue is received at the end of the year.
- There are no operating expenses except depreciation.
- All net income is paid out as a dividend. The balance of cash is banked at no interest return.
- The price indexes for Year 1 and Year 2 are as follows:

1st Jan	year 1	100
31st Dec	Year 1	105
31st Dec	Year 2	110

Required:

Prepare the balance sheet and income statements for Nyumba Ltd for the two years using the current purchasing power approach.

Solution:

NYUMBA LTD

Income Statement for Period ending

	Year 1 KShs	Year 2 KShs
Revenue	82,500	90,755
Depreciation (W1)	(47,250)	(49,500)
	35,250	41,255
Purchasing power Loss (W2)	______	(2,250)
Net Income	35,250	39,005

Balance Sheet as at end of

Assets	**Year 1** Kshs	**Year 2** Kshs
Buildings (net) (W3)	157,500	117,750
Cash (W4)	47,250	96,750
	204,750	214,500
Capital (W5)	204,750	214,500

Workings

W1 - Depreciation Expense

Year 1 → $\frac{105}{100} \times \frac{195,000}{4\ 1/3}$ = KShs 47,250

Year 2 → $\frac{110}{100} \times \frac{195,000}{4\ 1/3}$ = KShs 49,500

W2 - Purchasing Power Loss

Year 1 - No loss/gain as there was no monetary item at the beginning of the year.

Year 2 - Monetary assets-cash = 47,250 at beginning of Year 2.

Thus the PP loss

= $\frac{47,250 \times 110}{105} - 47,250$

= KSh. 2,250

W3 - Buildings

Year 1 -	Adjusted cost $(\frac{105}{100} \times 195,000)$ =	204,750
	Less Acc. Depreciation	(47,250)
		157,500

Year 2 -	Adjusted cost $(\frac{110}{100} \times 19,500)$ =	KSh 214,500
	Acc. Depreciation (47,250 + 49,500)	96,750
		117,750

W4 - Cash

Year 1 -	Amount of depreciation retained	=	KShs 47,250
Year 2 -	Amount of depreciation retained to date (47,250 + 49,500)	=	KShs 96,750

W5 - Capital

Year 1 - $\frac{195,000 \times 105}{100}$ = KShs 204,250

Year 2 - $\frac{195,000 \times 110}{100}$ = KShs 214,500

Purchasing Power Gain and Losses

- Purchasing power gains and losses arise as a result of holding non monetary assets or liabilities during a period when the price level changes.

- Purchasing power gains and losses arise because monetary items, which are fixed in terms of the number of shillings to be received or paid, gain or lose purchasing power as the price level changes.

- Monetary assets - assets receivable at fixed amounts either currently or in the future include cash, accounts receivable, notes receivable.

- Monetary liabilities - liabilities payable in fixed number of shillings either currently or in the future include both short term liabilities like LTD, notes payable etc.

- He potential for gains and losses is summarised in the table below where "net monetary assets" refers to total monetary assets exceeding monetary liabilities and the converse is true for "net monetary liabilities".

PURCHASING POWER GAINS AND LOSSES

	State of the Economy	
State of the Enterprise	Inflation	Deflation
Net monetary assets position	Purchasing power loss	Purchasing power gain
Net monetary liabilities position	Purchasing power gain	Purchasing power loss

Advantages of CPP

- Current Purchasing Power accounts provide a monetary unit of valuing all items in the financial statements for proper comparisons.

- Since CPP accounts are based on historical cost accounts the raw data is easily verified and can be edited

- The restatement of results enhances entities comparability.

- Profit is measured in real terms – as a result more accurate forecasts can be made of future profits.

- CPP accounts avoid the subjective valuations of CCA.

Problems and criticisms of CPP

Although the CPP restores the additivity of the figures, it has its own problems.

(a) Balance sheet treatment of non-monetary assets.
It is normally regarded as an extension of the historical cost approach. The resultant figures bear little resemblance to current values of such assets.

(b) The nature of CPP profit
The CPP profit consists of trading profits and losses, and monetary gains and losses. Some critics were concerned that a highly geared and illiquid company, with substantial liabilities, could show a trading loss and yet a substantial monetary gain. CPP profit could give a misleading impression of its ability to pay a dividend.

(c) Difficulty of understanding the purchasing power unit concept.

It has been argued that users of CPP statements may find the current purchasing power concept difficult to understand and explain. Items in the balance sheet and profit and loss account may appear rather abstract to non-accountants compared with the basic principles of, say, current value accounting.

5.6 CURRENT VALUE ACCOUNTING

FAST FORWARD: There is no such thing as a current value accounting system, but rather several systems which can be regarded as members of the current value family.

Three possibilities include:

(a) The economic value method

(b) The net realisable (or exit value) method

(c) The current replacement cost (or entry value) method

The Economic Value Method

Under this method, the current value of an individual asset is based on the present value of the future cashflows that are expected to arise as a result of owning the asset. This method requires information concerning the following:

i. the amount of future benefits in cash terms;

ii. The timing of those benefits (for discounting purposes);

iii. A suitable discount factor - the cost of capital over the future lifetime of the asset.

The method is soundly based from a theoretical viewpoint but can nevertheless be criticised on several grounds of a practical nature.

The criticisms include:

- It is difficult to see how cash flow information and estimated discount rates will be capable of verification by auditors, so that users of accounts may be unwilling to place reliance on the resulting financial statements.

- The method is highly subjective and the figures required to operate this method could be extremely difficult to produce e.g estimating cashflows that can be attributed to individual assets.

- Under this method it would be impossible to provide a detailed analysis of the year's profit figure. Profit for the year would be based on the difference between opening and closing net asset valuation figures (aggregated) adjusted for capital introduced and dividends.

The Net Realisable Method (NRV)

Under the NRV method, asset values in the balance sheet would be based on the net price that could be obtained in the open market if assets (stock and fixed assets) were sold in an orderly way at the balance sheet date. This method is sometimes referred to as the “exit value” approach.

Advantages of NRV include:

- Accounts prepared on this basis show the firm’s total position in terms of its net liquidity. This information will be useful to users of financial statements such as management, shareholders, creditors, bankers etc. For example, it may assist bankers in making lending decisions and managers in deciding the best use to which particular assets should be put.

- It also restores the additivity of balance sheet figures.

Disadvantages of NRV include:

- The method places a great emphasis on liquidation. This is inconsistent with the going-concern assumption.

- The method would be costly and time consuming, involving individual assessment of individual assets.

- It is also possible that some company assets may lack realisable/market values.

- It may also produce very unrealistic fixed assets values, for example, specialised plant could have a high value to a particular business, but still have a very low NRV in the market place. In the absence of liquidation, such a NRV would be meaningless.

- In the case of stocks, for example, profit is taken before goods are sold thus infringing the realisation concept.

The Replacement Cost Method

- The method is also referred to as the "Entry Value" approach.

- The method requires that the value of items be adjusted to reflect the cost at which it could have been replaced in the normal course of business either at the date of sale goods or at the balance sheet date.

- The method seems to represent the value of the firm.

>>> Example

The net realisable value method and the replacement cost method are illustrated below:

Assume the example in section 4.2.1 - Nyumba Ltd

Additional Information:

i. Replacement cost for a new building of the same type is KShs 180,000 at the end of Year 1 and KShs 210,000 at the end of Year 2.

ii. Net realisable value for the building is KSh 135,000 and KSh 120,000 a the end of Year 1 and Year 2 respectively.

Required:

Prepare the accounts for Nyumba Ltd using

(a) The Replacement Cost approach

(b) The Net Realisable Value approach

Replacement Cost Approach

Nyumba Ltd - Income Statement for Period ending

	Year 1	**Year 2**
	KShs	**KShs**
Revenue	82,500	90,755
Depreciation Expense (W1)	(41,538)	(48,462)
	40,962	42,293

Balance Sheet as at end of

Assets	Year 1 Kshs	Year 2 Kshs
Buildings (net) (W2)	138,462	113,076
Cash	41,538	90,000
	180,000	203,076
Capital	180,000	203,076

Workings:

(W1) - Depreciation Expense

Year 1 - $\frac{180,000}{4\ 1/3}$ = KSh 41,538

Year 2 - $\frac{210,000}{4\ 1/3}$ = KSh 48,462

(W2) - Buildings (net)

Year 1 - (180,000 - 41,538) = KSh 138,462
Year 2 - (210,000 - 2(48,462) = KSh 113,076

Net Realisable Value (NRV) Method

Nyumba Ltd- Income Statement For Year Ending

	Year 1 KShs	Year 2 KShs
Revenue	82,500	90,755
Depreciation Expense (W1)	(60,000)	(15,000)
	22,500	75,755

Balance Sheet as at End of

	Year 1 KShs	Year 2 KShs
Buildings (net) (W2)	135,000	120,000
Cash (W3)	60,000	75,000
	195,000	195,000
Capital	195,000	195,000

Workings:

W1 - Depreciation Expense

Year 1 - (195,000 - 135,000) = KSh 60,000
Year 2 - (135,000 - 120,000) = KSh 15,000

W2 - Buildings (net)

Year 1 - 135,000 as given
Year 2 - 120,000

STUDY TEXT

W3 - Cash	-	Year 1 - Amount of acc. depreciation = KShs 60,000
		Year 2 - Amount of acc. depreciation = KSh (60,000 + 15,000)
		to date = KSh 75,000

HOLDING GAINS AND LOSSES

Just as monetary items are subject to a gain or loss as the price level changes, non-monetary assets (also called real assets) are subject to a gain or loss as a result of change in their value.

Holding gains or losses on real assets can be divided into two parts:

- Monetary holding gains and losses - arise purely because of the change in the general price level during the period and

- Real holding gains and losses - these are the differences between general price-level-adjusted amounts and current values.

Monetary gains and losses are capital adjustments only. They are not a component of income.

Holding gains and losses can also be classified from the standpoint of being realized or unrealized in the conventional accounting sense.

>>> Example

Assume a piece of land was acquired for KSh 5,000 on Jan 2nd 20X0, when the general price index was 100. One-tenth of the land was sold on December 31, 20X0 for KSh 575. The entire parcel of land was valued at KSh 5,750 on Dec. 31 20X0. The total real and monetary holding gains are computed below:

Current value (31.12.X0)	KShs 5,750
General price-level adjusted Historical cost on 31.12.X0 $(5,000 \times \frac{110}{100})$	5,500
Total real holding gain	250
General price-level adjusted Historical cost on 31.12.X0	KShs 5,500
Historical cost	5,000
Total monetary holding gain	KShs 500

Holding gains and losses are realized by the process of selling the asset or in the case of a depreciable asset using it up over time. The division of the holding gains in the above example is summarized below:

Analysis of Holding Gains

Holding Gain Type

	KShs	KShs	KShs	
Realized	25	50	75	
Unrealized	225	450	675	
Total	250	500	750	

>>> Example

KAMUTI Ltd's financial statements for the year 20X0 are given below:

Kamuti Ltd : Income Statement for the period ended 31.12.20X0

	KShs	Kshs
Sales		400,000
Cost of goods sold		(240,000)
Gross profit		160,000
Less: Operating expenses		
Selling and Administration	(100,000)	
Depreciation expense	(40,000)	(140,000)
Net profit		20,000
Dividends		(10,000)
Retained profits		10,000

Kamuti Ltd - Balance Sheet As at:

	31.12.20X0 KShs	31.12.1999 KShs
Fixed Assets		
Equipment	400,000	400,000
Acc. Depreciation	(140,000)	(100,000)
	260,000	300,000
Current Assets – Inventory	160,000	100,000
- Accounts Receivable	20,000	40,000
- Cash	110,000	20,000
	550,000	460,000
Equity		
Ordinary Shares	200,000	200,000
Retained Earnings	30,000	20,000
	230,000	220,000
Liabilities		
Bonds payable	300,000	200,000
Accounts payable	20,000	40,000
	550,000	460,000

Additional Information:

- The equipment consists of three lots acquired at different times and each has a useful life of 10 yrs. Cost information is as follows:

At 31.12.1999

	Initial cost	Age (yrs)	Current cost
	KShs		KShs
Lot 1	240,000	3	260,000
Lot 2	120,000	2	140,000
Lot 3	40,000	1	60,000
	400,000		460,000

At 31.12.1990

	Initial cost	Age (yrs)	Current cost
Lot 1	240,000	4	300,000
Lot 2	120,000	3	180,000
Lot 3	40,000	2	80,000
	400,000		560,000

- Depreciation is to be charged using the straight-line method. The residual value is zero for lots of equipment.
- Inventory is accounted for using FIFO basis with an inventory turnover of approximately four times per annum. In the year 20X0, 12,000 units were sold.
- Current cost of inventory was KSh 104,000 as at Jan 1st 20X0. KSh 166,000 on Dec 31. 20X0. The unit cost of stock was KSh 20 and KSh 25 on 1.1.00 and 31.12.00 respectively.
- Interim dividend amounts to KSh 10,000 was paid on July 1st 20X0.
- The price indexes at relevant dates are as given below:

January	1st 20X0	250
December	31st 20X0	270
Average for	20X0	260
Last Quarter -	20X0	245
Last Quarter -	20X0	265

Equipment

Lot 1	200
Lot 2	225
Lot 3	240

Required

(a) Income statement for period ending 31.12.90 for KAMUTI Ltd adjusted for price level changes.
(b) Balance Sheet as at 31.12.00 for Kamuti Ltd adjusted for price level changes.

SOLUTION

(A) KAMUTI Ltd: Income Statement
For the year ended 31.12.20X0

	KShs	KShs
Sales		
Cost of sale (W1)		
Gross profit		400,000
Operating Expenses		(249,140)
Selling and		150,860
Administration		
Depreciation Expense		
(W2)		149,400
Net income from normal		1,460
operations	(100,000)	14,240
Add: Purchasing power Gain	(49,000)	
(W3)		15,700
		(10,000)
Net income for the year		5,700
Dividends		
Retained profits		

Workings:

W1 - Cost of sales

	Amount HCA KShs	Adjustment factor KShs	Adjusted amount KShs
Opening inventory (1.1.00)	100,000	260/245	106,120
Add purchases	300,000	260/260	300,000
Cost of goods available for sales	400,000		406,120
less: closing inventory (31.12.00)	(160,000)	260/245	(156,980)
Cost of sales	240,000		249,140

W2. Depreciation Expense

				KShs
Lot 1	240,000 x	$\frac{260}{200}$	x 10% =	31,200
Lot 2	120,000 x	$\frac{260}{220}$	x 10% =	13,866
Lot 3	40,000 x	$\frac{260}{240}$	x 10% =	4,334
			Total	49,400

W3. Purchasing Power Gain/Losses

	31/12/99 KShs	31/12/00 KShs
Monetary Assets	60,000	130,000
Monetary Liabilities	(240,000)	320,000
Net Monetary Liabilities	180,000	190,000

1.1.00- Purchasing power equivalent	(180,000 x 260/250)	187,200
Add net charge during 10 years	10,000 x 260/200	10,000
Less		
31.12.00- Purchasing power equivalent (190,000 x 260/270)		182,960
Purchasing power gain		14,240

(B) KAMUTI Ltd - Balance Sheet As at 31.12.20X0

		Kshs	Kshs
Fixed Assets			
			513,000
Equipment	(W1)		(145,390)
Acc. Depreciation	(W2)		367,610
Current Assets			
Inventory	(W3)		
Accounts Receivable	(W4)		293,020
Cash	(W4)	163,020	980,630
		20,000	
Equity		110,000	
Ordinary Shares	(W5)		
Retained Earning	(W6)		340,630
Holding Gain	(W7)	216,000	660,630
		31,160	
Liabilities		93,470	300,000
Bonds Payable	(W4)		20,000
Accounts Payable	(W4)		980,630

Workings

W1 - Equipment

	Initial cost	Adjust Factor	Adjusted Amount
Lot 1	240,000	(270/200)	324,000
Lot 2	120,000	(270/225)	144,000
Lot 3	40,000	(270/240)	45,000
	400,000		513,000

W2 - Accumulated Depreciation - Equipment

$$\left(140,000 \times \frac{270}{260}\right) = \text{KShs } 145,390$$

W3 - Inventory - 31.12.90

$$\left(160{,}000 \times \frac{270}{265}\right) = \text{KShs } 163{,}020$$

W4 - Monetary Assets and liability remain the same

W5 - Ordinary Shares

$$\left(200{,}000 \times \frac{270}{250}\right) = \text{KSh } 216{,}000$$

W6 - Retained Earnings

$$\left(30{,}000 \times \frac{270}{260}\right) = \text{KShs } 31{,}160$$

W7 - Holding Gain/Loss

Non Monetary Items Level Adjusted	General Price	Historical Cost	Difference Amount
	KShs	KShs	KShs
Equipment	513,000	400,000	113,000
Accumulation Depreciation	145,390	(140,000)	(5,390)
Inventory	163,020	160,000	3,020
Ordinary Shares	216,000	200,000	(16,000)
Retained Earnings	31,160	30,000	1,160
Holding Gain			93,470

5.7 ADJUSTMENTS TO CURRENT COST ACCOUNTING

Current cost accounts are usually produced by making adjustments to Historical cost accounts. The following adjustments are incorporated in current cost accounts:

- Depreciation adjustment (DA)
- Cost of sales adjustment (COSA)
- Monetary working capital adjustment (MWCA)
- Gearing adjustment (GA)

Depreciation adjustment is the additional depreciation arising due to increase in prices of goods. It is calculated as follows:

Apply the depreciation rate to the current value of the asset. From the resultant figure, deduct depreciation already charged in the profit and loss account (HCA). The DA should be treated as follows:

Dr. Current cost P/L Account	xx	
Cr. Provision for Depreciation		xx

Cost of sales adjustment (COSA) is the additional cost of sales arising due to inflation. There are two ways of computing the COSA.

i. If one or many items are involved, then the cost of the items sold is deducted from the current value of those items to get the COSA.

Example:
Assume 100 items were purchased at KShs 250 each and were sold at 400 each during the period. Extra stock was purchased at 310/= each. Then the COSA will be

= Change in cost of item x No. of units sold
= (310 - 250) x 100 = KShs 6,000

ii. Averaging Method

- Under this method, opening stock and closing stock are reinstated at the average price.

The procedure is as follows:

- Restate both the opening and closing stock to average price.
- Compute the difference between the value of opening stock and closing stock on historical basis. This difference is made up of two elements - volume change and price change.
- Compute the difference between opening and closing stock - both stated to average price - the difference is due to volume change.
- The difference between (b) and (c) above is the COSA.

(see example below).

Monetary working capital adjustment (MWCA)

- MWCA = Debtors - Creditors
- Does not include cash unless it is directly linked to movement in working capital
- MWCA represents the amount of additional (or reduced) finance needed for the monetary working capital as a result of changes in the input prices of goods and services used and financed by the business.
- Monetary working capital includes the following elements:-

Monetary Assets

- Trade debtors
- Trade bills receivable
- Prepayments
- VAT recoverable
- Any part of the bank balance (or overdraft) arising from fluctuations in the level of stock, debtors, creditors, etc.
- Any part of the cash floats required to support day to day operations of the business.
- Certain stocks not subject to COSA e.g
  - Seasonal purchases
  - Dealing stocks
  - Unique contracts

Monetary Liabilities

i. Trade creditors

ii. Trade bills payable

iii. Accruals and expense creditors

iv. VAT payable

NOTE:

(a) Creditors or debtors relating to fixed assets bought or sold under construction should be treated as part of borrowings rather than MWC.

(b) Advance Corporation Tax, Mainstream Corporation Tax (MCT), and deferred tax should be treated as borrowings.

Gearing Adjustment

This is the gain due to the shareholders as a result of financing the assets through loans. The acquired assets increase in value during periods of inflation while the amount of loan remains the same. Borrowings are usually fixed in monetary amount, irrespective of changes in the prices in the various parts of operating capability. If prices rise, the value to the business of assets exceeds the borrowing that has financed them. The excess (less interest on the borrowings) accrues to the shareholders and is realised as the assets are used or sold in the ordinary course of business.

Gearing Adjustment (GA)

$$= (DA + COSA + MWCA)^* \frac{\text{Borrowing (Average)}}{\text{Borrowing (Average)} + \text{Shareholders Funds (Average)}}$$

Borrowing comprises of all monetary liabilities less all monetary assets. In particular, convertible loan stock, debentures and deferred taxation should be included in borrowing.

>>> Example

The following are extracts from the historical cost accounts of Inflac PLC for the year ending 31.Dec. 20X9

Profit and Loss Account

	Kshs. '000'
Operating profit (after depreciation of Kshs. 150,000)	500
Interest	(100)
Profit before tax	400
Tax	(70)
Profit after tax	330
Dividends	(30)
Retained profit	300

Balance Sheet

	31/12/20X9 **Kshs '000'**	31/12/20X8 **Kshs '000'**
Fixed Assets-cost	2,000	2,000
- acc. Depreciation	(1,150)	(1,000)
	850	1,000
Current Assets – stock	800	600
- debtors	1,050	900
- cash	300	200
Total Assets	3,000	2,700
Capital and Reserves		
Ordinary shares	600	600
Retained profit	700	400
	1,300	1,000
Debentures	600	600
Deferred tax	100	100
Current liabilities		
Creditors	600	500
Overdraft	300	400
Taxation	70	75
Proposed dividends	30	25
Total Equity and Liabilities	3,000	2,700

Additional Information:

- Transactions occur evenly throughout the year.
- The price index for stock (and used for monetary working capital) was as follows:

At date closing stock - 20X8 were purchased	173.3
31 December 20X8	177.4
Average for 20X9	190.7
At date closing stock - 20X9 were purchased	197.9
31 December 20X9	202.4

- Cost of sales for 20X9 was Kshs. 2,200,000
- Fixed assets were purchased four years ago when the relevant index was 130. This index had moved to 195 by 31. December 20X8 and 227.5 by 31. December 20X9. Straight line depreciation of 7.5 per cent per annum.

Required

(a) Calculate the following adjustments for current cost accounts

i. Depreciation Adjustment
ii. Cost of sales adjustment
iii. Monetary working capital adjustment
iv. Gearing Adjustment

(b) Prepare the current cost accounts for Inflac Ltd for the year ending 31.12. 20X9.

Solution

i. Depreciation Adjustment

	Kshs`000’
Historic cost depreciation - 1999	150.0
Current cost depreciation $\left(\frac{150 \times 227.5}{130}\right)$	262.5
Depreciation adjustment	112.5

ii. Cost of sales adjustment (COSA)

	Historic cost Kshs`000’	Index Adj.	Current cost Kshs`000’
Closing stock	800	190.7/197.9	770.9
Opening stock	(600)	190.7/173.3	(660.3)
	200		110.6

Of the total increase of Kshs.200,000 in stock value Kshs.110,600 can be attributed to volume increases. The balance of Kshs.89,400 is considered to result from changing price levels and it is this amount which constitutes the COSA.

iii. Monetary working capital adjustment (MWCA)

Historic cost		Index Adj.	Current cost
Kshs`000'			Kshs`000'
Closing MWC	450	190.7/202.4	424
Opening MWC	(400)	190.7/177.4	(430)
	50		(6)

There has been a volume decrease of Kshs6,000. The increase of Kshs.50,000 results from a price increase of Kshs.56,000. This is the value of the MWCA.

iv. Gearing Adjustments (GA)

	20X9 Kshs. '000'	20X8 Kshs. '000'
Net borrowings:		
Debentures	600	600
Deferred Tax	100	100
Overdraft	300	400
Tax	70	75
Cash	(300)	(200)
	700	975

Simple average = $\frac{770 + 975}{2}$ = Kshs.872,500

Shareholders' funds: it is not convenient to calculate the capital and reserves at this point. The figures are calculated by reference to the current cost net assets.

	20X9 Ksh '000'	**20X8 Ksh '000'**
Fixed Assets	1,487.5	1,500
Stocks	818.2	614.2
Debtors	1,050	900
Creditors	600	500
Cash less overdraft		200
Tax	(70)	(75)
Deferred Tax	(100)	(100)
Debentures	(600)	(600)
	985.7	1,539.2

Simple Average = $\frac{1,985.7 + 1,539.2}{2}$ = Kshs.1,762,450

Gearing Adjustment =
Kshs. (Kshs.112,500 + Kshs. 89,400 + Kshs. 56,000) * $\frac{872,500}{\text{Kshs.872,500+ Kshs.1,762,450}}$
872,500 + 1,762,450

GA = Kshs. 85,400

(b) In order to prepare the current cost accounts, the following workings are necessary

W1 - Fixed Assets

Accumulated .Depreciation.(1.1.X9) =Kshs 1,000,000 x $\frac{195}{130}$ = Kshs.1,500,000

Accumulation .Depreciation.(31.12.X9) =Kshs.1,000,000 x $\frac{227.5}{130}$ = Kshs.1,750,000

Backlog depreciation charge 250,000

Accumulated current cost depreciation
= Acc. Dep (1.1.99) + Depreciation charge
= Kshs. 1,750,000 + 262,500 = Kshs. 2,012,500

Gross current cost of fixed assets
= Kshs. 2,000,000 x $\frac{227.5}{130}$ = Kshs.3,500,000

Net current cost of fixed assets = Kshs. 1,487,500

W2 - Stock

Closing stock should be based on the index on 31.12.X9

Thus Kshs.800,000 x $\frac{202.4}{197.9}$ = Kshs. 818,200

Opening stock should be based on the index on 31.12.X8

Thus Kshs.600,000 x $\frac{177.4}{173.3}$ = Kshs.614,200

Thus an adjustment (Kshs.818,200 - Kshs.614,200) = Ksh.6,000

Should be reflected in the reserves

W3 - Current Cost Reserve

	Kshs.`000'		Kshs.`000'
Backlog depreciation	250	Balance b/f	514.2
Gearing adjustment	85.4	Asset revaluation	500.0
COSA	89.4	MWCA	56.0
Balance cf	828.2	Stock increase	4.0
	1,163.6		1,163.6

Current cost profit and loss account for the year ended 31 December 1999

	Ksh. '000'	Kshs. '000'
Operating profit		
Current cost adjustment		500
Depreciation		
COSA		
MCWA		
Current cost operating	(112.5)	(257.9)
profit	(89.4)	242.1
Gearing adjustment	(56.0)	
Less: interest payable		(14.6)
Current cost profit before	85.4	227.5
tax	(100.0)	(70.0)
Taxation		157.5
Current cost profit after tax		30.0
Dividends		127.5
Retained profit-current cost		

Current Cost Balance Sheet As at 31.12.20X9

	KSHS.`000'
Fixed Assets (NBV)	1,487.5
Net Current assets	
Stock	818.2
Trade debtors less trade creditors	450.0
Other current liabilities	(100)
Total assets less current liabilities	2,655.7
Deferred tax	(100.0)
Debentures	(600.0)
	1,955.7
Capital and Reserves	
Ordinary Shares	600
Current cost Reserves	828.2
Retained profit	527.5
	1,955.7

5.8 CURRENT COST ACCOUNTING (CCA)

Merits of CCA (also called Current Cost Deprival Value Model)

1. It is relevant to the needs of users of financial statements in;
   - Assessing the stability and sustainability of the business entity.
   - Assessing the vulnerability of a business against take over predators.
   - Evaluating the performance of management in maintaining and increasing the operating capacity of the business.

- Evaluating future performance.

2. CCA can be implemented easily by making adjustments to cost.

3. By excluding holding gains from profits CCA can be use to indicate whether or not a dividend should be paid.

4. Assets are valued not only at their current costs but after management has evaluated the opportunity cost of holding them and the benefit of their future use to the business.

WEAKNESS OF CCA

IAS 15 has been criticised on a number of grounds;

(a) The inclusion of a monetary working capital adjustment and a gearing adjustment:

- Causes problems of definition particularly in relation to cash and overdrafts.

- Treats preference share capital like equity, although it is in reality nearer to borrowings in terms of sources of finance. This is due to the need to show profit attributable to all shareholders, ordinary and preference as required by the Companies Act.
  The guidance notes suggest that where a company has material amount of preference shares with fixed repayment rights, it may wish to show in a note the effect of including preference share capital in net borrowings.

- Includes in borrowings such disparate items as taxation and debentures. While the latter might be expected to be maintainable in a constant ratio to equity (excluding preference shares) the former will IAS 12 vary in relation to taxable profit.

(b) It can be regarded that monetary working capital and gearing adjustments reflect some of the benefit of borrowing in a period of inflation, by allowing for the netting off or adding back of that portion of the realized holding gain's financed by monetary liabilities.
However, there is still no indication given of the real effect, in general purchasing power terms, of inflation on the investor's stake.

(c) Profits are not comparable in real terms from year to year, nor from company to company within one year.

(d) Treatment of backlog depreciation: It is debited to current cost reserve (reducing the unrealized holding gain on fixed assets). Would it be better to treat it as under-provision for depreciation in earlier years and it set against cumulative retained current cost profits? Otherwise cumulative retained current cost profits? Otherwise cumulative retained current cost profit will not represent the amount which can be distributed without depleting the operating capability.

Practical problems in operating current cost accounting

Amongst the practical problems encountered in operating current cost accounting are the following:

Selection of a suitable index

It is not always easy to obtain an index which is perfectly suitable for measuring the movement in the current cost of a particular type of asset. This need not be an insuperable problem because the company may be able to construct its own index or to apply one which gives results which do not materially distort result.

Overseas assets

It is often difficult to obtain a suitable index for use with overseas assets. Once again a proxy is often possible.

Valuation of specialist plant and buildings

It is often difficult to obtain a suitable market value for specialist items, but indices may be constructed as an alternative.

d) **There may be no intention to replace an asset, possibly due to a change in the nature of the business**
In such a case the current cost of the existing asset was not given relevant adjustments. Where a company is trying to maintain its operating capacity in a different area it should use a suitable index base on a possible replacement in the new field of activity.

e) **There may be no modern equivalent asset due to the advance of technology**
In such a case it is necessary to calculate what proportion of the cost of a new asset is required in order to maintain the volume of output and determine the current cost of the old equivalent there from. That part of the charge which gives added output or cost advantages should be disregarded.

f) **It may be difficult to audit some of the adjustments**
In practice it is generally no more difficult to verify these areas than other subjective aspects of accounting.

In addition to the above penalties, any person guilty of insider trading is liable to pay

Compensation to any person who in the transaction for the purchase or sale of securities, entered into with the insider, or with a person acting on his behalf, suffers loss, by reason of the difference between the price at which securities were transacted and the price at which they would have likely have transacted if the offence had not been committed. In the event the harm is done on the market as a whole, or those harmed cannot be reasonably and practicably determined, the payment shall be made to the Compensation Fund of the CMA. The amount of compensation to be paid is the amount of loss sustained by the person claiming compensation.

5.9 SUMMARY

The history of the development of a system of accounting for price level changes is important to an understanding of why most companies still report financial results using historic cost accounting principles. Therefore, it is highly recommended that you need chapters 4,5,6 and 7 of Lewis/ Pendrill -before you attempt the reinforcing questions that follow.

In general, HCA it preferred because of the following reasons:

- It's simplicity relative to inflation-adjusted systems makes it faster and cheaper to use
- It is widely understood as a basis for accounting, even among non-accountants. The same cannot be said for much of the inflation accounting that has been proposed.
- It is more objective than inflation-adjusted accounting, since most inflation-adjusted statements make debatable changes to the Historical Cost accounts.
- The tax authorities in most countries, Kenya included, has historically continued to make assessments on the historical cost profits.
- It is a tried and tested system, requiring no major, radical shifts in our traditional understanding of the theory and practice of accounting.
- The relative simplicity and objectivity make it more valuable for purposes of comparison than statements prepared on other bases.

REQUIREMENTS OF IAS 29 Financial Reporting in Hyperinflationary Economies

The objective of IAS 29 is to establish specific standards for enterprises reporting in the currency of a hyperinflationary economy, so that the financial information provided is meaningful.

Restatement of Financial Statements

The basic principle in IAS 29 is that the financial statements of an entity that reports in the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the balance sheet date. Comparative figures for prior period(s) should be restated into the same current measuring unit. Restatements are made by applying a general price index. Items such as monetary items that are already stated at the measuring unit at the balance sheet date are not restated. Other items are restated based on the change in the general price index between the date those items were acquired or incurred and the balance sheet date.

A gain or loss on the net monetary position is included in net income. It should be disclosed separately.

The Standard does not establish an absolute rate at which hyperinflation is deemed to arise - but allows judgment as to when restatement of financial statements becomes necessary. Characteristics of the economic environment of a country which indicate the existence of hyperinflation include:

- The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;
- The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;
- sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short; and
- The cumulative inflation rate over three years approaches, or exceeds, 100%.

IAS 29 describes characteristics that may indicate that an economy is hyperinflationary. However, it concludes that it is a matter of judgment when restatement of financial statements becomes necessary.

When an economy ceases to be hyperinflationary and an enterprise discontinues the preparation and presentation of financial statements in accordance with IAS 29, it should treat the amounts expressed in the measuring unit current at the end of the previous reporting period as the basis for the carrying amounts in its subsequent financial statements.

Disclosure

- Gain or loss on monetary items
- The fact that financial statements and other prior period data have been restated for changes in the general purchasing power of the reporting currency
- Whether the financial statements are based on an historical cost or current cost approach
- Identity and level of the price index at the balance sheet date and moves during the current and previous reporting period

CHAPTER SUMMARY

Classical school-Historical cost accounting: the capital is maintained by money terms.

Neo-classical: This includes the Historical cost accounting adjusted for changes in general purchasing power. This model makes sure that the purchasing power of the capital is maintained.

Modern School - Current Value Accounting: This model tries to maintain the operating capability of the entity.

Operating capability of the business entity is its ability to replace assets as they are consumed or worn out or its ability to produce the same volume or value of goods i.e. the next year as in the current year.

There are two main approaches to inflation accounting. These are:

(a) Current purchasing power accounting system and
(b) Current value systems

The **CPP** accounts attempts to maintain the shareholders' capital in terms of the general or consumer purchasing power. This is known as the **proprietorship concept of capital maintenance.**

Depreciation adjustment is the additional depreciation arising due to increase in prices of goods.

Monetary working capital adjustment represents the amount of additional (or reduced) finance needed for the monetary working capital as a result of changes in the input prices of goods and services used and financed by the business.

Cost of sales adjustment (COSA) is the additional cost of sales arising due to inflation.

Gearing Adjustment

This is the gain due to the shareholders as a result of financing the assets through loans.

CHAPTER QUIZ

1. What is the relationship between profit and capital?
2. What models are used to measure income?
3. Explain Accounting models.
4. What are the arguments against Historical Cost Accounting?

ANSWERS TO THE CHAPTER QUIZ

1. Thus the relationship between profit (income) and capital can best be expressed by the following equation:

   $I = D + (K_2 - K_1)$

Where	I	=	Income for the period
	D	=	Dividends or distribution
	K_2	=	Capital at the end of the period
	K_1	=	Capital at the beginning of the period

2. These can be broadly categorised into two:
   (a) Economic income model
   (b) Accounting models

3. Accounting models include:

(a) Classical school - Historical cost accounting the capital is maintained by money terms. If the entity has a historical cost of Shs 1,000 at the beginning of the year and Shs 1,000 at the end of the year (assuming no distributions and no injections or withdrawal of capital):

Income = Sh 1,500 - Sh 1,000 = Shs 500

This is the traditional approach to profit measurement.

(b) Neo-classical
This includes the Historical cost accounting adjusted for changes in general purchasing power. This model makes sure that the purchasing power of the capital is maintained.

(c) Modern School - Current Value Accounting
This model tries to maintain the operating capability of the entity. The operating capability of the business entity is its ability to replace assets as they are consumed or worn out or its ability to produce the same volume or value of goods i.e. the next year as in the current year.

4. Historical cost accounting is likely to fail because:

(a) The balance sheet figures for assets, based on cost at time of acquisition are unlikely to reflect present day values since they lack additivity. The balance sheet includes a conglomerate of costs incurred on different dates which will not enable users to “realistically predict future cashflows” related to those assets.

(b) If profit (income) is dependent on measure of capital at different dates, then profit measurement can be considered to be the result of comparing two fairly meaningless totals. In addition the profit that results is usually considered to be overstated and any ratio, including return on capital employed, will also be overstated.

(c) Historic cost profit give a misleading impression of the ability of a company to continue to operate at the same level of operation and/or maintain capital in `real terms' - problem of capital maintenance.

(d) A series of historic cost accounts can give a misleading impression of the financial trends of a company.

PAST PAPER ANALYSIS

Current purchasing power (CPP) accounting was tested in the following examinations:

06/'07

06/'04

12/'01

Current Cost Accounting (CCA) was tested in the following examinations:

12/'04

12/'03

12/'02

12/'00

EXAM QUESTIONS

QUESTION ONE

"Inflation accounting is an element but a useless creature with a prodigious appetite for extra data. It is the sterile offspring of a scandalous marriage between high financial economics and mismanaged economics".

Required:

a) In light of the above statement, summarise some of the arguments that can be advanced to defend Historical cost accounting. (8 marks)

b) What flaws exist under Historical cost accounting that can encourage setting of an accounting standard for firms operating under inflationary conditions. (8 marks)

c) Provide the criteria that should be used in the selection of appropriate accounting measurements in business reports. (4 marks)

(Total: 20 marks)

QUESTION TWO

Zetoxide Limited is a small chemical manufacturing company which supplies zetoxide to a number of major manufacturers in the rubber industry in the East African region. It operates a single production line in rented premises situated in the industrial area of Nairobi. On 1 April 20X0 it took advantage of falling rents in Nairobi to move into spacious premises at the same rent as it was paying previously. On the same date it sold its previous production line to a competitor and purchased a new cost-efficient production line that could be operated independently of electricity. The historic cost balance sheets as at 30 September 19X9 and 20X0 and the historic cost income statement for the year ended 30 September 20X0 as follows:-

Balance sheets as at 30 September

	19X9	20X0
Property, plant and equipment: Cost	6,000	116,000
Depreciation	(4,200)	(800)
	1,800	15,200
Current assets: Inventory	7,200	5,100
Trade receivables	6,300	8,000
Cost at bank	1,200	-
	14,700	13,100
Current liabilities:		
Bank overdraft	-	900
Trade payables	2,900	4,200
Current tax	2,300	-
	5,200	5,100
Net current assets	9,500	8,000
	11,300	23,200
Ordinary share capital 200,000 ordinary share of Sh.10	2,000	2,000
Retained earnings	8,400	12,000
Shareholders' funds	10,400	14,000
Non-current liabilities:		
Deferred tax	900	3,200
Debentures	-	6,000
	900	**9,200**
	11,300	**23,200**

Income Statement for the year ended 30 September 20X0

	Sh. '000'	Sh. '000'
Sales Revenue		96,000
Raw materials	(49,000)	
Changes in inventory	2,100	
	(46,900)	
Staff costs	(36,600)	
Depreciation	(800)	
Other operating expenses		(7,600)
		(91,900)
Profit from operations		4,100
Profit on sale of plant		2,100
Finance costs		(300)
		5,900
Taxation: Current	Nil	
Deferred	(2,300)	
		(2,300)
Net profit retained		**3,600**

Additional information:

- The directors of the company produce current cost accounts each year in addition to the historic cost accounts.
- Sales, purchases and expenses have occurred evenly over the year.
- Opening stock represents two months purchases closing stock represents one month's purchases.
- Debtors and creditors at each balance sheet date represent one month's sales and purchases.
- Zetoxide Ltd. depreciates property, plant and equipment, both for historic cost and current cost purposes, from the date of purchase of the asset pro-data with time at 10% per annum no depreciation is charged in the year of sale. The old plant sold on 1 April 19X0 had been purchased on 1 October 19X2.

The following price indices are appropriate:

	Old Plan	**New Plant**	**Stock Debtors Creditors**
1 October 1992	120	-	-
1 August 1999	238	-	360
1 September 1999	239	-	363
1 October 1999	**240**	**-**	366
1 April 20X0	-	250	384
1 August 20X0	-	267	395
1 September 20X0	-	271	398
1 October 20X0	-	275	402
Average for year ended 30 September 20X0	-	-	384

- Zetoxide Ltd. bases its current cost depreciation charge on the year end value of property, plant and equipment. Any current cost profit or loss on disposal is based on the depreciated current cost at the date of disposal. The cost of sales adjustment and the monetary working capital adjustment are both computed on the average method. No part of the bank balance or bank overdraft should be included in monetary working capital. The gearing adjustment is always computed on the simple arithmetic average gearing for the year.
- Zetoxide Ltd's current cost reserve as at 30 September 19X9 was Shs. 3,680,000

Required:

Zetoxide Ltd's Current Cost Profit and Loss Account starting with the historic cost profit before finance costs for the year ended 30 September 20X0. Its Current Cost Balance Sheet as at 30 September 20X0 and the reconciliation of the Current Cost Reserve for the year ended 30 September 20X0. Round all figures to nearest Sh. 000. **(20 marks)**

CASE STUDY

Recent evidence in Australian current value accounting practices: is the Phoenix rising from the ashes?

Article Abstract:

In Australian accounting regulations, there has been a perceptible trend towards current value accounting. A survey of 176 public Australian companies reveals that there is increasing acceptance and usage of current value accounting. However, large-scale corporate acceptance of current value accounting practices is likely to be hindered by business concerns over its implementation.

Source: www.google.co.ke- case studies on current value accounting.

CHAPTER SIX

PRESENTATION AND ANALYSIS OF FINANCIAL STATEMENTS (PART B)

CHAPTER SIX

PRESENTATION AND ANALYSIS OF FINANCIAL STATEMENTS (PART B)

OBJECTIVES

After this chapter, the student will be able to:

- Tackle capital reductions and reconstructions problems

INTRODUCTION

Reasons for reduction of capital

These may be summarized as follows:-

- When the whole of the paid-up capital is not represented by valuable assets. (for example, fixed assets may have become obsolete, or stock-in-trade depreciated by market conditions).
- When substantial trading losses have accumulated.
- When the company is over- capitalized , it being impossible to remunerate adequately all the existing capital.

A scheme may take the form of:-

- Capital reduction (C.A. 1948 s.66) or
- External reconstruction (C.A. 1948 s. 287)

DEFINITION OF KEY TERMS

Capital Reorganizations - this is a plain reorganization involving the internal alterations of a company's capital, usually to make the company more appealing, for the issuing of new capital to raise funds and/or to avoid liquidation. Such a re-organization will leave the company in existence but with a different capital structure with the old shareholders and possibly some creditors having different rights.

Capital Reconstruction - these are capital change schemes involving the formation of a new company with a different capital structure to salvage the assets of the existing company, which is then wound up.

Capital reduction – utilizes the credit released in a reduction of the share capital to write down asset values and write of accumulated losses

External reconstruction – formation of a new company to take over all or part of the assets and liabilities of a company possibly in financial difficulties.

▶ EXAM CONTEXT

In past examinations, the examiner has tested the students' knowledge in Capital reductions and reorganizations.

Students should therefore understand these topics.

▶ INDUSTRY CONTEXT

Capital Reductions and External Reconstructions show firms how to account for the same.

Management's Discussion and Analysis gives the government's management team the opportunity to explain the results of the financial decisions made during the year and their impact.

6.1 CAPITAL REDUCTIONS AND REORGANIZATIONS (RECONSTRUCTIONS)

LEGAL ASPECTS

Capital reduction

C.A 1948 s.66 requires the following:-

a) Authority in the articles

b) Special resolution

c) Approval of the court.

A capital reduction usually occurs where losses have been incurred and the share capital is no longer represented by available assets. It may also occur if:-

a) The company finds it has surplus cash funds and wishes to repay a part of the capital to the members.

b) The company has issued shares as partly paid and does not intend to cal up the uncalled capital.

External reconstruction

Under s. 287 of the Companies Act 1948 a reconstruction can be effected under the following procedure:-

a) The company resolves to wind up voluntarily

b) A special resolution is passed giving the liquidator authority to sell the undertaking to another company usually formed for the purpose.

c) When the liquidator sells the undertaking, he will receive shares or other securities in the new company for distribution to the members and possibly creditors of the old company.

A reconstruction may take place for any of the following objects:-

a) Raising fresh capital by issuing partly paid shares in the new company in exchange for fully paid shares in the old company.

b) Amalgamating two or more companies.

c) Rearranging capital and rights of members as between themselves.

d) Effecting a compromise with creditors, or the allotment to them of shares or debentures in settlement of their claims.

Sundry matters

- Two cases where capital reduction occurs without consent of the court:-
  - Where shares are forfeited.
  - Where shares are surrendered to avoid forfeiture

- Two cases of apparent capital reduction when in fact no actual reduction occurs:-
  - Redemption of redeemable preference shares under 1948 s. 58
  - Unmissed shares cancelled under 1948 s.61.

6.1.1 CAPITAL REDUCTION - Double entry

Transaction	Debit	Credit
Amount written off share capital	Share capital account	Capital reduction account
Amount written off share premium (if any)	Share premium account	Capital reduction account
Amount written off debentures (if any)	Debentures account	Capital reduction account
Amount by which company assets are written down	Capital reduction account	Profit and loss account
Debt balance on profit and loss account written off	Capital reduction account	Profit and loss account
Preliminary expenses written off	Capital reduction account	Preliminary expenses account.

6.1.2 EXTERNAL RECONSTRUCTION

FAST FORWARD: In an external reconstruction, the company to be reconstructed sells its assets less liabilities to a newly formed company.

The purchase consideration may be in the form of shares in the new company.

From an accounting point of view, an external reconstruction is merely in form of acquisition, requiring the closing of the vendor's books and the opening of the purchaser's books.

Entries in the purchaser's books are exactly the same as any other acquisition.

Entries in the vendor's books are dealt with below as there are slight variations in the accounts although the principles involved remain exactly the same.

Double entry

Transaction	Debit	Credit
Book value of assets being sold to new company	Realization and reconstruction accounts (above the line)	Sundry asset accounts
Debit balance on profit and loss account	Realization and reconstruction account (below the line)	Profit and loss account
Preliminary expenses not yet written off	Realization and reconstruction account (below the line)	Preliminary expenses account
Book value of creditors taken over by new company	Creditors account	Purchaser's account
Premium (if any) given to creditors in new company	Realisation and reconstruction account (below the line)	Purchaser's account

Book values of debentures taken over by new company	Debentures account	Purchaser's account
Premium (if any) given to debenture holders in new company	Realisation and reconstruction account (below the line)	Purchaser's account
Preference share capital in old company	Preference shares account	Sundry members' account
Ordinary share capital in old company	Ordinary shares account	Sundry members' account
Shares issued by new company to preference shareholders of old company at agreed value	Sundry members' account	Purchaser's account
Reconstruction costs paid by new company	Realisation and reconstruction account(below the line)	Purchaser's account
Balance on purchaser's account being purchase consideration	Purchaser's account	Realisation and reconstruction account(above the line)
Balance on realization and reconstruction account (above the line) being loss on realization	Realization and reconstruction account (below the line)	Realization and reconstruction account (above the line)
Balance on realization and reconstruction account (below the line) being capital reduction	Sundry members' account	Realization and reconstruction account (below the line)

CAPITAL REDUCTIONS AND REORGANIZATIONS

Broadly there are three types of circumstances where a company may seek approval for a capital reduction or reorganization. These are:

(a) Where there is partly paid share capital and the company wishes to reduce the liability for the unpaid portion.

(b) Where the company has excess capital and wishes to repay part of it.

(c) Where the company wishes formally to acknowledge that capital has been lost typically as a result of adverse trading or the loss of value of assets.

(These circumstances are discussed and explained on Pages 356-358 - Lewis/Pendrill)

The legal requirements necessary for one to carry out a capital reduction of any of the three types given above include:

- Authorization in the articles and
- A special resolution of the company; and
- Confirmation by the High Court (with an opportunity for the creditors to object).

>>> Illustration - A given Scheme of Capital Reduction

The following example will highlight the accounting requirement of any given Scheme of Reduction over the years ended 31 May 20X7 and 20X8 Seito Ltd has suffered heavy losses.

The board of directors formulated a scheme of reorganization, for which a special resolution was subsequently approved by the High Court. The consequences are shown below:

- Accumulated costs to date on the development which are to be written off because the project has had to be abandoned largely due to lack of financial resources.
- value of trademarks has been re-assessed at Kshs.24,000.
- Goodwill no longer possesses an attributable value and is to be written off.
- Tangible assets have been revalued as follows

Land and buildings	Kshs. 33,000
Plant and machinery	Kshs. 138,600

- Investment are to be sold at an estimated loss on disposal of Kshs.6,250 on book value (Kshs.62,670) which is to be regarded as part of the cost of the scheme.
- Following the abandonment of the development project, certain of the stock items are now unusable and cannot be used for other purposes. Amounts to be written off are as follows:

	Kshs.
Raw material and consumables	13,240
Work in progress	22,480
Finished goods	11,100

- Provision for bad debts deducted in arriving at trade debtors (Kshs.33,180) is to be increased by a further Kshs.2,600.
- Recoverable Tax has been carried forward since 20X6 and should be written off.
- No dividends have been declared on the 7% preference shares in the financial years 20X7 and 20X8

- The preference shareholders have agreed to receive new ordinary shares of Kshs.1 per share, fully paid, at par, as follows:

  (a) In exchange for their preference shareholding:2 new ordinary shares for every 3 existing preference shares
  b) As compensation for non-payment of 20X7 and 20X8 dividends. 1 new ordinary share for every existing preference shares.

- Trade creditors have agreed to accept `5,000 new ordinary shares of Kshs.1 per share, fully paid, at par, in full settlement of part of their claims against the company.

- The debit balance on profit and loss account is to be written off, together with the credit balance on share premium account (Kshs.15,000).

- The ordinary share capital is to be written down to Kshs.0.07 per share and then converted into new ordinary shares of Kshs.1 per share fully paid.

- An issue of new ordinary Kshs.1 shares at par is to be made for cash in such quantities as to raise the issued new ordinary share capital to an aggregate of 250,000 shares.

- The bank loans would then be repaid.

The Balance Sheet of Seito Ltd as at 31 May 20X8 appeared as follows:

	Kshs.	Kshs.
Non Current assets		
Intangible (at cost or valuation)		
Development costs (Note 1)	191,800	
Trade marks (Note 2)	54,000	
Goodwill (Note 3)	62,700	308,500
Tangible (at written-down value or valuation)		
Land and buildings	103,000	
Plant and machinery	194,600	
Fixtures, Fittings, Tools and Equipment	82,580	380,180
Investments (at cost)		
Other investments other than loans	43,450	
Other loans	19,220	62,670
		751,350
Current Assets		
Inventory		
Raw materials and consumables	37,960	
Work in progress	46,510	
Finished goods	27,070	
		111,540
Receivables		
Trade	38,180	
Other (Bills Receivable)	10,550	
Tax recoverable	17,630	
Cash at bank and in hand	28,430	
		206,330
Payables (amounts due in less than one year)		
Debenture loans	45,000	
Bank loans	100,000	
Trade	127,230	
Bills payable	5,040	
Other creditors (including taxation)	29,210	
		306,480
Net current assets/(liabilities)		(100,150)
Total assets less current liabilities		651,200
Creditors (amounts due in more than one year)		
Debenture loans		(90,000)
		561,200
Capital and Reserves		
Called-up share capital (Note 5)		600,000
Share premium	15,000	
Revaluation Reserve (Note 4)	76,400	
Retained profits	(130,200)	(38,800)
		561,200

STUDY TEXT

The Balance Sheet of Seito Ltd as at 31 May 20X8 appeared as follows:

- These costs have been incurred in the development of a new high security communications system.

- This is the purchase of the "Hermus" trade mark when Seito acquired all the assets of Hermes and Company for cash in 20X3.

- Goodwill arose on the occasion of the acquisition referred to in Note 2 (above), the unamortised portion of which is Kshs. 62,700.

- Seito's tangible fixed assets were revalued in 20X3 and the following amounts were credited to revaluation reserve:

	Kshs.
Land and Buildings	70,000
Plant and Machinery	6,400
	76,400

- The share capital of Seito consisted of:

	Authorised	Issued
	Kshs.	Kshs.
50,000 7% preference shares of Kshs.1 per share fully paid	50,000	30,000
760,000 ordinary shares of Kshs.1 per share, 75p paid	760,000	570,000
	810,000	600,000

Required:

(a) Prepare the Accounting Journals that could be necessary to reflect the scheme.

(b) Prepare the capital deduction account

(c) Prepare the summarised balance sheet after reconstruction, assuming that all the reconstruction events occured after close of business on 31 May 20X8.

Solutions (a)

Ref Particulars	Debit	Credit
	Kshs.	*Kshs.*
1. Capital Deduction A/c	191,800	
Development costs		191,800
2. Capital Deduction A/c	30,000	
Trade Marks		30,000
3. Capital Deduction A/c	62,700	
Goodwill		62,700
4. Capital Deduction A/c	126,000	
Land and Buildings		70,000
Plant and Machinery		56,000
5. Capital Deduction A/c	6,250	
Cash at Bank	56,420	
Investments		62,670
6. Capital Deductions A/c	46,820	
Raw Materials and consumables		13,240
Work in progress		22,400
Finished goods		11,100
7. Capital Deduction A/c	2,600	
Trade Debtors		2,600
8. Capital Deduction A/c	17,630	
Tax Recoverable		17,630
9. Preference share capital Kshs.1 per share	30,000	
Ordinary share capital Kshs.1 per share		20,000
Capital Deduction A/c		10,000
9. Capital Deduction A/c (3,000/10 x 1)	3,000	
Ordinary shares capital Kshs.1 per share		3,000
10.Trade creditors	15,000	
Ordinary share capital Kshs.1 per share (15,000 x 1)		15,000
11.Capital Deduction A/c	130,200	
Profit and loss A/c		130,200
11. Share Premium A/c	15,000	
Capital Deduction A/c		15,000
12. Old Ordinary Share Capital (760,000 x 0.07)	570,000	
New ordinary shares capital (0.07 x 760,000)		53,200
Capital Deductions (760,000 x (0.75 - 0.07)		516,800
13. Compute the required share capital to be issued for cash		
New Share Capital (No 12 above)	53,200	
Add: Preference Shares Capital (No 9 above)	20,000	
Add: Dividend waiver (No 9 above)	3,000	
Add: Trade Creditors discharge (No 10 above)	15,000	
	91,200	
Cash issue (balancing figure)	158,800	
Required Share Capital	250,000	
13. Cash	158,800	
Ordinary Share Capital Kshs.1 per share		158,800
14. Bank loans	100,000	
Cash		100,000

(b) The Capital Deduction A/c is as follows:

(a) **CAPITAL REDUCTIONS A/C**

REF PARTICULARS	KSHS.	REF PARTICULARS	KSHS.
DEVELOPMENT COSTS	191,800	PREFERENCE SHARE CAPITAL	10,000
TRADEMARKS	30,000	SHARE PREMIUM A/C	
GOODWILL	62,700	ORDINARY SHARE REDUCTION	15,000
LAND AND BUILDINGS	62,700	ORDINARY SHARE REDUCTION	516,800
LAND AND BUILDINGS	70,000	REVALUATION RESERVE	76,400
PLANTAND MACHINERY	56,000		
LOSS ON INVESTMENTS	6,250		
Raw material & CONSUMABLES	13,240		
WORK-IN-PROGRESS	22,480		
FINISHED GOODS	11,100		
TRADE DEBTORS	2,600		
TAX RECOVERABLE	17,630		
PREFERENCE SHARE CAPITAL	3,000		
PROFIT & LOSS A/C	130,200		
Share premium (2 x 7% x 30,000 - 1/10 x 30,000)	1,200		
	618,200		618200

STUDY TEXT

(c)

SEITO LTD

BALANCE SHEET AS AT 31 MAY 20X8

	Kshs.	**Kshs.**
Non Current assets		
Intangible (at valuation)		
Trade Marks	24,000	
Tangible (at valuation)		
Land and Buildings	33,000	
Plant and Machinery	138,600	
Fixtures, fittings, tools & equipment	82,580	
Current Assets		
Inventory:		
Raw materials and consumables	24,720	
Work in progress (46,510 – 22,480)	24,030	
Finished goods (27,070 – 11,100)	15,970	
	64,720	
Receivables		
Trade (38,180 – 2,600)	35,580	
Other	10,550	
Cash at bank and in hand	143,650	
	(254,500)	
		254,180
Payables (amounts due in less than one year)		278,180
Debentures loans	45,000	
Trade (127,230 – 15,000)	112,230	
Bills of exchange payable	5,040	
Other creditors (including taxation)	29,210	
	191,480	
Net Current Assets	63,020	
Total assets less current liabilities	341,200	
Payables(amounts due in more than one year):		
Debenture loans	(90,000)	
	251,200	
Capital and Reserves		
Called-up Share Capital	250,000	
Share premium	1,200	
	251,200	

Note:

The practical effects of most capital reduction schemes is a weakening of the formal position of participants other than the ordinary shareholders. For instance, in the example above - Seito Ltd - the position of preference shareholders is apparently severely weakened by the implementation of the scheme of capital reduction. Before the capital reduction the preference shareholders owned shares with a nominal value of Kshs.30,000 plus arrears of dividends, apparently worth Kshs.4,200. After the reduction they have ordinary shares with nominal value Kshs.23,000 and a book value of Kshs.23,092 (i.e 23,000/250,000 x 251,200) this is an apparent loss in value of Kshs.11,108 (Kshs.34,200 - Kshs.23,092).

The Shires Property Construction Co. Ltd Journal entries

(1)	Ordinary shares of Kshs.1 each	200,000	
	Ordinary shares of 25p each		50,000
	Reconstruction account		150,000

Redesignation of issued ordinary share capital as 25p shares (formerly Kshs.1 shares) and transferring excess nominal value to reconstruction account.

(2)	5% Cumulative preference shares of Kshs.1 each	70,000	
	8% Cumulative preference shares of Kshs.1 each		35,000
	Ordinary shares of 25p each		35,000

Exchange of 5% preference shares for 8% preference shares and 25p ordinary shares.

(3)	Cash	60,000	
	Ordinary shares of 25p each – 200,000		50,000
	Share premium account 5p – 200,000		10,000

Issue of 200,000 25p ordinary shares at a premium of 5p to present ordinary shareholders.

(4) (a)	Interest payable on debentures	12,800	
	Ordinary shares of 25p each – 20,000		5,000
	Reconstruction account – difference		7,800

Capitalization of unpaid debenture interest

(b)	8% Debentures 19X12	80,000	
	9.5% Debentures 19X12		80,000

Increase in interest rate on 19X12 Debentures to 9.5%

(c)	Cash	8,100	
	Reconstruction	900	
	9.5% Debenture 19x12		9,000

Issue of Kshs.9,000 debentures at a discount of 0%
(Note the Kshs.900 could have been debited to share premium account)

STUDY TEXT

(5)	Loans from directors	16,000	
	Ordinary shares of 25p each – 10,000		2,500
	Share premium		7,500
	Reconstruction account (amount of loans cancelled)		6,000

Capitalisation and writing off of directors' loans

(6)	Reconstruction account	99,821	
	Goodwill		60,000
	Profit and loss account		39,821

Writing off of goodwill and debit balance on profit and loss account

(7)	Cash	60,000	
	Investment in shares quoted		27,000
	Reconstruction account		33,000

Sales of shares at a profit of Kshs.33,000

(8) No journal entry required

(9)	Trade creditors	46,000	
	Cash		46,000

(10)	Reconstruction account	7,069	
	Debtors		7,069

Writing off of bad debts.

(11)	Land	66,000	
	Building	52,754	
	Equipment	754	
	Stock and work-in-progress	70,247	
	Reconstruction account	84,247	
	Revaluation of fixed assets	Kshs.137,001	Kshs.137,001

(b) **The Shires Property Construction Co. Ltd**
Balance Sheet as at 1 January 20X0 (after reconstruction)

Non Current assets	Kshs.	Kshs.
Land at valuation		90,000
Building at valuation		80,000
Equipment at valuation		10,000
		180,000
Current assets		
Inventory		
Receivables		
Cash		
Payables: amounts falling due within one year Trade	50,000	
Net current assets	63,623	
Total assets less current liabilities	45,387	288763
9.5% Debenture 20X12	159010	(90000)
		199,763
	(50,247)	
Called up share capital	108,763	
Issued ordinary shares of 25p each		142,500
Issued 8% cumulative preference shares of Kshs.1 each		35,000
		17,500
Trade creditors		
Share premium account		4,763
		199,763

(c) Division of pre-tax profit

Interested parties before reconstruction After reconstruction

	Kshs.	Kshs.	Kshs.
Debenture holders			
Gross interest (W2)	6,400		8,455
5,000 ords (W4)	-		1,360
	6,400		9,815
Preference shareholders			
Dividend (W3)	3,500	2,800	
35,000 ords (W4)			12316
		9,516	
Directors (W4)			680
Ordinary shareholders			
Balance (W4)			
	40,100		27,189
	Kshs. 50,000		Kshs. 50,000

(d) Comments on the capital structure

Gearing is $\frac{\text{Kshs.35,000 + Kshs.89,000}}{\text{Kshs.288,763}}$ = 43%

Whether gearing is viewed as high or not depends upon the current economic climate. It will however reduce when the large debenture s paid off in 20X2. Indeed, dividends on ordinary shares will have to be very restrained if cash is to be available to redeem the debentures. Alternatively, debenture holders might agree to exchange them for ordinary shares.

The shareholders funds cover the cost of the fixed assets. The capital structure is reasonably satisfactory.

The debenture holders have done very well. Their interest has been increased by 1% but the redemption date has not been changed. The 10% capital gain over a period of less than three years is another advantage.

WORKINGS

(W1) Trial balance after reconstruction

	Dr. Kshs	Cr. Kshs
Land	90,000	
Building	80,000	
Equipment	10,000	
Stock	50,000	
Debtors	63,623	
Cash	45,387	
Ordinary shares of		142,500
8% Cumulative preference shares of		35,000
Kshs.1		89,000
9.5% Debenture 20X12		50,247
Trade creditors		17,500
Share premium account		4,763
Reconstruction account	339,010	339,010

(W2) Debenture interest gross

Before 8% x Kshs.80,000 = Kshs.6,400

After 9.5% x Kshs.89,000 = Kshs.8,455

This does of course include interest on capitalized interest

(W3) Preference dividends

Before 5% x Kshs.70,000 = Kshs.3,500

After 8% x Kshs.35,000 = Kshs.2,800

(W4) The balance of the profits of Kshs.50,000 belongs to ordinary shareholders

	Kshs.	Kshs.	Kshs.	Kshs.
Before Interest	50,000			50,000
Less: Debenture	(6,400)			
Interest			(8,455)	
Preference div.	(3,500)	(9,900)	(2800)	11,255
Available for ordinary Shareholders		40,100		38,745

STUDY TEXT

After

	Shares
Issued share capital	
Debenture holders	20,000
Preference shareholders	140,000
Directors' shares	10,000
Other shareholders	400,000
	570,000

Profits available to pay dividends

		Kshs.
Debenture holders	20,000/570,000 x Kshs.38,745	1,360
Preference shareholders	140,000/570,000 x Kshs.38,745	9,516
Directors	10,000/570,000 x Kshs.38,745	27,189
		38,745

6.1.3 LIQUIDATION OF A COMPANY

The Legal Requirements

To put a company into voluntary liquidation requires only a special resolution to be passed by members. Once a company has taken the necessary legal steps to effect the liquidation, any assets left after satisfying the claims of creditors may legally be transferred to shareholders. The distinction between one part of the shareholders' claim and another becomes irrelevant since on liquidation all of the shareholders' claim becomes distributable.

The Procedure in the liquidated company

1. The assets of the old company are sold to the new company for a value based on their market price. The new company typically undertakes to issue shares (in the new company) to satisfy the consideration for this transaction.

2. The old company will then use the consideration to pay off creditors (including loan stock/debenture holders) and, if anything is left, to satisfy, partially or fully, the claims of the preference and ordinary shareholders of the company. The absence of cash may mean that the creditors will need to be persuaded to become creditors of the new company so that the reconstruction can proceed. To do this the creditors may need to be offered an inducement such as an increased claim.

Accounting entries in the books of the liquidated company

FAST FORWARD: The liquidation of a company is very similar to the dissolution of a partnership (Read Chapter 6 - Jennings).

It involves the opening of the following accounts in the books of the old company**.**

- The Sundry Members A/c - takes all shareholders claim (share capital plus various reserves).
- Realisation account - the assets to be sold to the new company are transferred to this account and their disposal proceeds are credited to it. The account is also charged with any costs of liquidation and realisation to be borne by the old company. The balance will represent a surplus or deficit on disposal which must be transferred to the sundry members account.
- Purchaser's account - this is the personal account of the purchases of the old company's assets i.e. the new company. This account is debited with the amount of the consideration and credited with the actual payment in whatever form it takes.

Let's briefly look at the required bookkeeping entries involved with liquidating the old company.

Dr.	Realisation account	xxx	
	Cr. Various asset account		xxx

(To transfer the book value of all assets to be sold to the new company)

Dr.	Realisation account	xxx	
	Cr. Cash account		xxx

(Being the cost of liquidation or Realisation expenses incurred)

Dr.	Realisation account	xxx	
	Cr. Creditors account		xxx

(Being any enhancement/premium given to creditors (e.g. debenture holders) to encourage acceptance of the reconstruction scheme).

Dr.	Realisation account	xxx	
	Cr. Purchaser account		xxx

(Being the value of the consideration for the assets sold to the new company)

The balance in the realisation account should now be transferred to the Sundry members account.

Dr. Creditors account xxx

Cr. Cash account xxx

(Being cash paid to discharge creditors)

Dr. Creditors account xxx

Cr. Purchaser account xxx

(Being any shares or debentures in the new company which the creditors have agreed to accept to discharge their claim against the old company).

Dr. Sundry members xxx

Cr. Purchaser's account xxx

(Being any shares in the new company which the old company shareholders have agreed to accept under the liquidation).

Let's use the following example to illustrate the above procedure.

>>> Example:

The summarised Balance Sheet of ERIOKI Ltd on 31 December 20X1 was as follows:

	Kshs.	Kshs.
PPE (net of depreciation)		76,000
Current assets		
Inventory	22,000	
Trade receivables	15,000	
Cash	20,000	
	57,000	
Less: Creditors: amounts falling due within one year		
Trade payables	18,000	39,000
		115,000
Less: Creditors: amounts falling due after more than one year		(60,000)
10% debentures		55,000
Capital and Reserves		
Ordinary shares of Kshs. 1 each fully paid	80,000	
Share premium account	15,000	
Profit and loss account	(40,000)	55,000

The necessary special resolution to liquidate the company at 31 December 20X1 has been passed and a new company ERIOKI (20X2) Ltd is formed.

The following has been established.

- The trade creditors insist on full payment in cash.
- The 10% debenture holders have agreed to accept Kshs.66,000, 12% debentures in ERIOKI (20X2) Ltd in full discharge of their claim against ERIOKI Ltd.
- The shareholders' claim will be settled by the issue, at par, of ordinary Kshs.1 shares of ERIOKI (20X2) Ltd, sufficient to meet the claim in full.
- The assets of ERIOKI Ltd, after settlement of the creditors are all to be acquired by ERIOKI (20X2) Ltd at the following valuations:

	Kshs.
Fixed Assets	70,000
Stock	21,000
Trade debtors	15,000

Required:

Write up the following accounts in the books of ERIOKI Ltd to record the transactions specified above:

(a) Cash account
(b) Realisation account
(c) Sundry members account
(d) Purchaser (ERIOKI (20X2)) Ltd account
(e) 10% debentures account

Solution

BOOKS OF ERIOKI LTD

(a) CASH ACCOUNT

	KSHS.			KSHS.
31.12.X1 BALANCE C/D	**20,000**		**31.12.X1 TRADE CREDITORS**	**18,000**
			31.12.X1 REALISATION	**2,000**
	20,000			20,000

	Kshs.		Kshs.
31.12.X1 Balance c/d	20,000	31.12.X1 Trade creditors	18,000
		31.12.X1 Realisation	2,000
	20,000		20,000

(b) REALISATION ACCOUNT

	Kshs.		Kshs.
31.12.X1 Cash	76,000	31.12X1 Stock	21,000
PPE	22,000	Trade debtors	15.000
Inventory	15,000	Fixed Assets	70,000
Trade receivables	6,000		
Premium on debentures	2,000	Sundry members	
Cash		(deficit on realisation)	15,000
	121,000		121,000

(c) SUNDRY MEMBERS ACCOUNT

31.12.X1 Profit loss 40,000 31.12.X1 Ordinary shares 80,000

	Kshs		Kshs
Realisation	15,000	Share Premium	15,000
Purchaser	40,000		
	95,000		95,000

(d) PURCHASER (ERIOKI (20X2)) ACCOUNT

		Kshs.			Kshs.
31.12.X1	Realisation	106,000	31.12.X1	10% debentures	66,000
				Ordinary Kshs.1 shares	40,000
		106,000			106,000

(e) 10% DEBENTURES ACCOUNT

		Kshs.			Kshs.
31.12.X1	Purchaser 12%	66,000	31.12.X1	Balance c/d	60,000
	debentures in ERIOKI (1992) Ltd			Realisation	6,000
		66,000			66,000

Accounting Treatment in the books of the new company

— This is well covered in Jennings Chapter 1 Pages 245-265 otherwise it is relatively straightforward. As is typically the case where a company takes over an existing business as a going concern, the consideration for the share issue and debentures is in the form of assets generally, not just cash.

— Any shortfall in the nominal value of the shares issued by the new company below the value of the assets to be taken over, net of any debentures issued by the new company as part of the consideration, will be share premium. This must be treated as such in the accounts of the new company.

— Generally, one should debit the asset accounts with the assets taken over, credit the liability accounts (including debentures) with the liabilities assumed and credit the share capital account and possible share premium account with the nominal value of the shares issued.

— Closing entries in the books of the old company should be made. The following transactions will be found in practice (and in examinations).

Dr. Various asset accounts
Cr. Vendor (old company) account

With the assets to be acquired at the agreed value). Note that the agreed value is not necessarily the book value of the assets in the accounts of the old company.

Dr.	Vendor (old company) account	xxx	
Cr.	Various creditors accounts		xxx

(With the creditors taken over by the new company at the agreed value)

Dr.	Vendor (old company) account	xxx	
Cr.	Share capital account		xxx

(With the nominal value of the shares to be issued. If the shares are to be issued partly paid, the paid up portion of the nominal value will be the appropriate figure)

Dr.	Vendor (old company) account	xxx	
Cr.	Share premium account		xxx

(With any excess of the agreed value of net assets agreed value less agreed liability values) over the nominal (or paid up) value of the shares issued.

Note:

If there were an excess of nominal (or paid up) value over net asset values, it would amount to a share issue at a discount. This would be illegal.

>>> Example:

Consider the previous example - ERIOKI Ltd. Open all the relevant accounts in the books of ERIOKI (20X2) Ltd and make the appropriate entries to record the opening transactions. Also show the balance sheet of the new company immediately following these transactions.

Solutions Books of ERIOKI (20X2) Ltd

Fixed Assets	**Kshs.**	**Kshs.**
31.12.X1 Vendor		70,000

Stock in Trade	**Kshs.**	**Kshs.**
31.12.X1 Vendor		21,000

Trade Debtors

	Kshs.	**Kshs.**
31.12.X1 Vendor		15,000

Vendor (ERIOKI Ltd)

31.12.X1 Vendor	66,000	

Ordinary Shares of Kshs.1 each		**Kshs.**	**Kshs.**
31.12.X1	Vendor	42,000	

Cash		**Kshs.**	**Kshs.**
31.12.X1	Vendor	2,000	

		Kshs.		Kshs.
31.12.X1 12% Debentures		66,000	31.12.X1 Fixed Assets	70,000
Ordinary shares		42,000	Stock in Trade	21,000
			Trade debtors	15,000
			Cash	2,000
		108,000		108,000

ERIOKI (20X2) LTD

Balance Sheet

As at 31 December 20X1

	Kshs.	**Kshs.**
PPE (at valuation)		70,000
Current Assets:		
Stock in trade	21,000	
Trade debtors	15,000	
Cash	2,000	38,000
		108,000
Less: creditors: amounts falling due after more than one year		(66,000)
		42,000
Capital and Reserves		42,000
Ordinary shares of Kshs. 1 each, fully paid		

6.1.4 SUMMARY

Remember, there are almost limitless variations on the precise arrangements of the bookkeeping entries involved in accounting for capital reconstructions. It is not, therefore, practical to cover them all and we have only considered the basic ones. Provided you understand the principles of what you are doing it should be easy for you to deduce the correct treatment of any "variations".

Also the examiner may require you to design the reconstruction scheme especially for capital reorganization. It should not be difficult if you note the following points - steps to follow.

(a) Determine losses to be written off which includes:

- Debit balance in the profit and loss account
- Fictitious assets
- Under provisions for liabilities
- Arrears of dividends - for preference share capital

(b) Evaluate the asset cover for different parties in the event of liquidation

(c) Ensure that the scheme you design is

- Fair in its own right.
- Creditors should be secured, unless the value of security is inadequate.
- Preferential creditors should normally be ranked high.
- Then followed by debenture holders secured by a floating charge who may be induced to accept a reduction of their claim if there is a possibility of a loss in the event of a liquidation or compensate them by increasing the interest rate or allot them ordinary shares.
- Unsecured creditors may be forced to make sacrifices if the company is insolvent and most likely compensate them by issue of equity shares.
- Also the preference shareholders may be willing to sacrifice if they cannot be paid in full. Most probably, they may be compensated by increasing the rate of their dividends or an issue of equity shares or bonds whichever is appropriate.
- The equity shareholders normally bear the major sacrifice. Usually, the existing shareholders would be required to subscribe for additional shares so that they can raise working capital for the company being reconstructed.

(d) A Balance Sheet after a scheme of reconstruction is effected to reflect reconstruction is effected to reflect the financial position of the company reconstructed or the new company formed.

(e) Future estimates of profit and how it can be shared among the various parties concerned is also necessary.

Otherwise, the following points should always be considered where one is effecting or implementing an already designed scheme of - Capital Reorganization.

- It is an alternative to liquidation/winding up
- It must meet the legal requirements i.e. the parties must pass a special resolution,

be permitted by the articles, and must pass a special resolution, be permitted by the articles, and must be confirmed and registered by the court

- There should be prospects of the company pulling through i.e there should be prospects of making profits in the future
- It must be essential to do a reconstruction
- The scheme should be equitable
- The scheme should maintain the existing control
- There should be sufficient provision for working capital
- Any pressing loans or claims and liabilities should be carefully catered for

6.2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Source: Milestone Professional Services

The purpose is to provide introduction to the basic financial statements and provide analytical overview of the government's financial activities.

Management's Discussion and Analysis should be prepared by the governmental unit and not the auditors.

6.2.1 Overview of MD&A

MD&A should help the reader of the financial statements understand whether the government's financial position has improved as compared to the prior year. This is from management's perspective and with the insight available from that perspective.

6.2.2 Basic Guidelines

MD&A is included in RSI – Impact of this:

- Only required elements can be included.
- Other management discussion items can be included in Letter of Transmittal
- Required for CAFRs and AFR
- Location: Precedes the basic financial statements.
- Included in Financial Section of the financial statements

- Generally follows the Letter of Transmittal (if included) and auditor's opinion

- Analysis of Basic Financial Statements
  - Objective
  - Easy to read
  - Based on currently known information
  - Both short and long term focused
  - Based on management's understanding of financial report and fiscal policy
  - Comparative – both negative and positive
  - Use of charts and graphs to enhance the reader's understanding
  - Focus is on primary government
  - Avoid "boilerplate" approach

6.2.3 Specific requirements

- Discussion of basic financial statements and their relationship to each other including significant differences in the information they provide.

  - Purpose is to help readers of MD&A understand the relationship of the results reported in the governmental funds financial statements and those reported for governmental activities
  - The cause of these differences should be evident in the reconciliations accompanying the fund financial statements.
  - What types of questions should this address?

- How are the statements similar and how are they different?

- What activities are accounted for?

- How are these activities similar and how are they different, and how is this evident in the statements?

- Condensed financial information derived from government-wide financial statements.

  - Should compare current to prior year
  - Should include specific elements

- Total assets, distinguishing between capital and other assets

- Total liabilities, distinguishing between long-term and other liabilities

- Total Net Assets, distinguishing among amounts invested in capital assets, net of related debt; restricted amounts and unrestricted amounts

Sample Table

CITY OF CASSELBERRY, FLORIDA

STATEMENT OF NET ASSETS

September 30, 2006

City of Casselberry
Stmt of Changes in Net Assets
September 30, 2006

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Revenues						
Charges for services	$ 2,895,708	$ 2,743,289	$ 11,603,865	$ 10,775,251	$ 14,499,573	
Operating grants and contributions	748,768	1,770,817	-	71,833	748,768	1,842,650
Capital grants and contributions	274,244	67,294	691,008	115,148	965,252	182,442
General Revenues					-	
Property Taxes	,351,781	5,156,690	-	-	5,351,781	5,156,690
Other Taxes	6,921,771	6,452,127	-	-	6,921,771	6,452,127
Other	5,122,524	4,667,290	639,250	365,741	5,761,774	5,033,031
Total Revenues	21,314,796	20,857,507	12,934,123	11,327,973	34,248,919	32,185,480
	5,212,638	3,351,170	-	-	5,212,638	3,351,170
	11,037,425	10,248,677	-	-	11,037,425	10,248,677
	1,342,321	171,731	-	-	1,342,321	171,731
	2,299,073	4,351,339	-	-	2,299,073	4,351,339
	94,551	144,327	-	-	94,551	144,327
	1,992,179	1,451,166	-	-	1,992,179	1,451,166
	615,250	238,546	-	-	615,250	238,546
	-	-	8,932,310	8,641,538	8,932,310	8,641,538
Total Expenses	22,593,437	19,956,956	8,932,310	8,641,538	31,525,747	28,598,494
	(1,278,641)	900,551	4,001,813	2,686,435	2,723,172	3,586,986
Transfers	1,907,843	1,384,264	(1,907,843)	(1,384,264)	-	-
	629,202	2,284,815	2,093,970	1,302,171	2,723,172	3,586,986
	30,719,659	29,084,243	31,695,120	30,392,949	62,414,779	59,477,192
	$ 31,348,861	$ 31,369,058	$ 33,789,090	$ 31,695,120	$ 65,137,951	$ 63,064,178

For MD&A Content

	$ 31,348,861	$ 33,789,090	2,723,172
	$ 30,719,659	$ 31,695,120	3,586,986
	$ 629,202	$ 2,093,970	(863,814)
	2.0%	6.2%	

Elements of the condensed financial information cont.

- Program revenues, by major source
- General revenues, by major source
- Total Revenues
- Program expenses at least by function
- Total expenses
- Excess (deficiency) before contributions
- Contributions
- Special and extraordinary items
- Transfers
- Change in Net Assets
- Ending Net Assets

Sample Table (Part 1)

City of Casselberry
Stmt of Changes in Net Assets
September 30, 2006

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
venues						
gram Revenues						
Charges for services	$ 2,895,708	$ 2,743,289	$ 11,603,865	$ 10,775,251	$ 14,499,573	$ 13,518,540
Operating grants and contributions	748,768	1,770,817	-	71,833	748,768	1,842,650
Capital grants and contributions	274,244	67,294	691,008	115,148	965,252	182,442
neral Revenues					-	
Property Taxes	5,351,781	5,156,690	-	-	5,351,781	5,156,690
Other Taxes	6,921,771	6,452,127	-	-	6,921,771	6,452,127
Other	5,122,524	4,667,290	639,250	365,741	5,761,774	5,033,031
Total Revenues	21,314,796	20,857,507	12,934,123	11,327,973	34,248,919	32,185,480

Sample Table (Part 2)

Stmt of Changes in Net Assets
September 30, 2006

	Governmental Activities		**Business-type Activities**		**Total**	
	2006	2005	2006	2005	2006	2005
Expenses						
General Government	5,212,638	3,351,170	-	-	5,212,638	3,351,170
Public Safety	11,037,425	10,248,677	-	-	11,037,425	10,248,677
Physical Environment	1,342,321	171,731	-	-	1,342,321	171,731
Transportation	2,299,073	4,351,339	-	-	2,299,073	4,351,339
Human Services	94,551	144,327	-	-	94,551	144,327
Culture/Recreation	1,992,179	1,451,166	-	-	1,992,179	1,451,166
Interest on Long-Term Debt	615,250	238,546	-	-	615,250	238,546
Water and Wastewater	-	-	8,932,310	8,641,538	8,932,310	8,641,538
Total Expenses	22,593,437	19,956,956	8,932,310	8,641,538	31,525,747	28,598,494

Sample Table (Part 3)

Stmt of Changes in Net Assets
September 30, 2006

	Governmental Activities		**Business-type Activities**		**Total**	
	2006	2005	2006	2005	2006	2005
Change in Net Assets - before transfers	(1,278,641)	900,551	4,001,813	2,686,435	2,723,172	3,586,986
Transfers	1,907,843	1,384,264	(1,907,843)	(1,384,264)	-	-
Change in Net Assets	629,202	2,284,815	2,093,970	1,302,171	2,723,172	3,586,986
Net Assets – Beginning	30,719,659	29,084,243	31,695,120	30,392,949	62,414,779	59,477,192
Net Assets – Ending	$ 31,348,861	$ 31,369,058	$ 33,789,090	$ 31,695,120	$ 65,137,951	$ 63,064,178

Specific requirements cont.

- Analysis of government's overall financial position and results of operations
  - Purpose is to assist users to evaluate whether financial position has improved or deteriorated
  - Analysis should address governmental and business-type activities
  - Information should be from the government-wide statements
  - Reasons should be included not just amount and percentage changes

STUDY TEXT

Specific requirements cont.

- Analysis of government's overall financial position and results of operations
  - Purpose is to assist users to evaluate whether financial position has improved or deteriorated
  - Analysis should address governmental and business-type activities
  - Information should be from the government-wide statements
  - Reasons should be included not just amount and percentage changes

Sample Table

Governmental

Functions/Programs	**Expenses**	**% of Total**	**Program Revenues**	**% of Total**	**Net (Expense) Revenue**
General Government	$ 5,212,638	23.1%	$ 314,424	8.0%	$ (4,898,214)
Public Safety	11,037,425	48.9%	1,448,769	37.0%	(9,588,656)
Physical Environment	1,342,321	5.9%	1,713,987	43.7%	371,666
Transportation	2,299,073	10.2%	132,962	3.4%	(2,166,111)
Economic Environment	-	0.0%	4,318	0.1%	4,318
Human Services	94,551	0.4%	481	0.0%	(94,070)
Culture/Recreation	1,992,179	8.8%	303,779	7.8%	(1,688,400)
Interest on Long-Term Debt	615,250	2.7%	-	0.0%	(615,250)
	$ 22,593,437	100.0%	$ 3,918,720	100.0%	$ (18,674,717)

Business-Type

Functions/Programs	**Expenses**	**Program Revenues**	**Net (Expense) Revenue**
Water & Wastewater	$ 8,932,310	$ 12,294,873	$ 3,362,563

For use in MD&A

Govt funds revenues	21,459,682	CY
	22,410,111	PY
	(950,429)	Change
	-4.2%	
Govt funds expend	22,560,973	CY
	27,227,591	PY
	(4,666,618)	Change
	-17.1%	

Utility Net Assets	33,789,090	CY
	31,695,120	PY
	2,093,970	Change
	6.6%	

GF Total FB	6,642,830
GF Unrestricted FB	5,946,450
GF total expend	20,122,077
	29.6%
	33.0%

Govt Fund Balances	$ 16,806,627	CY
	15,800,664	PY
	1,005,963	Change

Sample Table

Governmental		
Program Revenues		
Charges for services	$ 2,895,708	12.5%
Operating grants and contributions	748,768	3.2%
Capital grants and contributions	274,244	1.2%
General Revenues		
Property Tax	5,351,781	23.0%
Infrastructure Surtax	1,269,348	5.5%
Public Service Tax	3,281,645	14.1%
Gas Tax	437,584	1.9%
Unrestricted State Revenue Sharing	3,065,326	13.2%
Franchise Fees	1,933,194	8.3%
Unrestricted Intergovernmental Revenues	418,749	1.8%
Interest Revenue	791,070	3.4%
Miscellaneous	847,379	3.6%
Transfers	1,907,843	8.2%
	$ 23,222,639	100.0%

Specific requirements cont.

Government-wide financial analysis cont.

- What types of questions should be answered here?
  - Did overall assets of the entity change and why?
  - Did expenses exceed revenues for the governmental programs?
  - Were there major changes in the government's operation and what was the financial impact of these decisions?

- Analysis of balances and transactions of individual funds that addresses:
  - Reasons for significant changes in fund balance or fund net assets
  - Whether restrictions, commitments or other limitations significantly affect availability of fund resources for future use

- Analysis of significant variations between original and final budget, and between final budget and actual
  - For general fund (or equivalent)
  - Include currently known reasons for variations that are expected to have a significant effect on future services or liquidity

- Description of significant capital asset and long-term debt activity including discussion of :
  - Commitments made for capital expenditures
  - Changes in credit ratings
  - Debt limitations that may affect financing of planned facilities or services
  - Footnotes where more information is available

Sample Capital Asset Table

	Governmental Activities	Business-type Activities	Total
Land	$ 11,882,919	$ 1,738,685	$ 13,621,604
Building and Improvements	22,961,671	43,218,956	66,180,627
Machinery and Equipment	5,421,141	4,131,094	9,552,235
Vehicles	3,876,781	-	3,876,781
Infrastructure	19,218,417	-	19,218,417
Construction in Progress	802,837	1,972,424	2,775,261
	64,163,766	51,061,159	115,224,925
Accumulated Depreciation	(15,913,070)	(21,445,521)	(37,358,591)
Capital Assets, Net	$ 48,250,696	$ 29,615,638	$ 77,866,334

STUDY TEXT

Sample Debt Table

	Governmental Activities	Business-type Activities	Total
Revenue and Other Notes	$ 13,958,395	$ 13,777,656	$ 27,736,051
Capital Lease	402,811	113,884	516,695
Compensated absences	903,912	178,712	1,082,624
Total Long-term liabilities	$ 15,265,118	$ 14,070,252	$ 29,335,370

Special requirements cont.

- Governments that use modified approach for infrastructure reporting must discuss:
  - Changes in assessed condition of assets
  - Comparison of current assessed condition to established condition level
  - Significant differences in actual amounts spent to maintain assets from estimated annual amount
- Description of currently known facts, decisions or conditions that are expected to have a significant effect on financial position or results of operations
  - Currently known means to have been aware of at the auditor's report date
  - Must have already occurred, been enacted, adopted, agreed upon or contracted

Currently known facts cont.

- This discussion should highlight but not repeat information in the footnotes (such as in a subsequent events or contingencies note)
- Discussion should address both governmental and business-type activities
- Examples of discussions not allowed:
  - Predicting sales tax increase based on new mall being built
  - Predicting that data-processing system will pay for itself over a certain time period
  - Speculation of events or upcoming trends or projects

STUDY TEXT

Questions and Answers

Q: How do you handle comparative financial statements for MD&A?
A: Comparative financial statements would address both years in one MD&A presentation. Comparative data included in the basic financial statements would require only one MD&A analysis for current to prior year information.

Q: Are governments allowed to discuss other issues in MD&A that are not required elements?
A: No. However, the manner in which the required elements are addressed may allow governments to provide additional information that directly relates to a required element.

Q: How should the Letter or Transmittal be modified to avoid duplication with MD&A?
A: Required elements must be in MD&A thus Letter of Transmittal should be modified to avoid duplicity. Transmittal letter can refer to MD&A or provide additional insights of future impact or other discussions outside limitations of MD&A.

Q: Can charts and graphs be used to meet some of the required elements?
A: No, charts and graphs by themselves cannot meet the required elements. Use of charts and graphs to enhance the discussion is encouraged but these cannot replace narrative discussion.

Q: Should component units be addressed in the MD&A?
A: MD&A should focus on the primary government. The size and nature of the relationship with the primary government will determine whether a component unit is discussed. If included, then the MD&A must distinguish between the two.

Q: Is the analysis of balances and transactions of individual funds that is required limited to a discussion of major funds?
A: Normally, this would be confined to major funds but a government is not precluded from including relevant discussion regarding non-major funds.

Q: Should the discussion of long-term debt include special assessment debt for which the government is not obligated?
A: No, such debt is not debt of the government and is not required to be included in the discussion. It might be included in the capital asset discussion if used to build or acquire infrastructure for the government.

Q: Can Service Efforts and Accomplishments (SEA) and performance data be included in MD&A?
A: No. Generally, SEA would not be included since it is not a required element per GASB. However, if it provides additional information directly related to a required element, it might be included as additional analysis.

Q: When discussing significant general fund budget variances, is it sufficient to state that the original budget was increased to cover higher-than-expected expenditures?
A: No, the analysis needs to discuss the reasons for these variances and the impact on future services or liquidity.

Practical Suggestions

- Where possible, link tables to financial statements
- Don’t duplicate information
- If rounding to 000s, make sure that narratives are written from this perspective
- Double check totals and percent calculations if rounding to 000s to make sure they foot and equal 100%
- Make sure to update the words “increase” and “decrease” if using prior year template so that the proper descriptive term is used for the change you are analyzing
- Read through for clarity and to evaluate if the analysis makes sense.

CHAPTER SUMMARY

Capital Reorganizations - this is a plain reorganization involving the internal alterations of a company's capital, usually to make the company more appealing, for the issuing of new capital to raise funds and/or to avoid liquidation. Such a re-organization will leave the company in existence but with a different capital structure with the old shareholders and possibly some creditors having different rights.

Capital Reconstruction - these are capital change schemes involving the formation of a new company with a different capital structure to salvage the assets of the existing company, which is then wound up.

Capital reduction – utilizes the credit released in a reduction of the share capital to write down asset values and write of accumulated losses

External reconstruction – formation of a new company to take over all or part of the assets and liabilities of a company possibly in financial difficulties.

CHAPTER QUIZ

1. What are the reasons for capital reduction?

2. What are the three types of circumstances where a company may seek approval for a capital reduction or reorganization?

ANSWERS TO QUIZ QUESTIONS

1. Reasons for reduction of capital:

(1) When the whole of the paid-up capital is not represented by valuable assets. (for example, fixed assets may have become obsolete, or stock-in-trade depreciated by market conditions).
(2) When substantial trading losses have accumulated.
(3) When the company is over- capitalized , it being impossible to remunerate adequately all the existing capital.

2. Three types of circumstances where a company may seek approval for a capital reduction or reorganization are:

(a) Where there is partly paid share capital and the company wishes to reduce the liability for the unpaid portion.
(b) Where the company has excess capital and wishes to repay part of it.
(c) Where the company wishes formally to acknowledge that capital has been lost typically as a result of adverse trading or the loss of value of assets.

PAST PAPER ANALYSIS

Capital reductions and was tested in the following examinations:

12/'07

06/'04

12/'02

12/'00

External Reconstruction was tested in the following examinations:

06/'07

12/'06

06/'05

12/'04

EXAM QUESTION

Shida Ltd. reported favourable trading results until three years ago when it started reporting successive trading losses.

Provided below is the balance sheet of the company as at 30 September 2004:

Balance sheet as at 30 September 2004

	Sh. '000'	Sh. '000'
Assets:		
Non-current assets:		
Goodwill	20,000	
Land and buildings	48,000	
Motor vehicles	37,000	
Furniture and equipment	25,000	130,000
Current assets:		
Stock	18,000	
Debtors	6,500	24,500
Total assets		154,500
Equity and liabilities:		
Capital and reserves:		
Ordinary share capital	50,000	
10% preference share capital	30,000	
Share premium	10,000	
Profit and loss account balance	(30,000)	60,000
Non-currency liability:		
6% debentures		70,000
Current liabilities:		
Creditors	14,500	
Bank overdraft	10,000	24,500
Total equity and liabilities		154,500

Additional information:

1. Both the ordinary and preference shares are of Sh.I0 each and are all fully paid.

2. On 30 September 2004, preference dividends were three years in arrears.

3. Debentures are secured on a floating charge over the assets of the company. Debenture holders who are also suppliers of goods to the company are owed Sid 3 million. This amount is included in the creditors account.

4. The bank overdraft is secured on a fixed charge on motor vehicles.

5. The articles of association of the company give preference shareholders priority over ordinary shareholders on repayment of the capital contributed. The articles of association also provide for repayment of contributed capital only after settlement of any preference dividend arrears outstanding.

STUDY TEXT

6. Due to successive trading losses that the company has reported in the past three years, the directors have decided either to liquidate or reconstruct the company.

   The realisable values of the company's assets as at 30 September 2004 were as follows:

	Sh. '000'
Land and buildings	60,000
Motor vehicles	32,000
Furniture and equipment	15,000
Stock	12,500
Debtors	5,200

On liquidation of the company, dissolution costs of Sh. 5 million would be incurred.

7. On reconstruction of the company, the following measures would be effected:

3 The authorised capital of the company would be increased from Sh.80 million to Sh.150 million composed of ordinary shares of Sh.l0 each.

4 6% debentures of nominal value Sh 50 million would be settled by the issue of ordinary shares at par fully paid. The balance of the 6% debentures would be exchanged for 8% debentures of the same nominal value. The trade debt due to debenture holders would be settled immediately in cash.

5 The 10% preference shareholders would be issued with two fully paid ordinary shares of Sh.l0 each for every five 10% preference shares held.

6 Preference dividend arrears would be settled by the issue of five fully paid ordinary shares for every Sh.l00 of the arrears.

7 Present ordinary shareholders would be issued with one fully paid ordinary share of Sh.10 for every ten ordinary shares held.

8 It is estimated that in order to effect the scheme of reconstruction, a cost of Sh.4 million would be incurred.

9 On reconstruction of the company, 4,850.000 ordinary shares of Sh.10 par value and paid for immediately, would be issued to the present ordinary shareholders and 10% preference shareholders in the ratio of four to one respectively. The cash received from the issue of the shares wou1d be used to purchase trading stock valued at Sh.12 million, settle the bank overdraft and pay the trade debt due to the debenture holders. The balance would be used as working capital.

10 It is anticipated that on reconstruction, the company would make an annual profit before interest and tax of Sh.9,100,000. The tax rate is expected to be 30%.
In order to compensate the present shareholders for the loss they would incur on reconstruction of the company, the directors have decided to retain only 20% of the anticipated net profit.

11. Assume that all the transactions on reconstruction were completed on 1 October 2004.

Required:

(a) The amount the present ordinary and preference shareholders would receive on liquidation of Shida Ltd. (6 marks)

(b) The opening balance sheet of Shida ltd. as at 2 October 2004, after completion of the reconstruction. (14 marks)

(Total: 20 marks)

(CPA 2005)

CASE STUDY

Management's Discussion and Analysis of Financial Condition and Results of Operations

orm 10-K Part II

The economic impact of our acceleration of tax deductions will also affect how we view future asset transactions with Genesis.

Transactions which are not sales for tax purposes, such as the $175 million financing lease on the NEJD CO2 Pipeline (see

"Overview – Genesis Transactions" above) would not be affected provided that they meet other necessary tax criteria. Those transactions which constitute a sale for tax purposes, such as the $75 million sale and associated long-term transportation service agreement entered into with Genesis on our Free State CO2 Pipeline (see "Overview – Genesis Transactions" above), will be less advantageous from a tax perspective.

Sale of Louisiana Natural Gas Assets. In February 2008, we received the $48.9 million remaining portion (30%) of the proceeds from the sale of our Louisiana natural gas assets, the prior 70% of which closed in December 2007. Production attributable to the sold properties averaged 302 BOE/d (approximately 81% natural gas) during the first quarter of 2008, representing production prior to the closing date for the portion of the sale that closed in February.

Recent 2009 Transactions Purchase of Hastings Field. On February 2, 2009, we closed the $201 million acquisition of the Hastings Field, which is located near Houston, Texas, and is a potential tertiary oil field to be supplied by the Green CO2 Pipeline which has commenced construction. In August 2008, we exercised our option with a subsidiary of Venoco, Inc. ("Venoco") to purchase Hastings Field, and in consideration of our exercising the option in 2008 rather than 2009, Venoco agreed to extend the deadlines for capital expenditures, commencement of CO2 injections and certain other contractual requirements by one year.

Management Succession Plan. On February 5, 2009, our Board of Directors adopted a management succession plan under which our current executive officers will assume new roles on or about June 30, 2009. Gareth Roberts, the Company's founder, will relinquish his position as President and CEO and become Co-Chairman of the Board of Directors and will assume a non-officer role as the Company's Chief Strategist. Phil Rykhoek, currently Senior Vice President and Chief Financial Officer, will become CEO; Tracy Evans, currently Senior Vice President – Reservoir Engineering, will become President and Chief Operating Officer; and Mark Allen, currently Vice President and Chief Accounting Officer, will become Senior Vice President and Chief Financial Officer.

Subordinated Debt Issuance. On February 13, 2009, we issued $420 million of 9.75% Senior Subordinated Notes due 2016 (the "Notes"). The Notes were sold to the public at 92.816% of par, plus accrued interest from February 13, 2009, which equates to an effective yield to maturity of approximately 11.25% (before offering expenses). Interest on the Notes will be paid on March 1 and September 1 of each year, beginning September 1, 2009. The Notes will mature on March 1, 2016. We used the net proceeds from the offering of approximately $381 million to repay most of the then outstanding debt on our bank credit facility.

Capita l Resources and Liquidity During the last six months, we have taken several steps to improve our liquidity as a result of the deterioration in the capital markets and the decrease in oil and natural gas commodity prices. These included a $400 million increase to our bank commitment amount (see "Increased Bank Credit Line" below for more details), cancellation of the $600 million acquisition of Conroe Field, purchase of oil derivative contracts covering approximately 80% of our currently estimated 2009 oil production, and reduction of our capital budget for 2009. Also, in February 2009, we issued $420 million of Senior Subordinated Notes (see "Overview – Recent 2009 Transactions – Subordinated Debt Issuance").

Prior to the decline in economic conditions, we had intended, in a tax free exchange, to exchange the Barnett Shale properties for the Conroe and Hastings Fields, both of which are future tertiary flood candidates located near Houston, Texas. However, because of the deterioration in capital market conditions, we believed that the sale of our Barnett Shale properties at a price that we would consider reasonable was doubtful, and without the certainty of a Barnett Shale property sale, we did not feel comfortable increasing our leverage. As such, we cancelled our $600 million contract to purchase Conroe Field, forfeiting a $30 million non-refundable deposit which we expensed in the third quarter. To further protect our liquidity in the event that commodity prices continued to decline, in October 2008 we purchased oil derivative contracts for 2009 with a floor price of $75 / Bbl and a ceiling price of $115 / Bbl for total consideration of $15.5 million. The collars cover 30,000 Bbls/d representing approximately 80% of our currently anticipated 2009 oil production. See "Oil and Natural Gas Derivative Contracts" below in this section for information regarding the counterparties for these collars. We further significantly increased our liquidity in February 2009 by issuing $420 million of subordinated debt. We used net proceeds from that offering ($381 million) to repay most of our then outstanding bank debt, freeing-up most of our bank credit line for future capital needs, as our total bank commitment amount of $750 million was not reduced because of the offering.

PART C

CHAPTER SEVEN

STUDY TEXT

PUBLIC SECTOR ACCOUNTING

CHAPTER SEVEN

PUBLIC SECTOR ACCOUNTING

OBJECTIVES

After this chapter, the student should have knowledge of the following:

- State the accounting concepts, bases and policies of relevance to government accounting.
- Prepare, analyse and interpret financial statements of government units.
- Public sector accounting; the development of accounting standards and their applicability to the public sector.
- Fund accounting and its relationship to entity theory
- Income measurement and valuation in the public sector.
- Prepare the accounts of state corporations and similar organisations.

INTRODUCTION TO THE INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS

The International Federation of Accountants' International Public Sector Accounting Standards Board (IPSASB) develops accounting standards for public sector entities referred to as International Public Sector Accounting Standards (IPSASs).

The IPSASB recognizes the significant benefits of achieving consistent and comparable financial information across jurisdictions and it believes that the IPSASs will play a key role in enabling these benefits to be realized.

The IPSASB strongly encourages governments and national standard-setters to engage in the development of its Standards by commenting on the proposals set out in its Exposure Drafts.

The IPSASB issues IPSASs dealing with financial reporting under the cash basis of accounting and the accrual basis of accounting. The accrual basis IPSASs are based on the International Financial Reporting Standards (IFRSs), issued by the International Accounting Standards Board (IASB) where the requirements of those Standards are applicable to the public sector. They also deal with public sector specific financial reporting issues that are not dealt with in IFRSs.

The adoption of IPSASs by governments will improve both the quality and comparability of financial information reported by public sector entities around the world. The IPSASB recognizes the right of governments and national standard setters to establish accounting standards and guidelines for financial reporting in their jurisdictions.

The IPSASB encourages the adoption of IPSASs and the harmonization of national requirements with IPSASs. Financial statements should be described as complying with IPSASs only if they comply with all the requirements of each applicable IPSAS.

▶ DEFINITION OF KEY TERMS

Fund is a distinct accounting entity with a self balancing set of accounts which has objectives set out to be met.

Accounting theory refers to the financial reporting that may be adopted by the organisation.

A **fund accounting system** is a collection of distinct entities or funds in which each fund reflects financial aspects of a particular segment of the organisation's activities.

General funds are funds established to account for resources devoted to financing the general services which the governmental unit performs for its citizens.

A **budget** may be defined as a financial and quantitative statement prepared prior to a definite period of time of the policy to be perused during that time for the purposes of attaining a given objective.

EXAM CONTEXT

This topic has not been tested before in this section.

▶ INDUSTRY CONTEXT

Public sector accounting is applied by organizations to prepare, analyse and interpret financial statements of government units.

Public sector accounting enables organizations to prepare the accounts of state corporations.

This chapter enables organizations to know Fund accounting and its relationship to entity theory and also Income measurement and valuation in the public sector.

7.1 DEVELOPMENT OF IPSASS

The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is "to serve the public interest, strengthen the accountancy profession worldwide and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards, furthering the international convergence of such standards, and speaking out on public interest issues where the profession's expertise is most relevant." In pursuing this mission, IFAC established the IPSASB.

The IPSASB (formerly Public Sector Committee (PSC)) is a Board of IFAC formed to develop and issue under its own authority International Public Sector Accounting Standards (IPSASs). IPSASs are high quality global financial reporting standards for application by public sector entities other than Government Business Enterprises (GBEs).

The IPSASB's Consultative Group is appointed by the IPSASB. The Consultative Group is a non-voting group. It provides a means by which the IPSASB can consult with and seek advice as necessary from a broad constituent group.

The Consultative Group is chaired by the Chair of the IPSASB. The Consultative Group is primarily an electronic forum. However, regional chapters of the Consultative Group meet with the IPSASB in conjunction with any IPSASB meetings in their region.

All Consultative Group members are invited to these meetings. In addition, a full meeting of all members of the Consultative Group may be held if considered necessary.

7.1.1 Objectives of IPSASB

The objectives of the IPSASB are to serve the public interest by developing high quality public sector financial reporting standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of financial reporting throughout the world. The IPSASB achieves its objectives by:

- Issuing International Public Sector Accounting Standards (IPSASs);
- Promoting their acceptance and the international convergence to these standards; and
- Publishing other documents which provide guidance on issues and experiences in financial reporting in the public sector.

The IPSASs are the authoritative requirements established by the IPSASB.

Apart from developing IPSASs, the IPSASB issues other non-authoritative publications including studies, research reports and occasional papers that deal with particular public sector financial reporting issues.

7.2 SCOPE AND AUTHORITY OF INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS

7.2.1 Scope of the Standards

The IPSASB develops IPSASs which apply to the accrual basis of accounting and IPSASs which apply to the cash basis of accounting.

IPSASs set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events in general purpose financial statements.

The IPSASs are designed to apply to the general purpose financial statements of all public sector entities. Public sector entities include national governments, regional governments (for example, state, provincial, territorial), local governments (for example, city, town) and their component entities (for example, departments, agencies, boards, commissions), unless otherwise stated. The Standards do not apply to GBEs. GBEs apply International Financial Reporting Standards (IFRSs) which are issued by the International Accounting Standards Board (IASB). IPSASs include a definition of GBEs.

Any limitation of the applicability of specific IPSASs is made clear in those standards. IPSASs are not meant to apply to immaterial items.

The IPSASB has adopted the policy that all paragraphs in IPSASs shall have equal authority, and that the authority of a particular provision shall be determined by the language used. To avoid any unintended consequences the IPSASB has determined to apply this policy prospectively as it reviews and reissues previously issued IPSASs.

7.2.2 General Purpose Financial Statements

Financial statements issued for users that are unable to demand financial information to meet their specific information needs are **general purpose financial statements**. Examples of such users are citizens, voters, their representatives and other members of the public. The term “financial statements” used in this preface and in the standards covers all statements and explanatory material which are identified as being part of the general purpose financial statements.

When the accrual basis of accounting underlies the preparation of the financial statements, the financial statements will include the statement of financial position, the statement of financial performance, the cash flow statement and the statement of changes in net assets/equity.

When the cash basis of accounting underlies the preparation of the financial statements, the primary financial statement is the statement of cash receipts and payments.

In addition to preparing general purpose financial statements, an entity may prepare financial statements for other parties (such as governing bodies, the legislature and other parties who perform an oversight function) who can demand financial statements tailored to meet their specific information needs.

Such statements are referred to as special purpose financial statements. The IPSASB encourages the use of IPSASs in the preparation of special purpose financial statements where appropriate.

7.2.3 IPSASs for the Accrual and Cash Bases

The IPSASB develops accrual IPSASs that:

- Are converged with International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) by adapting them to a public sector context when appropriate. In undertaking that process, the IPSASB attempts, wherever possible, to maintain the accounting treatment and original text of the IFRSs unless there is a significant public sector issue which warrants a departure; and

- Deals with public sector financial reporting issues that are either not comprehensively dealt with in existing IFRSs or for which IFRSs have not been developed by the IASB.
  As many accrual based IPSASs are based on IFRSs, the IASB's "Framework for the Preparation and Presentation of Financial Statements" is a relevant reference for users of IPSASs.
  The IPSASB has also issued a comprehensive Cash Basis IPSAS that includes mandatory and encouraged disclosures sections.

Moving from the Cash Basis to the Accrual Basis

The Cash Basis IPSAS encourages an entity to voluntarily disclose accrual based information, although its core financial statements will nonetheless be prepared under the cash basis of accounting.

An entity in the process of moving from cash accounting to accrual accounting may wish to include particular accrual based disclosures during this process. The status (for example, audited or unaudited) and location of additional information (for example, in the notes to the financial statements or in a separate supplementary section of the financial report) will depend on the characteristics of the information (for example, reliability and completeness) and any legislation or regulations governing financial reporting within a jurisdiction.

The IPSASB also attempts to facilitate compliance with accrual based IPSASs through the use of transitional provisions in certain standards. Where transitional provisions exist, they may allow an entity additional time to meet the full requirements of a specific accrual based IPSAS or provide relief from certain requirements when initially applying an IPSAS.

An entity may at any time elect to adopt the accrual basis of accounting in accordance with IPSASs. At this point, the entity shall apply all the accrual based IPSASs and could choose to apply any transitional provisions in an individual accrual based IPSAS.

Having decided to adopt accrual accounting in accordance with IPSASs, the transitional provisions would govern the length of time available to make the transition. On the expiry of the transitional provisions, the entity shall report in full in accordance with all accrual based IPSASs.

International Public Sector Accounting Standard (IPSAS) 1, "Presentation of Financial Statements" includes the following requirement:

> "An entity whose financial statements comply with International Public Sector Accounting Standards should disclose that fact. Financial statements should not be described as complying with International Public Sector Accounting Standards unless they comply with all the requirements of each applicable International Public Sector Accounting Standard."

IPSAS 1 also requires disclosure of the extent to which the entity has applied any transitional provisions.

7.2.4 Authority of International Public Sector Accounting Standards

Within each jurisdiction, regulations may govern the issue of general purpose financial statements by public sector entities. These regulations may be in the form of statutory reporting requirements, financial reporting directives and instructions, and/or accounting standards promulgated by governments, regulatory bodies and/or professional accounting bodies in the jurisdiction concerned.

The IPSASB believes that the adoption of IPSASs, together with disclosure of compliance with them will lead to a significant improvement in the quality of general purpose financial reporting by public sector entities.

This, in turn, is likely to lead to better informed assessments of the resource allocation decisions made by governments, thereby increasing transparency and accountability.

The IPSASB acknowledges the right of governments and national standard setters to establish accounting standards and guidelines for financial reporting in their jurisdictions. Some sovereign governments and national standard setters have already developed accounting standards that apply to governments and public sector entities within their jurisdiction.

IPSASs may assist such standard-setters in the development of new standards or in the revision of existing standards in order to contribute to greater comparability.

IPSASs are likely to be of considerable use to jurisdictions that have not yet developed accounting standards for governments and public sector entities.

The IPSASB strongly encourages the adoption of IPSASs and the harmonization of national requirements with IPSASs.

Standing alone, neither the IPSASB nor the accounting profession has the power to require compliance with IPSASs. The success of the IPSASB's efforts is dependent upon the recognition and support for its work from many different interested groups acting within the limits of their own jurisdiction.

7.3 PUBLIC SECTOR ACCOUNTING

FAST FORWARD: Public sector accounting is necessary because of the central rule it plays both politically and in economic terms.

The public sector is composed of the following:

- Central Government
- Local government
- Parastatals
- Charitable organisations

All public sector organisations have one characteristic, namely they derive their specific power from Parliament, and as a result they are represented in Parliament. The accountability of public sector to Parliament takes a variety of forms. For example, under central government, the department heads are directly accountable to Parliament for the activities of their organisation, such as the PS of a given ministry is accountable to Parliament through what is known as Parliamentary Accounts Committee for the proper management of his ministry. The Parastatals are accountable through their ministries, while local authorities are partially accountable to Parliament, and to some extent, to the local electorate. Typically a local authority can set out policies necessary for the improvement of services to the local population, and will look for funds either directly or from Parliament.

The accountability to Parliament will then set the basis for objectives for different organisations. For the central government, the objectives are directly set by Parliament, while the parastatals (e.g. KPLC) will have general objectives set by Parliament, but specific operational objectives are to be set by the Board of Directors appointed by the minister to oversee the operations of the Parastatal.

The following are objectives of Public Sector Accounting:

- To provide financial information useful for the determination and predicting of the cash inflows, the balances and financial requirements to meet the short term needs of the organisation, i.e. the accounting information should be able to provide adequate information regarding the tax base as the main source of income to the organisation.
- To provide financial information useful for determination and predicting the economic condition of the organisation.
- To provide information useful for determining and evaluating the performance of the organisation in terms of legal, contractual and statutory requirements, i.e. the financial

statements should be able to indicate whether the transactions of the organisation have been carried out legally and in accordance with statutory requirements and contractual terms.

- To provide financial information necessary for the preparation of the budget-planning and to predict the impact of the acquisition and allocation of resources to the organisation.

- To provide information necessary for evaluating the managerial performance of the organisation.

The users of public sector accounts can be summarised as follows:

- Parliament – for control purposes

- Government departments – to evaluate performance.

- Tax payers – to confirm how tax has been used

- Voters – to decide whether to elect a parliament back and evaluate government performance.

- Investors and persons giving grants – such as donors.

7.4 FUND ACCOUNTING

A fund is defined as a distinct accounting entity with a self balancing set of accounts which has objectives set out to be met. In commercial accounting, a fund may be equated to a specific division of the company; that division being charged with specific responsibilities or given specific objectives, such as would be the case for a production department.

In government accounting the emphasis is based on the fund as a part of an entity contributing to the overall objectives of the organisation. For this reason, a fund account will be set to receive cash inflows, record expenditures, show assets, as well as liabilities. An example would be a library fund A/C.

An organisation may be composed of various fund entities; each fund will have its own books of account as if it was completely independent from the whole organisation.

Accounting Theory

Accounting theory refers to the financial reporting that may be adopted by the organisation. It is necessary to note that fund accounting is the representation of the entity accounting theory as used in commercial accounting. This means a fund will be considered a distinctive unit separate from the people related to it. The financial statements prepared for each fund will be for use of those who are interested in the fund. The parallel in commercial accounting is that a company is a separate entity from shareholders, directors, debtors and creditors. The financial statements of the company are prepared to be used by such people.

In public sector accounting, the main accounting concepts used are that of stewardship and accountability. Under the stewardship accounting concept, the steward is charged with the responsibility of making sure that the assets of an organisation are not misappropriated. Under accountability, the head of department is accountable for his actions regarding the management of the organisation as whole.

Financial Accounting Techniques

Public sector organisations may adopt different accounting techniques; the most important listed are below:

1) Budgetary Accounting
2) Cash Accounting
3) Accruals Accounting
4) Commitment Accounting (encumbrances)
5) Fund Accounting

1) Budgetary Accounting

Refers to the preparation of operating accounts in form of budgets. A budget is a management plan that has been transformed into figures necessary to evaluate the achievement of the organisations' objectives.

Under budgetary accounting, the concept is based on the forecasted cash flows, and operations must be limited to the budget estimates. The organisation cannot overspend above budget restrictions without Parliamentary approval.

Budgetary accounting therefore, aims at achieving the following:

(a) Ensure efficiency of managers.

(b) Communicate the objectives of the organisation to the employees

(c) Provide controls

(d) Provide a yardstick for measuring performance of employees.

2) Cash Accounting

Under this system only cash inflows and outflows are recognised and recorded. The system does not recognise any revenue or expenditure that has not been received or paid. (i.e. accrued)

3) Accrual Accounting

FAST FORWARD: The accruals concept states that revenues and costs are recognised as they are earned and incurred.

Most of the organisations in the private sector prefer this method. However, under public sector accounting, both cash and accrual accounting can be used by different entities or kinds of organisations; e.g. if a part of an organisation is charged with the responsibility of running activities on the same basis as commercial organisations, such an entity may adopt accrual accounting irrespective of the accounting techniques adopted by the main organisation.

4) Commitment Accounting

This accounting system recognises transactions when the organisation is committed to them. It means the transaction is not recognised when cash is paid or received, nor when an invoice is received or issued, but at an early stage where orders are received and placed. This accounting method is meant to ensure that government units do not overspend because transactions will only be entered into after checking committed balances.

5) Special funds

Some specific departments of a governmental organisation may adopt special fund accounting according to the set objectives they have to meet. The following are some common special funds to governmental organisations:

(a) **Trust funds:** These are those funds where the government receives money in the capacity of a trustee. They are also referred to as Agency funds, or Fiduciary funds. Examples of such funds include NSSF and NHIF. The governmental organisation does not have absolute title to the assets held; there are statutory restrictions upon their use.

(b) **Sinking funds:** These are funds created to account for the accumulation of resources for retiring term bonds at their maturity. Thus their main purpose is the repayment of public debts. Such funds are set up through the approval by the Parliament, and some appropriation may be made from these funds. The amounts appropriated are invested to earn interest; when public debt matures, the sinking fund is used to redeem this debt.

(c) **Working capital funds/Revolving funds:** They are also known as internal service funds and enterprise funds. They are used to account for services provided to other departments (internal departments – internal service funds, external services = Enterprise funds) for a fee – usually cost-reimbursement basis. They are set up through the approval of Parliament to have the necessary resources for achieving their specific objectives.

(d) **Capital Project Funds:** This provides resources for the completion of some specific capital projects. The main sources of financing such funds include proceeds from treasury bonds, grants, and transfers from other ministries and funds. This category excludes any capital projects under trust funds or revolving funds.

(e) **Specific Revenue funds or special funds:** Funds of this class are created and operated to account for revenue designated by law for specific purpose. An example of this would be library services.

(f) **General funds:** These are funds established to account for resources devoted to financing the general services which the governmental units perform for its citizens. These include general administration, protection of life and property etc.

Note: In government accounting, sources of income can be divided into two, namely

1) Recurrent expenditure income;
2) Development expenditure income.

Recurrent expenditure income can be equated to operating income in financial accounting. Development expenditure income can be equated to capital income in commercial accounting.

7.5 CONSOLIDATED FUND

FAST FORWARD: All Revenues for the government are recorded into a fund known as a consolidated fund. The consolidated fund account is kept by the treasury under the ministry of finance, and all revenues and grants received by the Government are paid into this account.

No money can be withdrawn from this account without approval of Parliament, i.e. Parliament is the sole signatory to this account. This is necessary to ensure that all government incomes are used to carry out activities of public interest; and interests are represented in such decision making through the MPs. It is also important to note that each governmental unit may be in a position to raise funds from its local activities (e.g. Ministry of Education – Fees from students, Ministry of Health – Hospital fees).

Money realised in this manner is called Appropriations-In-Aid (A-I-A). Each governmental unit is expected to make a budget of its estimated Appropriation-In-Aid and submit the budget to Parliament through the relevant ministry. Appropriations-In-Aid is supposed to be retained by the government unit that generated it. It will be added to the appropriation (allocation by Parliament) to cover the expenditure of the governmental unit.

The following books of accounts are kept by each department (governmental unit) to record the transactions of the organisation:

1. Cash Book

The cash book is that book in which all receipts and payments are recorded. Each accounting unit will maintain a cash book. There are different types of receipts and payments in different ministries, and the general point is that all receipts whether in cash or cheque will be recorded in the cash book.

>>> Illustration

The following cash transactions (cash) took place for a government unit for the month of January 19X8

		Sh.
02/01/119X8	Opening balance: Cash	4,000
	Bank	25,000
02/01/19X8	Received cheque in respect of trading license	62,500
03/01/19X8	Paid Peter and Sons (cheque for goods supplied)	20,000
05/01/19X8	Cash received in respect of fees	2,500
05/01/19X8	Paid telephone charges (cheque)	8,700
06/01/19X8	Paid AB Ltd by cheque	52,000
06/01/19X8	Paid cash to James Burton	2,800
08/01/19X8	Received cheque for Licenses	210,000
09/01/19X8	Paid wages in cash	5,000
10/01/19X8	Kept a cash balance 10,000 and banked rest together with all cheques in hand.	

Required: Prepare a cash book for the governmental unit.

Solution

CASHBOOK

Jan 19X8		**CASH Shs.**	**BANK Shs.**	**Jan 19X8**		**CASH Shs.**	**BANK Shs.**
2 Jan	Balance	4,000	25,000	3 Jan	Peter &		20,000
2 Jan	b/d	62,500		5 Jan	Sons		8,700
8 Jan	Trade	210,000		6 Jan	Telephone	2,800	52,000
10	Licenses		261,200	6 Jan	chg.	5,000	
Jan	Licenses			9 Jan	AB Ltd	261,200	-
	Cash			10	James	10,000	
			4,500	Jan	Burton		
10				10	Wages		
Jan	Balance			Jan	Bank		
	c/d				Balance		
		279,000	290,700		c/d	279,000	290,700
11	Balance	10,000	-	11Jan	Balance	-	4,500
Jan	b/d				b/d		

Note: In the illustration, the government unit has a debit balance in the bank – meaning they have an overdrawn account with the bank. For control purposes and using the cash accounting technique, such a situation is not allowed. The accounting officer should only release government cheques when there is at least an equivalent amount in the bank, otherwise such cheques may be dishonored.

2. Vote book

In commercial accounting, ledgers are a set of accounts; entries being recorded in such accounts. Under public sector accounting, ledgers are substituted with an equivalent called the vote book. In this book, various accounts are opened. These accounts relate to various expenditure heads and sources of revenue. In the vote book, the vote number of any particular department or ministry is used. This is an equivalent to a folio number under commercial accounting. The common head numbers include:

110 – Travelling and accommodation

120 – Postal and telegram expenses

121 – Telephone expenses

130 – Official entertainment

174 – Stationery etc.

These vote heads are necessary to speed up the processing and posting of various expenditures.

Note: The vote book accounts are not to be balanced off as would be in the case of commercial accounting (personal or real accounts) but is a statement to indicate the total amount committed together with the payments that have been made against a given vote. It is presented generally in the form of a T- Account with commitments indicated on the left hand side, and actual payments and balances on the right thereof, i.e.

Commitments	Payment	Balance

>>> Illustration

Vote head – Ministry of Public Works

A I E (Authority to incur expenditure) No. 225 – 35.

A I E (Authority to incur expenditure) K£5,000 (or Ksh100,000)

Transactions (Dec 19X6)

1 Dec Ordered for iron sheets and cement from Ton & Co. for Sh.25,000; L.P.O. No. 5213

6 Dec Paid Sh.3,000 for lorry hire to transport cement; PV No. 357

Transactions (Jan 19X7)

10 Jan Paid Ton & Co. Sh.15, 000 being part payment for goods ordered through LPO No. 5213; PV No. 358.

15 Jan Purchased goods from AB & Co. for Sh.5,000 (timber); PV No. 359

20 Jan Issued LPO No. 5214 to Patel & Sons for windows and doors for Sh.20,000.

25 Jan Part payment to Patel & Sons Sh.7,000; PV No. 360.

Solution

Commitment				Payment			
Date 19X6		**Ref**	**Estimated Cost**	**Date 19X6**	**PV No.**	**Amount**	**Balance**
1 Dec	Tom & Co.	LPO 5213	Shs. 25,000	6th Dec	357	Shs. 3,000	Shs. 100,000 97,000
19X7				**19X7**			
20th	Patel & Co.	LPO 5214	20,000	10th Jan 15th Jan 25th Jan	358 359 360	15,000 5,000 7,000	82,000 77,000 70,000

On 25th January the balance on the vote book will indicate Sh.70,000 with a commitment of Sh.23,000. (Tom = 10,000; Patel = 13,000) Any other commitment must take into account the only expendable amount in the vote is Sh.70,000 – 23,000 = Sh47,000.

Annual Accounts

Every governmental unit will prepare financial statements to account for the money allocated to them. The financial statements differ according to the nature of the activities undertaken by the governmental unit. However, the following types of accounts are common among government units:

1) Income and expenditure accounts;
2) Statement of assets and liabilities,
3) General Accounts of Vote (GAV)
4) The exchequer account
5) Paymaster General Account (PMG)
6) Appropriation account
7) Revenue Account

The techniques involved in preparation of the account shall be given by means of the following worked examples:

1) Income & Expenditure A/C

This is similar to income and expenditure accounts for non-profit making organisations. It is however prepared by governmental units, which provide commercial services e.g. a staff canteen or students welfare canteen (at governmental colleges).

>>> Illustration

The following account balances were extracted form the books of a pension fund for the year ended 30th June 19X7:

	Dr (Shs)	Cr (Shs)
Payments to members	500,000	
Members' contributions		800,000
Payment for management expenses	150,000	
Interest on investment by fund		400,000
Fund Account		1,800,000
Cash balance (PMG)	350,000	
Investment A/C	2,000,000	
	3,000,000	3,000,000

Requitred: Prepare an income and expenditure account for the year ended 30th June 19X7 and a balance sheet as at that date.

Note: The fund is the amount set aside to meet the specific objectives of the governmental unit. It is equal to the capital in a business in commercial accounting.

Solution

Income and Expenditure account for the year ended 30th June 19X7

Income	**Sh.'000**	**Sh.'000**
Members' contribution		800
Interest income from investments		400
		1,200
Payments to members	500	
Expenses of management	150	
		(650)
Surplus		**550**

Balance Sheet as at 30 June 19X7

Assets	**Sh.'000**	**Sh.'000**
Investment A/C		2,000
Cash balance		350
		2,350
Fund Account B/F	1,800	
Add Surplus	550	2,350
		2,350

2) General Account of Vote (GAV)

During a budget speech, the Minister for Finance will give detailed appropriations (allocations) of funds to different governmental units. Through an appropriation bill, The Parliament will approve different estimates to individual governmental units. The amount approved to each governmental unit by Parliament is then recorded into a particular account known as "General Account of Vote" (GAV). This account therefore records funds allocated to various governmental units.

All incomes of the government are received and recorded into an account called the "Exchequer account". The total amount available in the exchequer represents the consolidated fund, i.e. the consolidated fund operates an account called exchequer.

>>> Illustration

The approved estimates and actual details of the Ministry of Culture and Social Services for the year 19X6/19X7 were as follows:

Gross estimated expenditure	K£640,000	
Estimated Appropriation-In-Aid		K£ 40,000
Drawings from exchequer		K£530,000
Gross Expenditure		K£480,000
Actual appropriations in aid		K£30,000

Required: Prepare

a)
- i) The General Account of Vote
- ii) The exchequer account
- iii) Paymaster General Account

b) A statement of assets and liabilities as at 30-6-19X7

Solution

Note:

(i) The exchequer account records the amount accrued by the consolidated fund to a particular government unit

(ii) The GAV account will record amounts approved by Parliament to a particular governmental unit. However, the consolidated fund will issue different amounts for a given period of time to a particular government unit subject to the maximum, which was approved by Parliament. E.g. Parliament may approve K£600,000 for a particular governmental unit, but due to various reasons, the consolidated fund may issue a different amount to the unit, but not exceeding K£600,000.

(iii) The Paymaster General Account (PMG) is the cash account operated by the individual governmental units. It records amounts so far withdrawn from the exchequer.

All money approved for a governmental unit is intended to meet a specific purpose. This means each governmental unit will maintain an expenditure account, in which shall be recorded debits for various expenses incurred. The corresponding credit is in the PMG account (cash account). The expenditure account will then be closed to GAV. The difference between the amount approved by Parliament and total expenditure will then represent a fund balance, that should be surrendered back to the treasury at year end if not used.

GENERAL ACCOUNT OF VOTE

	K£			K£
30 June 19X7 Expenditure	480,000	1 July 19X6	Exchequer	640,000
30 June 19X7 Balance c/d	190,000	30 June 19X7	Appropriation in Aid	30,000
	670,000			670,000

EXCHEQUER ACCOUNT

		K£			K£
1 July 19X7	General Account for vote	640,000	30 June 19X7	PMG A/C	530,000
			30 June 19X7	Balance c/f	110,000
		640,000			640,000

PAYMASTER GENERAL ACCOUNT

		K£			K£
30 June 19X7	Exchequer	530,000	30 June 19X7	Expenditure	480,000
30 June 19X7	Appropriation In Aid	30,000	30 June 19X7	Balance c/d	80,000
		560,000			560,000

EXPENDITURE ACCOUNT

30 June 19X7	PMG A/C	480,000	30 June 19X7	General Account of Vote	480,000

Notes:

1) Appropriation-In-Aid (AIA) is the amount to be generated by the governmental unit from its internal activities. It is subtracted from the gross estimate (gross vote) to arrive at net estimate of (net vote) which is approved by Parliament to be released from the consolidated fund. An A-I-A account may be maintained,

Where: When A-I-A is received from own operations:
Dr PMG Account
Cr A-I-A Account
At the year end:
Dr A-I-A Account
Cr GAV Account

2) At the beginning of each year, each governmental unit has an estimated Appropriation-In-Aid which will guide them on the total amount expected to be generated internally. Thus the sum of net estimates approved and actual appropriation in aid will constitute the total funds allocated to each governmental unit. This sum constitutes the credit side of the GAV account.

STATEMENT OF ASSETS AND LIABILITIES AS AT 30-6-19X7

Assets	**K£**	**K£**
Exchequer (Amount not yet drawn)	110,000	
Paymaster General (PMG)	80,000	190,000
Funded by		
General Account of Vote		190,000

Thus funds allocated have been adequately accounted for and the balance of K£190,000 will be surrendered back to the Treasury.

In this case, the government unit will surrender the Sh80,000 from the PMG, while the exchequer will surrender Sh 110,000 on behalf of the ministry.

>>> Illustration:

The following information relates to a governmental unit for the fiscal year 19X6/19X7.

Gross estimates:	K£720,000
Appropriation-In-Aid estimated:	K£90,000
Drawings from the exchequer	K£450,000
Actual gross expenditure	K£520000
Actual appropriation-in-aid	K£120,000

Required:

a) Prepare the following accounts:
   i) General Account of vote (GAV)
   ii) Exchequer A/C
   iii) PMG A/C

b) Statement of assets and liabilities as at 30 June 19X7.

Solution:

For clear accounting procedure it is necessary to distinguish between the proportion of gross estimate that will be generated internally and that proportion that is expected from the treasury after Parliamentary approval.

GENERAL ACCOUNT OF VOTE

	K£		K£
30 June 19X7 Excess in A-I-A	30,000	1 July 19X6Exchequer A/C	630,000
30 June 19X7 Expenditure	52,000	30 June 19X7 A-I-A	120,000
30 June 19X7 Balance c/d	20,000		
	750,000		750,000

Note: To simplify accounting entries, the A-I-A is recorded in the GAV at the end of the fiscal year. This will enable us to determine whether there was a shortfall (deficiency) in A-I-A from the expected amount, or there was a surplus.

EXCESS APPROPRIATION-IN-AID

	K£		K£
30 June 19X7 Balance c/d	30,000	30 June 19X7 GAV A/C	30,000

EXCHEQUER ACCOUNT

	K£		K£
1 July 19X6 General Account of vote	630,000	30 June 19X7 PMG	450,000
		30 June 19X7 Balance c/d	180,000
	630,000		630,000

PMG ACCOUNT

	K£		K£
30 June 19X7 Exchequer A/C	450,000	30 June 19X7 Exchequer A/C	520,000
30 June 19X7 A-I-A	120,000	30 June 19X7 Balance	50,000
	570,000		570,000

APPROPRIATION IN AID ACCOUNT

	K£		K£
30 June 19X7 GAV	120,000	30 June 19X7 PMG	120,000

Note: amounts to be surrendered back to the exchequer will be £230,000. The governmental unit is also expected to remit any A-I-A to the consolidated fund – This is more apparent in a statement of appropriation. (also known as appropriation A/C).

STATEMENT OF ASSETS AND LIABILITIES AS AT 30th June 19X7

Assets	K£	K£
Exchequer A/C	180,000	
Paymaster General (PMG)	50,000	230,000
Funded by		
Excess in AIA	30,000	
General Account of Vote	200,000	230,000

Appropriation Accounts

These may be drawn in two different ways (one being a slight variation from the other).

An example of an appropriation account would be as follows:

APPROPRITATION ACCOUNT FOR THE YEAR ENDED 30TH JUNE 19X4 (K£)

Details	Approved estimate		Actual Expenditure	Amount under-spent	Amount overspent
Personal emoluments:					
- original estimate	80,000				
- supplementary	<u>8,000</u>	88,000	90,000		2,000
estimate		15,000	13,000	2,000	
House allowance		5,000	4,500	500	
Passage and Leave					
Travelling expenses:	22,000				
- original estimate	<u>(2,000)</u>	20,000	23,000		3,000
- supplementary		6,000	6,500		500
estimate		<u>50,000</u>	<u>40,000</u>	<u>10,000</u>	______
Electricity & Water					
Purchase of plant & mach.					
Gross Appropriation		184,000	177,000	<u>12,500</u>	<u>5,500</u>
Appropriation-In-Aid		<u>(15,000)</u>	<u>(12,000)</u>		
Net Appropriation		<u>169,000</u>	<u>165,000</u>		

Note:

1) Net estimate exceeds actual expenditure by K£4,000. This indicates that there was no over expenditure for the governmental unit as a whole. However, there are some over-expenditures on individual items; but since these are not significant, no explanations are required by the accounting officer.

2) The gross estimates and gross actual expenditures are recorded before taking into account the effect of A-I-A. In this case gross expenditure estimate exceeds the gross actual expenditure by K£7,000. But in order to determine the surplus to be returned to the treasury or over-expenditure, we must take into account the effects of either surplus AIA or deficiency of AIA. In this case, there is a shortage in AIA of K£3,000. The deficiency must be netted off from the surplus of "approved estimates and actual expenditure":

Surplus of estimates over actual expenditure	K£7,000
Less deficiency in A-I-A	<u>(3,000)</u>
Expendable balance	K<u>£4,000</u>

Therefore, there is no net over-expenditure by the ministry.

>>> Illustration

The approved estimates and actual expenditure details of the Ministry of Agriculture for the year 19X7/19X8 were as follows:

CODE	Details	Approved estimates K£	Actual Expenditure K£
000	Personal emoluments	123280	97,520
050	House Allowance	19,550	14,260
080	Passage and Leave	41,040	667
100	Travelling and accommodation	1,334	1,656
110	Transport and maintenance	16,100	13,593
120	Postal and Telecom expenses	4,600	3,312
190	Miscellaneous charges	17,480	16,882
196	Training expenses	5,980	4,738
230	Purchase of equipment	21,000	39,800
620	AIA (Realised income)	1,000	5,560

The ministry made fair equal withdrawals from the exchequer in July 19X7, October 19X7, January 19X8 and May 19X8. In total, the ministry had drawn K£200,000 by the year-end.

Required:

a) The general account of vote
b) The exchequer account
c) The PMG account
d) Statement of assets and liabilities as at 30th June 19X8.

Solution

It would help if an appropriation account is drawn up. In this illustration it is drawn in a slightly varied version:

CODE	Details	Approved Estimates K£	Actual Expenditure K£	Over/Under Expenditure K£
000	Personal emoluments	123280	97,520	25,760
050	House Allowance	19,550	14,260	5,290
080	Passage and Leave	41,040	667	40,373
100	Travelling and accommodation	1,334	1,656	(322)
110	Transport and maintenance	16,100	13,593	2,507
120	Postal and Telecom expenses	4,600	3,312	1,258
190	Miscellaneous charges	17,480	16,882	598
196	Training expenses	5,980	4,738	1,242
230	Purchase of equipment	21,000	39,800	(18,800)
	Gross Appropriation	250,364	192,428	57,936
620	A-I-A	(1,000)	(5,560)	4,560
	Net Appropriation	249,364	186,868	62,496

GAV ACCOUNT

	K£		K£
30 June 19X8 Excess A–I – A A/C	4,500	1 July 19X7 Exchequer A/c	249,364
30 June 19X8 Expenditure A/c	192,428	30 June 19X8 A – I – A A/C	5,560
30 June 19X8 Balance c/d	57,936		
	254,924		254,924

Excess Appropriation in Aid Account

	K£		K£
30 June 19X8 Balance c/d	4,560	30 June 19X8 GAV A/C	4,560

Exchequer Account

	K£		K£
1 July 19X7 GAV A/C	249,364	30 June 19X8 Expenditure	200,000
		30 June 19X8 Balance c/d	49,364
	249,364		249,364

PMG Account

	K£		K£
30 June 19X8 Exchequer (Total)	200,000	30 June 19X8 PMG (Total)	192,428
30 June 19X8 A – I – A A/C	5,560	30 June 19X8 Balance c/d	13,132
	205,560		205,560

Expenditure

	K£		K£
30 June 19X8 PMG	192,428	30 June 19X8 GAV A/C	192,428

Appropriation-In-aid Account

	K£		K£
30 June 19X8 GAV	5,560	30 June 19X8 PMG	5,560

STATEMENT OF ASSETS AND LIABILITIES AS AT 30 JUNE 19X8

Assets	**K£**	**K£**
Exchequer A/C	49,364	
Paymaster General A/C	13,132	62,496
Funded by		
General Account of Vote	57,936	
Excess appropriation-in-aid	4,560	62,496

STUDY TEXT

Revenue Accounts

A revenue account records only the estimated revenue and actual revenue from each particular revenue source for the governmental unit. The difference between the two, if significant must be explained by the accounting officer. Alternatively the significant difference between the two can be used to correct future estimations by the governmental unit. It could also represent new factors emerging during the year which were not taken into account during the previous budget.

>>> Illustration

From the following data, prepare a statement of revenue for the year ended 30th June 19X7.

	Estimated Revenue	Actual Receipts
Renting building and equipment	K£850,000	K£870,000
Fee for trading licenses	K£430,000	K£400,000
Fees for import/export licenses	K£470,000	K£480,000
Other receipts	K£235,000	K£210,000

The following additional details are available:-

(i) Balance on hand on 30th June 19X6 K£247,000
(ii) Balance on hand on 30th June 19X7 K£160,000

REVENUE A/C FOR THE YEAR ENDED 30TH JUNE 19X7

Details	Estimate £	Actual £	Details	£
Balance b/d (30-June-19X6)		247	Payment to Treasury	2,047
Rent for building/ machinery	850	870		
Fees for trading licenses	430	400		
Fees for import/export	470	480		
Others	235	210	Balance c/f (30.6.19X7)	160
	1,985	1,960		
		2,207		2,207

Note:

There are no serious differences between estimate and actual receipts; hence no explanation is required by the accounting officer.

>>> Illustration:

The following are extracts from the trial balance for revenue head No. 180 – 240, Airport revenue collection for the year ended 30th June 19X8:

Code	Details	Dr(£)	Cr (£)
630	Renting building and equipment		807,456
631	Rent from land		3,796,205
651	Aviation landing fee	3,542,221	
652	Airport passenger tax	3,991,029	
670	Other airport receipts	798,144	
	Payment of revenue to exchequer	13,288,687	

The following additional details are made available:

i) Balance in hand at 30th June 19X7 £2,568,242.
ii) Estimated receipts for the year:

CODE	AMOUNT
630	£1,000,000
631	£2,500,000
651	£3,000,000
652	£3,600,000
670	£1,100,000

Required:

a) A statement of revenue for the year ended 30th June 19X6
b) Give appropriate footnotes for material differences between estimates and the actual receipts.

Solution

REVENUE ACCOUNT FOR THE YEAR ENDED 30TH JUNE 19X8

Details	Estimate £	Actual £	Details	K£
			Payment to Treasury	13,288,687
Balance b/d (30-June-19X7)	1,000,000	2,568,242		
Renting building/machinery	2,500,000	807,456		
Rent for land	3,000,000	3,796,205		
Aviation landing fees	3,600,000	3,542,221		2,214,610
Airport passenger tax	1,100,000	3,991,029	Balance c/f	160
Other airport receipts	11,200,000	798,144	30.6.19X8	
		12,935,055		
		15,503,297		15,503,297

Note: There may have been a significant increase in the volume of business at the airport. It is possible that a new airline (previously not operational to Kenya) has decided to make Kenya one of its destinations/stopovers. It is also possible that some land and buildings have been sold, thus leading to a fall in rental income.

7.6 GENERAL AND SPECIAL FUNDS ACCOUNTS

In carrying out its functions to meet both economic and political needs of the country, the government sets out various funds that are charged with specific governmental units, ministries or departments that will oversee the operations of the fund.

Note: A fund is an entity with self-balancing books to meet specified objectives. For proper accounting, different funds are named in accordance with the activities they are supposed to undertake. For example, the **general fund** of a governmental unit is the entity that accounts for all resources and assets used for financing the general administration of the unit. The general administration of the unit is for traditional services provided to the people, such as security, health, education and eradication of poverty.

In some cases, the government may set aside funds to meet special duties or activities which are different from ordinary traditional services being offered to the people. This means whenever a tax or other revenue source is authorised by Parliament to be used for a specified purpose, then a governmental unit avails itself of that source, and may create what is known as a **Special Revenue Fund.**

The purpose of a special revenue fund is to show that the revenue from such sources was used for a specific purpose only; and the governmental unit will then operate what is known as a special fund account to record the resources and liabilities for such an entity.

The general fund and special funds are commonly known as revenue funds of a governmental unit. Thus, where there is no specification, the revenue fund of a governmental unit may refer either to the general fund or the special fund.

It is important to note that the general fund as well as special revenue fund only record current assets and current liabilities of the governmental unit. Long term assets as well as long term liabilities for governmental units are covered under different funds e.g. property funds. The difference between current assets and current liabilities of a general or special fund constitute what is known as "fund equity". Fund equity would thus be an equivalent of net working capital in commercial accounting. However from the governmental accounting point of view, fund equity represents the fund balance that has not been directly used or committed. The fund equity can further be divided into two parts:

i) Fund balance

ii) Reserves

The reserves part of a fund equity represents funds that have been committed but the liability not yet incurred. For example, where a contract has been entered into, and the contractor has been issued with an LPO, but he has not yet supplied or provided the service; the amount committed to the LPO will be represented in form of a reserve to indicate that it is fund balance which cannot be distributed/utilised. The other distributable amounts are listed under fund balance.

Budgetary Accounting

All funds set up by the government to meet different objectives will have a budget as a source of control with regard to estimated revenue as well as estimated expenditure (appropriations). In order to record transactions of a governmental unit, the following general ledger control accounts are recommended:

i) Estimated revenue A/C
ii) Appropriation A/C
iii) Encumbrances A/C

These three accounts are general ledger control accounts which must be supported by the relevant subsidiary accounts as illustrated below:

>>> Illustration

The expected revenue source of a particular governmental unit was as shown below:

Revenue Ledger

Taxes	£882,500
Licenses and permits	£125,500
Intergovernmental revenues	£200,000
Charges for services rendered	£90,000
Fines and forfeitures	£32,500
Miscellaneous revenues	£19,500
Total Expected Revenue	**£1,350,000**

The Expected revenue would be recorded in the general ledger control accounts as £1,350,000; being the sum of individual expected revenue. The journal entry to record this transaction is:

	Dr £	Cr £
Estimated Revenue	1,350,000	
Fund balance		1,350,000
To record approved revenue to a governmental unit		

Subsidiary ledgers will however record details of individual sources of revenue.

Note: Estimated revenues are potential assets for the non-governmental organisation and are comparable to debtors in commercial accounting; hence the debit entry in the estimated revenue control account. On the other hand, appropriations are potential liabilities and are recorded through credit entries in the appropriations control A/C.

Estimated revenues represent what the government unit expects from various sources. At the end of year, the actual revenue realised may be different from the estimated revenue. The revenue realised is recorded through the following entries:

Debit Cash

Credit Revenue A/c (This also acts as a control A/C)

The revenue account is then closed to estimated revenue account to indicate whether estimated revenue exceeds actual revenue or vice versa.

Expenditure Account

This account records actual liability incurred as opposed to the appropriation account which records estimated or potential liability. The corresponding credit is in the individual liability accounts, e.g.

Expenditure Account

	£		**£**
Wages payable	60,000	Appropriations A/C	74,000
Postage payable	14,000		
	74,000		74,000

The total expenditures incurred will then be compared with appropriations (or estimated expenditure). For this reason, the expenditure account is closed to appropriations A/C.

Wages Payable

	£		**£**
Cash	60,000	Expenditure A/C	60,000

Postage payable

	£		**£**
Cash	14,000	Expenditure A/C	14,000

Encumbrances

Encumbrances record the commitments that have been entered into but services are yet to be received. The purpose of recording the commitments is to ensure that the budgeted appropriations are not exceeded. In this way, accounting officers may guard against over expenditure.

E.g. assume that approved estimates for a governmental unit was Sh1,000,000, and so far during the year Sh800,000 had already been incurred. Also assume that LPOs amounting to Sh120,000 have been committed to vote books. This therefore means that out of the Sh1,000,000, only Sh80,000 is available either to be retained to the treasury or to be expended by the governmental unit.

The commitments are recorded in:

i) Encumbrances accounts;
ii) Fund balance reserved for encumbrances A/C

In the above example, the encumbrances of Sh.120,000 will be recorded as follows:

Encumbrance

	Sh		Sh
Fund balance reserved...	120,000		

Fund balance reserved for encumbrance

			Sh
		Encumbrance	120,000

After the expenditure has been incurred (commitments have been fulfilled). The above entries are reserved. At the same time, the expenditure is fully recorded. Assume the encumbrance of Sh120,000 was in respect of pool chlorine for training governmental unit forces; and the supplier has already fulfilled the commitment and has been paid:

Encumbrance A/C

	Sh		Sh
Fund balance reserved...	120,000	Fund balance reserved…	120,000

Fund balance reserved for encumbrance

	Sh		Sh
Encumbrance	120,000	Encumbrance	120,000

Expenditure A/C

	£		£
Pool Chlorine	120,000	Appropriations	120,000

Pool Chlorine A/C

	Sh		Sh
Cash	120,000	Expenditure	120,000

Sometimes there is an overlap between the end of the accounting period and when the commitments are fulfilled. Assume that the governmental unit accounting period ends on 30th June every year, and a commitment entered into during the month of April for Sh250,000 have been partially services to the tune of Sh210,000 at the end of the accounting period to 30th June 19X7. From the point when commitment was entered into, the following entries shall be made:

Encumbrance A/C

	Sh		Sh
Fund balance reserved...	250,000	Fund balance reserved…	210,000
		Fund balance	40,000
	250,000		250,000

This account is not to be balanced but closed to fund A/C

Fund balance reserved for encumbrance

	Sh		Sh
Encumbrance	210,000	Encumbrance	250,000
Balance c/d	40,000		
	250,000		250,000
		Balance b/d	40,000

The fund balance reserve for encumbrances will then appear in the statement of assets and liabilities at the end of the period.

Comprehensive illustration

The city of Westcycle fiscal period ends on 30th June. The trial balance of the general fund as on 1 July 19X7 was as follows:

	Dr £	Cr £	
Cash Balance	12, 600		
Savings A/C	66,800		
Property tax receivable	480,600		
Accounts payable		7,300	
Wages payable		4,450	
Fund balance		548,250	
	560,000	560,000	less by 600

The operations for the year ended 30th June 19X8 are summarised as follows:

i) Estimated revenues: £2,400,000; Appropriations: £2,350,000
ii) Revenues from property taxes levy: £1,925,500
iii) Cash received from property taxes: £2,005,600; and other revenues: £485,700
iv) Expenditures encumbered and evidenced by purchase orders: £1,760,000
v) Liquidation of encumbrances and vouchers prepared for purchase order billings: £1,755,000.
vi) Expenditure for payroll £602,000
vii) Cash disbursed for vouchers: £1,740,000
Cash for payment of wages: £598,000
Cash transferred to savings A/C: £150,000.

Required:

a) Open the ordinary 'T' accounts for the accounts appearing in the trial balance and enter the balances as at 1 July 19X7.

b) Open 'T' accounts for: Fund balance reserves for encumbrances
: Estimated revenues
: Revenues
: Appropriations
: Expenditure
: Encumbrances

c) Prepare journal entries to post the foregoing summarised operations.

d) Post the entries recorded in (c) above into the accounts.

e) Record appropriate entries to dwell the accounts as at 30th June 19X8.

f) Prepare a balance sheet as at 30th June 19X8.

Cash

	£		£
Balance b/d	12,600	Accounts payable	174,000
Property tax	2,005,600	Wages	598,000
Other revenue	485,700	Savings	150,000
		Balance c/d	15,900
	2,503,900		2,503,900

Savings

	Sh	Sh	
Balance b/d	66,800		
Cash	150,000	Balance c/d	216,800
	216,800		216,800

Fund Balances

	Sh		Sh
Appropriations	2,350,000		Balance b/d
Encumbrance	5,000		548,250
Appropriation	7,000		Estimated revenue
Balance c/d	597,450		2,400,000
			Estimated revenue
			11,200
	2,959,450		2,959,450
		Balance b/d	**597,450**

Fund Balance reserved for encumbrances

	Sh		Sh
Encumbrances	1,755,000	Encumbrances	1,760,000
Balance c/d	5,000		
	1,760,000		1,760,000
		Balance b/d	**5,000**

Estimated revenue

	Sh		Sh
Fund balance	2,400,000	Revenue	2,411,200
Fund balance	11,200		
	2,411,200		2,411,200

Property taxes

	Sh		Sh
Balance b/d	480,600	Cash	2,005,600
Revenue A/C	1,925,500	Balance c/d	400,500
	2,406,100		2,406,100
Balance b/d	405,500		

Wages payable

	Sh		Sh
Cash	598,000	Balance b/d	4,450
Balance c/d	8,450	Expenditure	602.000
	606,450		606,450
		Balance b/d	8,450

Accounts payable

	Sh		Sh
Cash	**1,740,000**	Balance b/d	7,300
Balance c/d	22,300	Expenditure	1,755,000
	1,762,300		1,762,300
		Balance b/d	**22,300**

Encumbrances

	Sh		Sh
Fund reserved …	1,760,000	Fund reserved …	1,755,000
		Fund balance	5,000
	1,760,000		1,760,000

Appropriations

	Sh		Sh
Expenditure A/C	2,357,000	Fund balance	2,350,000
		Fund balance	7,000
	2,357,000		2,357,000

Revenue A/C

	Sh		Sh
Estimated revenue	2,411,200	Property tax	1,925,500
		Other revenue	485,700
	2,411,200		2,411,200

Expenditure A/C

	Sh		Sh
Wages payable	602,000		
Accounts payable	1,755,000	Appropriations	2,357,000
	2,357,000		2,357,000

Other revenue

	Sh		Sh
Revenue account	485,700	Cash	485,700

The Journal

	Dr (Sh)	Cr (Sh)
Estimated Revenue A/C	2,400,000	
Fund Balance A/C		2,400,000
Fund Balance A/c	2,350,000	
Appropriations A/C		2,350,000
Property Taxes receivable A/C	1,925,500	
Revenue A/C		1,925,500
Cash	2,005,600	
Property taxes receivable A/C		2,005,600
Cash	485,700	
Other Revenue A/C		485,700
Other revenue A/c	485,700	
Revenue A/C		485,700
Encumbrances	1,760,000	
Fund balance reserved for encumbrances		1,760,000
Fund balance reserved for encumbrances	1,755,000	
Encumbrances		1,755,000
Fund balance	5,000	
Encumbrances		5,000
Expenditure A/C	602,000	
Wages Payable		602,000

Wages payable	598,000	
Accounts payable	1,740,000	
Savings bank A/C	150,000	
Cash		2,488,000
Expenditure A/C	1,755,000	
Accounts payable		1,755,000
Revenue A/C	2,411,200	
Estimated Revenue A/C		2,411,200
Estimated Revenue	11,200	
Fund Balance		11,200
Appropriations A/C	2,357,000	
Expenditure		2,357,000
Fund Balance	7,000	
Appropriations		7,000

Balance Sheet as at 30th June 10X8

Assets	**Sh**	**Liabilities**	**Sh**
Cash	15,900	Wages payable	8,450
Savings A/C	216,800	Accounts payable	22,300
Property taxes receivable	400,500	Fund Balance	597,450
		Reserve for encumbrances	5,000
	633,200		633,200

>>> Illustration

The following data relates to the city of Kababwe:

Trial Balance As At 1 – 7 – 19x7	**Dr (Shs)**	**Cr (Shs)**
Cash	242,500	
Savings A/C	250,000	
Property taxes receivable	185,000	
Investment in government Treasury Bills	350,000	
Accounts payable		162,600
Wages payable		30,000
Fund Balances		834,900
	1,027,500	1,027,500

The transactions completed during the year for the general fund are summarised and recorded as follows for the year ended 30 – June – 19X8.

STUDY TEXT

JOURNAL	Sh	Sh
a) Estimated Revenue A/c	9,100,000	
Appropriations		9,070,000
Fund Balance		30,000
b) Property Taxes receivable		
Revenue		
c) Cash	9,105,000	
Property taxes receivable A/C		6,470,000
Other revenue		2,635,000
d) Expenditure	3,280,000	
Wages payable		3,280,000
Encumbrances	5,800,000	
Fund balance reserved for		5,800,000
encumbrances	5,785,000	
Fund balance reserved for encumbrances		5,785,000
Encumbrances	5,785,000	
Expenditure		5,785,000
Accounts payable	5,800,000	
Accounts payable	3,270,000	
Wages payable		
Cash		
		9,100,000
Estimated Revenue		38,000
Fund balances	9,070,000	
Appropriations		9,065,000
Expenditure		5,000
Fund Balance	15,000	
Fund balance		15,000
Encumbrances		

Required:

a) Open appropriate accounts, post entries therein, and balance them at the year end
b) Draw a trial balance as at 30.6.19X8
c) Prepare a statement of assets and liabilities.

Solution

Cash A/C

	Sh		Sh
Balance b/d	242,500	Accounts payable	5,800,000
Property taxes	6,470,000	Wages payable	3,270,000
Other revenue	2,635,000	Balance c/d	277,500
	9,347,500		9,347,500

Property tax receivable

	Sh.		Sh.
Balance b/d	185,000	Cash	6,470,000
Revenue	6,500,000	Balance c/d	215,000
	6,685,000		6,685,000

Wages payable

	Sh.		Sh.
Cash	3,270,000	Balance b/d	4,450
Balance c/d	40,000	Expenditure	602,000
	3,310,000		3,310,000

Revenue A/C

	Sh.		Sh.
Estimated revenue	9,135,000	Property tax	6,500,000
		Other revenue Cash	2,635,000
	9,135,000		9,135,000

Encumbrances

	Sh.		Sh.
Fund reserved …	5,800,000	Fund reserved …	5,785,000
		Fund balance	15,000
	5,800,000		5,800,000

Fund reserved for encumbrances

	Sh.		Sh.
Encumbrances	5,785,000	Encumbrances	5,800,000
Balance c/d	15,000		
	5,800,000		5,800,000

Savings A/C

	Sh.		Sh.
Balance b/d	250,000	Balance c/d	250,000

Treasury Bills A/C

	Sh.		Sh.
Balance b/d	350,000	Balance c/d	350,000

Accounts payable

	Sh.		Sh.
Cash	5,800,000	Balance b/d	162,600
Balance c/d	147,600	Expenditure	5,785,000
	5,947,600		5,947,600

Fund Balances

	Sh.		Sh.
Appropriations	9,070,000	Balance b/d	834,900
Encumbrance	5,000	Estimated revenue	9,100,000
Appropriation	7,000	Estimated revenue	35,000
Balance c/d	889,450	Appropriations	5,000
	9,974,900		9,974,900

Expenditure A/C

	Sh.		Sh.
Wages payable	3,280,000		
Accounts payable	5,785,000	Appropriations	9,065,000
	9,065,000		9,065,000

Appropriations

	Sh.		Sh.
Expenditure A/C	9,065,000	Fund balance	9,070,000
Fund balance	5,000		
	9,070,000		9,070,000

Estimated revenue A/C

	Sh.		Sh.
Fund balance	9,100,000	Revenue	9,135,000
Fund balance	35,000		
	9,135,000		9,135,000

Trial Balance As At 30 – 6 – 19x8

	Dr	Cr
Cash	277,500	
Savings A/C	250,000	
Treasury Bills	350,000	
Property taxes receivable	215,000	
Accounts payable		147,600
Wages payable		40,000
Fund balance reserved for encumbrances		15,000
Fund balance		889,900
	1,092,500	1,092,500

Balance Sheet as at 30 – 6 – 19X8

ASSETS	**Shs.**	**Shs.**	**Shs.**
Cash			277,500
Savings A/C			250,000
Treasury Bills			350,000
Property taxes receivable			215,000
			1,092,500
LIABILITIES			
Wages payable		40,000	
Accounts payable		147,600	(187,600)
			904,900
FUND EQUITY			
Unreserved fund balance			889,900
Fund balance reserved for encumbrances			15,000
			904,900

>>> Illustration:

The city's general fund trial balance as at 1 June 19X7 is as follows:

	Dr £	**Cr £**
Cash	225,000	
Savings A/C	80,000	
Property taxes receivable	122,500	
Investment in treasury bills	100,000	
Accounts payable		52,700
Wages payable		19,200
Fund balance		455,600
	527,500	527,500

The following data summarises operations for the current fiscal year that ends operations on 30 – 6 – 19X8:

		£
a)	Estimated: Revenues	2,180,000
	: Appropriations	2,115,000
b)	Revenue from property tax levy	1,450,000
	Cash received from property taxes	1,460,000
	Other revenues received	760,000
c)	Expenditure on payroll	1,150,000
	Expenditure encumbered and evidenced by LPOs	1,210,000
	Liquidation of encumbrance vouchers for order billings	1,050,000

d) Cash disbursed: for vouchers 1,065,000
: for payment of wages 1,155,800
: for savings A/C 40,000

Cash A/C

	£		£
Balance b/d	225,000	Accounts payable	1,065,000
Property taxes	1,460,000	Wages payable	1,155,800
Other revenue	760,000	Savings A/C	40,000
		Balance c/d	184,200
	2,445,000		2,445,000

Savings A/C

	£		£
Balance b/d	80,000		
Cash	40,000	Balance c/d	120,000
	120,000		120,000

Property tax receivable

	£		£
Balance b/d	122,500	Cash	1,460,000
Revenue	1,450,000	Balance c/d	112,500
	1,572,500		1,572,500

Accounts payable

	£		£
Cash	1,065,000	Balance b/d	52,700
Balance c/d	37,700	Expenditure	1,050,000
	1,102,700		1,102,700

Wages payable

	£		£
Cash	1,155,800	Balance b/d	19,200
Balance c/d	13,400	Expenditure	1,150,000
	1,169,200		1,169,200

Estimated revenue A/C

	£		£
Fund balance	2,180,000	Revenue A/C	2,210,000
Fund balance	30,000		
	2,210,000		2,210,000

Revenue A/C

	£		£
		Property tax	1,450,000
Estimated revenue	2,210,000	Cash (other revenue)	760,000
	2,210,000		2,210,000

Appropriations

	£		£
Expenditure A/C	2,200,000	Fund balance	2,115,000
		Fund balance	85,000
	2,200,000		2,200,000

Encumbrances

	£		£
Fund reserved …	1,210,000	Fund reserved …	1,050,000
		Fund balance	160,000
	1,210,000		1,210,000

Fund Balances

	£		£
Appropriations	2,115,000	Balance b/d	455,600
Appropriations	85,000	Estimated revenue	2,180,000
Encumbrance	160,000	Estimated revenue	30,000
Balance c/d	305,600		
	2,665,600		2,665,600

Expenditure A/C

	£		£
Wages payable	1,150,000		
Accounts payable	1,050,000	Appropriations	2,200,000
	2,200,000		2,200,000

Fund reserved for encumbrances

	£		£
Encumbrances	1,050,000	Encumbrances	1,210,000
Balance c/d	160,000		
	1,210,000		1,210,000

STUDY TEXT

BALANCE SHEET AS AT 30 – 6 – 19X8

Assets	**£**	**£**
Cash		184,200
Savings A/C		120,000
Treasury bills		100,000
Property Taxes receivable		112,500
		516,700
Liabilities		
Accounts payable	37,700	
Wages payable	13,400	(51,100)
		465,600
Financed by		
Unreserved fund B/F		305,600
Fund balance reserved for encumbrances		160,000
		465,600

7.6.1 SPECIAL FUNDS

FAST FORWARD: Special fund accounts are created by governmental units to account for the revenues and expenditures of specialised governmental unit operations, which are outside the traditional services offered by the government.

Once a particular activity is identified, a special fund account is created to ensure that revenues allocated to this account are properly received and accounted for; and that expenditure from this fund must be incurred in respect of activities associated with the special fund.

Once identified, the special operation necessitating creation of special fund will be treated exactly in the same way as general fund accounting, i.e. estimated revenue, revenue, appropriations and expenditure will be recorded in the same way as was done with the general fund. This also applies to encumbrances.

Common examples of activities that require creation of special funds are:

1) Construction and maintenance of streets, roads and bridges

2) Libraries

3) Grants received either from foreign countries or specific government bodies that are geared towards specified operations.

Note: Grant accounting requires a slightly different approach in the sense that the grantor would require the grantee to use the grants for a specified purpose; and in order to attain this objective, grant accounting is on the basis of reimbursement. This means that grant revenue will only be recognised as having been received after actual expenditure has been incurred.

It is only then the grantor will release the grant revenue. However, for any given period it is possible for the grantee to account for any grant receivable by creating an account known as deferred revenue.

The deferred revenue account is a liability account showing that there is a potential revenue which will only be recognised upon meeting certain conditions. Relevant entries are as follows:

Assume that Town X was given a grant of Sh.50,000,000 for construction of streets in a particular region of the town. Upon receiving this information, the governmental unit will record the transaction as follows:

Dr Grant receivable 50,000,000
 Cr Deferred Revenue A/C 50,000,000

The basis of this entry is that the recognised accounting principles under special funds/general funds in the "modified accrual basis of accounting". Under this principle, both revenues and expenditures are only recognised when the possibility of their realisation is certain.

Grants will normally be released under specified conditions are being met; and under modified accrual basis of accounting such revenues cannot be recognised until the conditions required have bee fulfilled.

In the above example, assume that 3 months later, Town X has identified the contractor and given out contracts to construct streets in the required region to the tune of Sh.30,000,000. When this is done, then the specified conditions have been met and the grant receivable revenue is recognised. The following entries are then made:

1. **Dr** Deferred Revenue 30,000,000
 Cr Revenue Account 30,000,000

2. **Dr** Expenditure 30,000,000
 Cr Accounts payable 30,000,000

The second entry is required to enter the liability incurred when the contract is entered into while the first entry is now to recognise part of the grant revenue as receivable revenues under the modified accrual basis. However, where the contract has been entered into but the work is not yet performed, the encumbrance entries will be recorded instead of (2) above.

The concept of modified accrual basis of accounting is used in many other governmental units funds that will require the revenue to be recognised when there is uncertainty regarding their realisation.

One such fund is the capital projects fund. The capital projects fund is a fund created to cater/ account for revenues and resources that are associated with capital projects of a governmental unit. The capital projects fund is an equivalent to capital budgeting/ financing under commercial accounting.

General funds and special funds are not normally used to finance capital projects. Major sources of financing capital projects of a governmental unit are as follows:

(1) Long-term debt
(2) Governmental treasury bonds
(3) Grants from other governmental units or foreign governments.
(4) Transfer from other funds within the government.
(5) Gifts (from individuals or organisations) that are specified to be used in particular projects.

Once the sources of funds have been identified and set aside, a special account called the capital project fund account will be created to ensure proper utilisation of resources. The capital project fund will then operate on the basis of modified accrual principles of accounting, whereby related revenues and expenditures are recognised when there is a certainty of their occurrence.

Assume that a governmental unit gets authority to issue long-term bonds to finance a particular capital project. Once authority is granted, the concerned governmental unit will only record the request's acceptance, but the revenue arising thereon will only be recognised when bonds are issued and sold to the public.

Under capital project funds, contracts will be entered into, and there may be a time lapse from when the contract is granted and when services are received. Such activities will be recorded as encumbrances in respect of the particular capital project. Actual expenditure incurred will be recorded against account payable. At the conclusion of the capital project comparison will have to be carried to between:

1) Sources of funds identified to finance the project;
2) Total expenditure – including the encumbrance incurred.

The difference between (1) and (2) represents the excess/deficit of funds arising from a particular project; and is transferred to the governmental unit's fund balance in the year in which the project was completed, e.g. suppose a particular capital project was to last 5 years, the financial statements for the interim period (1 – 4) will not include the balance in the capital project fund account. The surplus/deficit will be transferred to fund account at the end of year 5. Such transfers are known as equity transfers.

7.6.2 FUND ACCOUNTING

The accounts of a government unit are partitioned into segments called funds, and separate financial statements are prepared for each fund. A fund accounting system is a collection of distinct entities or funds in which each fund reflects financial aspects of a particular segment of the organisation's activities. Separate funds are used to aggregate activities by functions because of the diverse nature of the services offered and because it is necessary to comply with legal provisions regarding activities of the government unit. Although funds are separate entities, the structure of funds is such that a single transaction may occasion entries in the accounts of several funds.

Definition

A fund is defined as a distinct accounting entity with a self-balancing set of accounts recording cash and other financial resources together with all related liabilities and residual equities or balances and charges therein.

In other words, a fund is a segregated collection of both assets and equity accounts, together with related revenue and expenditure accounts that describe a particular aspect of the organisation. Each fund is established to account for specific activities or objectives in accordance with applicable regulations and restrictions. Since each fund represents a distinct reporting entity, separate financial statements are prepared for each fund, in addition combined financial statements may also be prepared.

Types of funds

The types of funds recommended for use by central and local governments are classified in three categories:

(i) Government funds;
(ii) Proprietary funds; and
(iii) Fiduciary funds.

In the first group, governmental funds, are:-

1. General Funds

General funds are funds established to account for resources devoted to financing the general services which the governmental unit performs for its citizens.

These include general administration, protection of life and property, sanitation and similar broad services. The general fund is sometimes described as the one use to account for all financial transactions not properly accounted for in another fund. Some activities, such as governmentally supported liberties, are often of sufficient importance and magnitude to have a special fund; when this is not true they become a function and responsibility of the general fund.

2. Special Revenue, or Special, Funds

Funds of this class are created and operated to account for revenue designated by law for a particular purpose. For the specific purpose of function to which it is devoted, a special revenue fund is much in the nature of a general fund. Some of the governmental services for which special funds are frequently established are education, libraries, streets and bridges, welfare, etc.

3. Capital Projects Funds

The receipt and disbursements of all financial resources to be used for the acquisition of capital facilities other than those financed by special assessment funds, proprietary funds and trust funds is accounted for by capital projects funds.

4. Debt Service Funds (Sinking funds)

A debt service fund is created to account for the resources devoted to the payment of interest and principal on long-term general obligation debt other than that payable from special assessments and that serviced by governmental enterprises.

5. Special Assessment Funds

Special assessment funds are designed to account for the construction, or purchase through contract, of public improvements-streets, sidewalks and sewer systems, for example – which are financed in whole or in part by special levies against property owners adjudged to receive benefits from the improvements materially in excess of benefits received by the general body of taxpayers, and for the maintenance and upkeep of such assets.

The following two fund types are referred to as proprietary funds:-

6. Internal Service Funds (Working capital/Revolving funds)

Internal service funds are established by governmental units as a means of providing services to other funds or departments of the same unit, or to other governmental units, on a cost-reimbursement.

7. Enterprise Funds

Internal service funds are established to provide services for governmental customers, but enterprise funds are operated to provide electric, water, gas, or other services to the general public. Except for ownership, they bear a close resemblance to investor-owned utility or other service enterprises. Enterprise funds are also used to account for activities for which the governmental body desires periodic computation of revenues earned, costs incurred, or net income. The third category of funds recommended for use by state and local governmental units is fiduciary funds.

8. Fiduciary Funds (Trust/Agency funds) E.g. NSSF, NHIF

Fiduciary funds are used to account for transactions related to assets held by a governmental unit as a trustee or agent. In most cases the governmental unit does not have absolute title to the assets held; and in the remainder, they are owned with specific restrictions upon their use.

In addition to the eight generally recognised types of funds, governmental units employ two self-balancing groups of accounts which are accounting entities, but which are not fiscal entities and therefore, are not funds. These groups are called the “general fixed assets group” and the “general long-term debt group”. General fixed assets are those not used exclusively by any one fund, and general long-term debt is that long-term debt which is presently a liability of the municipality as a whole and not of individual funds.

Although funds are employed extensively and effectively to promote the use of governmental resources for their intended purposes, the practice can be carried to extremes. In the opinion of many, accounting and reporting are facilitated through use of the minimum number of funds consistent with legal and operating requirements.

Integration of budgetary Accounts

A second distinctive characteristic of governmental accounting resulting from the need to demonstrate compliance with laws governing the sources of revenues available to governmental units, and laws governing the utilisation of those revenues, is the formal recording of the legally approved budget in the accounts of funds operated on annual basis.

Briefly, Budgetary accounts are opened as of the beginning of each fiscal year and closed as of the end of each fiscal year; therefore they have no balances at year-end. During the year, however the budgetary accounts of a fund are integrated with its proprietary accounts. Proprietary accounts, in the governmental sense, include accounts similar to the real and nominal groups found in accounting for profit-seeking entities – that is, asset, liability, net worth, revenue, and expense (or expenditure) accounts.

The Basis of Accounting

Use of the accrual basis of accounting is considered appropriate for proprietary funds, non-expendable trust funds, and pension trust funds of governmental units. Accrual accounting means: -

1. That revenues should be recorded in the period in which the service is given, although payment is received in a prior or subsequent period, and

2. That expenses should be recorded in the period in which the benefit is received, although payment is made in a prior or subsequent period.

In business enterprise accounting, the accrual basis is employed to obtain a matching of costs against the revenue flowing from those costs, thereby producing a more useful income statement. In governmental entities, however, even for those funds which do attempt to determine net income, only certain trust funds have major interest in the largest possible amount of gain. **Internal service and enterprise funds are operated primarily for service;** they make use of revenue and expense accounts to promote efficiency of operations and to guard against impairment of ability to render the services desired. For these reasons, operating statements of proprietary funds, non-expendable trust funds, and pension trust funds are called statements of revenue and expenses, rather than income statements.

Funds of other types (general funds, special revenue funds, capital projects funds, debt service funds, special assessments funds, and expendable trust funds) are not concerned with income determination. These funds are concerned with matching expenditure of legal appropriations, or legal authorisations, with revenues available to finance expenditures. Accordingly, the “governmental” funds and expendable trust funds should use the “modified accrual” basis. The modified accrual basis is defined as:

Revenues should be recognised in the accounting period in which they become available and measurable. Expenditures should be recognised in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term debt and on special assessment in-debtness secured by interest-bearing special assessment levies, which should be recognised when due.

The modified accrual basis is accepted by the American Institute of Certified Public Accountants as being consistent with generally accepted accounting principles. The AICPA recognises that it is not practicable to account on an accrual basis for revenues generated on a self assessed basis such as income taxes, gross receipts taxes, and sales taxes. For such taxes, determination of the amount of revenue collectible is ordinarily made at the time of the collection, thus placing the fund partially on the cash basis.

Number of Funds

Government units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.

Accounting for Fixed Assets and Long-term Liabilities

A clear distinction should be made between;

(A) Fund fixed assets and general fixed assets; and

(B) Fund long-term liabilities and general long-term debt

(i) Fixed assets related to specific proprietary funds or Trust Funds should be accounted for through those funds. All other fixed assets of a governmental unit should be accounted for through the General Fixed Assets Accounts Group.

(ii) Long-term liabilities of proprietary funds, special assessment funds, and Trust Funds should be accounted for through those funds.

All other unmatured general long-term liabilities of the governmental unit should be accounted for through the General long-term debt account group.

Valuation of Fixed Assets

Fixed assets should be accounted for at cost or, if the cost is not practicably determinable, at estimated cost. Donated fixed assets should be recorded at their estimated fair value at the time received.

Depreciation of Fixed Assets

(a) Depreciation of general fixed assets should be recorded in the accounts of governmental funds. Depreciation of General Fixed Assets may be recorded in cost accounting systems or calculated for cost finding analysis; and accumulated depreciation may be recorded in the General Fixed Assets Account Group.

(b) Depreciation of fixed assets accounted for in a proprietary fund should be recorded in the accounts of that fund. Depreciation is also recognised in those Trust Funds where expenses, net income and/or capital maintenance are measured.

Accrual Basis in Governmental Accounting

The modified accrual or accrual basis of accounting as appropriate should be utilised in measuring financial position and operating results.

(a) Governmental fund revenues and expenditures should be recognised on the modified accrual basis. Revenues should be recognised in the accounting period in which they become available and measurable. Expenditures should be recognised in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term debt and on special assessment indebtness secured by interest-bearing special assessment levies, which should be recognised when due.

(b) Proprietary fund revenues and expenses should be recognised on the accrual basis. Revenues should be recognised in the accounting period in which they are earned and become immeasurable; expenses should be recognised in the period incurred, if measurable.

(c) Fiduciary fund revenues and expenses or expenditures (as appropriate) should be recognised on the basis consistent with funds accounting measurement objective. Non expendable Trust and Pension Trust Funds should be accounted for on the accrual basis; Expendable Trust Funds should be accounted for on the modified accrual basis. Agency Fund assets and liabilities should be accounted for on the modified accrual basis.

(d) Transfer should be recognised in the accounting period in which the interfund receivable and payable arise.

Budget and Budgetary Controls

Budgets are key elements of legislative control over government units. The executive branch of a government unit proposes the budget, the legislative branch reviews, modifies and enacts the budgets and finally the executive branch implements the budget. The two basic classifications of budgets for governmental units are the same as for commercial enterprises;

(i) Annual budgets – which include the estimated revenues and Appropriations for a specific fiscal year end;

(ii) Capital budgets – which are used to control the expenditures for construction projects or other planned asset acquisitions.

The operations of the two proprietary funds (i.e. enterprise and internal service) are similar to those of business enterprises. Consequently, annual budgets are used by these funds as a managerial planning and control rather than a legislative control tool. Thus, annual budgets of enterprise funds and internal service funds are NOT Recorded in ledger accounts by these funds.

7.7 PUBLIC SECTOR ACCOUNTING

The Consolidated fund

FAST FORWARD: This is the main fund operated by the government. The Exchequer and Audit Act states that all government revenue excluding income which a ministry is allowed to keep a cover part of its own expenses (i.e. Appropriation-In- Aid) must be put into this fund, and no money may be withdrawn from this fund without the authority of parliament.

Each year, the Parliament votes on the appropriations bill, which sets out:

a) The estimated total revenue of the government for the coming fiscal year (1st July – 30th June) and;

b) The amount of money which each ministry expects to be allocated for its needs in that fiscal year.

Thus the Appropriation Act for 1986/1987 Parliament authorised a gross sum f K£95,002,150 for the Ministry of Health in respect of recurrent expenditure. This was described in the 1986/87 estimates of recurrent expenditure as follows:

	K £
Gross vote	95,002,150
Appropriations-In-Aid	(2,280,250)
Net Vote	K£ 92,721,900

The above description means that the Ministry was authorised to spend K£92,721,900 being supplied form the consolidated fund, and the remainder coming from the ministry's own Appropriations-In-Aid. Examples of Appropriations-In-Aid within Ministry of Health would include Hospital Boarding fees, X-ray fees, Lab fees etc.

Consolidated Fund Services

Certain government expenditure does not have to be voted every year by Parliament because Parliament has already given its approval for the specific items concerned in the past. These items are known as consolidated fund services, and include salaries and allowances of the Judiciary, subscriptions to international organisations, such as OAU, UN etc., payment of pension to civil servants, payments of national debt, etc.

Sources of Government Revenue

Government revenue falls into two categories:

a) Recurrent
b) Development

The main sources of revenue are taxes, government borrowings (both domestic and foreign) and grants.

An example of revenue estimates for the year 1986/87 is:

Recurrent Revenue Estimates	**(K£ Millions)**
Customs and excise duty	298.5
Income tax	370.0
Sales tax /Value Added Tax	437.0
Export duty and other taxes	107.4
Miscellaneous (15 categories)	160.9
	1,373.8
The development revenue estimates were	64.5
	1,438.3

The annual estimates of expenditure for the fiscal year 1986/1987 were:

Recurrent expenditure	1,420.8
Development expenditure	292.6
	1,713.4

There is a shortfall of K£275.1m expected for the 1986/87 fiscal year. The gap is normally closed by borrowing either from abroad or from the domestic market. Domestic borrowings usually take the form of Treasury Bills.

Government Expenditure

As with revenue, expenditure falls into two categories

(i) Recurrent expenditure
(ii) Development expenditure

Recurrent Expenditure

This is expenditure on the day to day business of the government. In commercial accounting, it could be called revenue expenditure.

Recurrent expenditure may be referred to as maintenance expenditure as it covers items concerning the maintenance and operation of existing government services e.g. salaries to government officers, electricity, water, telephone etc.

Development Expenditure

This is expenditure concerning new projects e.g. construction of hospitals, roads, bridges etc.

Recording Government expenditure and revenues:

(1) Government accounting is "cash-based" i.e. limits itself to transactions which have been entered in the cash book. Thus government accounting has no personal accounts for debtors/creditors, nor does it have accruals/prepayments. The only debtor-creditor relationship arises in transactions between the government and the ministries, but not third parties.

(2) Government Accounting does not make any distinction between fixed assets and a day-to-day expense. Both are treated as expenditure in the period in which they are paid (properly classified as either recurrent or development expenditure) and hence there are no fixed asset accounts.

(3) Since there are no fixed asset accounts, there is no such thing as depreciation in governmental accounting. The effect of passing fixed assets through the usual expenditure accounts is to write them off in the year of purchase.

The reason for this treatment of fixed assets is that the government is not aiming at realizing profits or quantifying losses, and hence does not need to divide the benefits of capital expenditure over the financial years, nor to assess the loss of value in that asset in a given year.

There is also the difficulty of trying to value assets such as Nairobi-Mombasa Road etc.

Accounting for and individual ministry

In accordance with the normal rules of double entry book-keeping cash received is debited to the cash account (PMG) and the revenue account is credited. Thus in the books of Ministry X, the receipt of Ksh5,000 will be recorded as:

Pay Master General A/C (Cash)

Revenue A/C 5,000		Exchequer 5,000

STUDY TEXT

Revenue

	Pay Master General 5,000

The paymaster General is the cash account of all ministries. Since all revenue (apart from Appropriation-In-Aid) must be transferred immediately to the consolidated fund, funds received will be paid over immediately to the Treasury which administers the consolidated fund on behalf of the government. The Account within which the Treasury administers the consolidated fund is called the Exchequer Account.

Exchequer A/C

Pay Master General 5,000	

At the end of each financial year, each ministry which has collected funds on behalf of the government makes out a "statement of revenue".

Expenditure

A ministry operates within the strict limits of the vote allocated to it by Parliament. The Accounting system is merely used to reveal whether the ministry is keeping within the limits of voted expenditure or not. The ministry has no authority to spend over parliamentary allocations, and the authority to spend is only for the duration of the financial year.

If a ministry under spends in a financial year, or if there are any excess receipts, it may not retain the available funds, but must surrender them to the exchequer to be reincorporated into the consolidated fund and eventually re-distributed to the ministries as determined by Parliament.

If the ministry overspends, the only body empowered to ratify this overspending is Parliament. In the subsequent financial year the matter is presented in Parliament in the form of "excess vote" and Parliament decides whether to approve the excess vote or to recover it from the officers responsible for exceeding the vote.

The Pay Master General (PMG)

FAST FORWARD: The PMG is an office rather than an officer, and no person bears the title "Pay-Master General". The functions of the PMG are carried out by a section of the treasury.

The PMG is subordinate to the treasury and has the following functions: (which are regulated by the Minister of Finance)

1) It is the principal paying agent for the government and banker of all government departments as regards voted expenditures and payments on consolidated fund services.

2) It arranges with the treasury at regular intervals (usually twice a month) for funds to be withdrawn from the exchequer and put to the credit of the PMG's account in the Central Bank of Kenya;

3) It allows authorised signatures from these ministries to draw cheques on this account;

4) It keeps a record of the above transaction and sends statements on a monthly basis to the accounting officers (i.e. the Permanent Secretaries) of each accounting unit together with supporting vouchers;

5) It receiver monthly reconciliations of these statements from accounting officers;

6) It supplies the treasury with the following:
   a) A monthly statements and balance sheet
   b) Annual statements and balance sheet.

It should be noted that the PMG is just a single account kept at the Central Bank of Kenya and administered by the PMG's office in the treasury.

All ministries are authorised to draw on this single PMG account. The PMG's office is able to analyse the different payments and receipts to allocate to various ministries, and to send them monthly statements.

Cash book

There are significant differences between commercial accounting and government accounting as regards operation of the cash book.

These are: -

(1) Restricted analysis – The government cash book makes an analysis between "cash" and "bank" only, i.e. there is no further analysis into categories/classes of expenditure.

(2) The usage of the cash column – Cheques received are considered cash until they are banked. The book-keeping entry is: -

Debit Cash (Cash column of cash book)
    Credit Revenue (or Appropriation- In-Aid)

When a cheque is banked,
Debit Bank Column
    Credit Cash Column

A dishonoured cheque can be recorded as:
Debit Cash Column
    Credit Bank Column

Three cash books are maintained:

(i) Current revenue and expenditure cash book.
(ii) Development revenue and expenditure cash book
(iii) Deposits cash book.

Vote books:-

The cash book and vote book from the bank-bone of the accounting system. The vote book is essentially a book of prime entry, and does not form part of the double entry system. The totals of the vote book are transferred to the ledger:

Debit Expenditure item (as per vote book)
Credit Cash book

Year-end Accounts: -

By 31 October each year, 4 months after the end of the financial year, each ministry must present its final accounts to the Auditor General. These consist of

(a) Statements of Revenue

(b) Appropriation Accounts

(c) Final Accounts – These refer to the various funds administered by different ministries and require an income and expenditure A/C as well as a statement of assets and liabilities for each fund.

>>> Illustration 1:

Prepare a statement of revenue for the year ended 30.6.97 for Ministry of Domestic Affairs:

Exchange Control fees (Code 740)	– Estimated receipts	K£300,000
Actual receipts	K£3,460,968	
Insurance premiums (Code 750)	- Estimated receipts	K£130,000
	- Actual receipts	K£174,000
Other income (Code 679)	- Estimated receipts	K£20,000
	- Actual receipts	K£10,334
Extra exchequer income (Code 999)	– Estimated receipts	K£1,055,000
	– Actual receipts	K£6,843,238
Payments to exchequer		K£8,68,422
Balance due to exchequer (1 July 96)		K£249,529

Public Sector Accounting: Theory

This part of the lesson has been built up using the question and answer approach.

QUESTION ONE

Discuss the role and functions of the Treasury and its relationship with other Government department, in planning and controlling government expenditure.

Solution

The role and functions of the treasury include:

(1) Advising on the setting of objectives for economic policy.
(2) Coordinating government expenditure towards the achievement of economic policy.
(3) Ensuring the execution of Policies in the most economic fashion by Government Departments.
(4) The overall supervision of national finance.
(5) Involvement in the process of settlement of levels of national expenditure and the raising of revenue.
(6) Controlling Government borrowing.
(7) Management of pensions
(8) Administration of contingency funds e.g. disbursements, distaden funds etc.
(9) Payments forward – chief cashier to the government debts, incomes expenditures etc.

Links with other Government Departments

(1) Involvement in scrutinizing of annual estimates
(2) Consultation on possible revisions of estimates.
(3) Ensuring adequate financial controls exists within departments including adequate staffing and accounting procedures.
(4) Involvement jointly in preparation of annual budget.

Further points for Discussion

(1) Importance of Treasury control during periods of economic stringency.
(2) Financial specialisation and expertise needed in dealing with estimates and financial control.
(3) Criticism of Treasury
   - Too much Treasury Control and interference stifling departmental initiative.
   - Staffing by career civil servants and injection of specialists from outside often resented.
   - Too narrow a view taken by Treasury is often over-cautious.

QUESTION TWO

Discuss the role of the Controller and Auditor General.

Solution

The Controller and Auditor General is an officer of Parliament (not a civil servant) who has two main functions:-

(1) As controller, he acts as Paymaster, controlling receipts and payments of public money through various accounts.

(2) As External Auditor, he audits the various departmental accounts reporting on the Appropriation Account, etc. to the parliament, which refers them to the **Public Accounts Committee.** This is a Select Committee whose duty is to consider the report and issues arising from it.

From Audit point of view, his work covers the following:

Financial and Regularity Audit

(a) **Financial:** - to ensure that accounting and financial control systems operate correctly so that all financial transactions are both properly authorised and properly accounted for.

(b) **Regularity**: - to ensure that expenditure is incurred on approved matters and is legal.

(c) **Value for money audit:** - an examination based on economy and efficiency to curb extravagance expenditure and maximise receipts. The Public Accounts Committee also tends to concentrate on this question.

(d) **Effectiveness of audit:** - An examination to assess whether programmes undertaken to meet established policy objectives have achieved those objectives.

QUESTION THREE

Explain the main functions of an annual Budget for a public sector organisation with which you are familiar.

Solution

A budget may be defined as a financial and quantitative statement prepared prior to a definite period of time of the policy to be perused during that time for the purposes of attaining a given objective.

A statement of the organisation’s intention against which its achievement can be measured.

Main function of an annual budget of local authority:

1. To assist in fixing the general rate, local authority is required to levy a rate sufficient to cover the needs of the year.

2. To assist Policy making - to help members to making decisions on the provision of services.
3. To assist control – or Income and expenditure.
4. To authorise expenditure – authority to incur the expenditure or collect the income.
5. To provide a standard against which to judge performance.

>>> Example 1

(a) In accounting for Central Government and Local Government units, a fund called Capital Project Fund is usually created. What is the purpose of this fund? (5 marks)

(b) The City Council of Matopeni authorises the construction of a new city hall on 1 January 1991. This hall is expected to cost sh.100,000,000. Financing for the project is to beSh50,000,000 from 6½ per cent serial bond issue, Sh.40,000,000 from a Government Grant, and Sh.10,000,000 from the general fund (GF). Transactions and events during 1991 are as follows:

(i) The city transfers Sh.10,000,000 from the GF to the City Hall Capital Project Fund (a CPF created for the construction).
(ii) Planning and architect's fees are paid in the amount of Sh.4,000,000.
(iii) The contract is awarded to the lowest bidder for Sh.95,000,000.
(iv) The bonds are sold for Sh.50,200,000.
(v) The amount of the premium is transferred to the debt service fund.
(vi) The construction is certified to be 50 percent compete and a bill for Sh.47,500,000 is received from the contractor.
(vii) Contracts payable, less a 10 percent retained percentage, is paid.
(viii) The books are closed and financial statements are prepared.

Required:

(i) Journal entries to record the above transactions. (10 marks)
(ii) Financial statement of the capital project fund for the year 1991. (5 marks)
(20 marks)

Solution

(a) Capital project fund (CPF)

The purpose of capital project fund is to provide resources for the completion of some specific capital project. The main sources of financing include the proceeds of bond issues, grants and transfers from other funds. A separate capital project fund is created for each major project.

(b)

(i) JOURNAL ENTRIES

NO.	**PARTICULARS**	**F**	**Dr** (Sh '000')	**Cr** (Sh '000')
1.	Transfers to city call CPF			
	General Fund		10,000	
	Cash A/C			10,000
	(Being the transfer to city hall CPF)			
2.	Capital project fund (CPF):			
	Cash account		10,000	
	General Fund (GF) A/C			10,000
	(Being the receipt of funds from G.F)			
3.	**CPF**			
	Planning and architect's fees A/C		4,000	4,000
	Cash A/C			
	(Being the payment of planning and architect's fees)			
4.	**CPF**			
	Encumbrances		95,000	
	Reserve for encumbrances			95,000
	(Being the recording of encumbrances for the amount of contract)			
5.	**CPF**			
	Cash account		50,200	
	Bonds account			50,000
	Premium on bonds etc.			200
	Being the proceeds from the issue of bonds)			
6.	Premiums on bonds A/C		200	
	Cash A/C			200
	(Being the transfer of premium bonds to City Hall debt service fund)			
7.	Reserve for encumbrances A/C		47,500	
	Encumbrances A/C			47,500
	(Being the transfer of half of the amount encumbered)			
8.	Contract expenditures A/C		42,500	
	Contract payable A/C			42,750
	Contract payable – retention A/C			4,750
	(Being the expenditure on the City Hall contraction recorded)			

9.	Contract payable A/C	42,750	
	Cash A/C		42,750
	(Being the partial payment to the contractor)		
10.	**CPF** – Adjusting entry due from government grant	40,000	
	Revenue A/C		40,000
	(Being the accrued revenue from the government grant.)		
11.	**CPF (Closing Entries)**		
	Revenue A/C	40,000	
	General Fund A/C	10,000	
	Proceeds from issue	50,000	
	Expenditures		46,750
	Encumbrances		47,500
	Fund balance		5,750
	(To close the books at the end of 1994)		

(ii) CITY COUNCIL OF MATOPENI

A statement of Revenue and Expenditure and charges in the Fund Balance for the year ended 31st December 1991.

	(Sh '000')
Project authorisation	100,000
Sources of Financial Funds	
Revenue from government grant	40,000
Transfers:	
Proceeds from fund issue	50,000
Transfers from general fund	10,000
	100,000
Use of Financial Resources	
Expenditures	51,500
Excess of Revenue and Transfers over expenditure	48,500
Less: Increase in encumbrances	47,500
Fund Balances as at 31st December 1994	1,000

CITY OF MATOPENI

City Hall Capital Project Fund

Balance Sheet as at December 31, 1991

	(Sh '000')	(Sh '000')
Assets		
Cash		13,250
Due from government grant		40,000
		53,250
Contracts payable – retention money		4,750
Fund equity:		
Reserve for encumbrance	47,500	
Fund balance	1,000	48,500
		53,250

>>> Example 2

The Ministry of Trade and Commerce had the following estimated revenues to collect during the financial year ended 30 June 1993.

	Sh.
Hotel and Restaurant licenses	900,000
Cattle traders licenses	1,000,000
Licenses under Trade Licensing Act	765,000
Liquor licenses	500,000
Professional Licenses	75,000
Licenses for registration of Insurance Companies	320,000

During the year and prior to any issue of Licenses, it was found necessary to suspend the issue of liquor Licenses and professional Licenses. The Receiver of Revenue further found out that more people were interested in scrap metal business. The Treasury authorised the Receiver of Revenue to open a new head for scrap metal Licenses with an estimated collection of Sh.955,000.

At the close of the financial year, the Receiver of Revenue had collected the following amounts:

	Sh.
Hotel and Restaurant Licenses	1,131,250
Cattle traders Licenses	2,261,250
Licenses under Trade Licensing Act	705,000
Liquor Licenses	-
Professional licenses	-
Registration of insurance companies	255,000
Scrap metal Licenses	1,117,500

The Receiver of Revenue had provided the following additional information:

(i) The ministry had a balance of Sh.33,750 at the beginning of the financial year.
(ii) An amount of Sh.335,000 in respect of scrap metal Licenses was still in the hands of agents as at 30 June 1993.
(iii) A sum of Sh.8,750 was due to the Exchequer at the end of the year.

Required

(a) A Statement of Assets and Liabilities for the year ended 30 June 1993 (5 marks)

Ministry Of Trade and Commerce

Statement of Assets and Liabilities as at 30 June 1992

Assets	**Sh.**
Cash balance	5,503,750
Receivable from agents	335,000
	5,838,750
Fund Balance and Liabilities	
Fund balance (brought forward)	33,750
Fund balance (current year) (W – 1)	5,796,250
Payable to the exchequer	8,750
	5,838,750

(b) STATEMENT OF REVENUE

For the year ended 30 June 1993

Head	Estimates	Actual	Over (under) Estimated
	Sh.	**Sh.**	**Sh.**
011 – Hotel & Restaurants	900,000	1,131,250	(231,250)
012 – Cattle traders Licenses	1,000,000	2,261,250	(1,261,250)
013 – Licenses under Trade Licensing Act	765,000	705,500	60,000
014 – Liquor Licenses	500,000	-	500,000
021 – Professional Licenses	75,000	-	75,000
022 – Registration of Insurance Companies	320,000	255,000	65,000
031 – Scrap metal Licenses	955,000	1,117,500	(162,500)
	4,515,000	5,470,000	(955,000)
Balance b/f from previous year			33,750
Amount payable to the exchequer			5,503,750
Amount transferred to exchequer **(Bal. Fig)**		5,495,000	
Amount due to exchequer			8,750

(W – 1) Fund Balance Current year:

Amount transferred to exchequer	5,495,000
Add: Amount receivable from agents	335,000
	5,830,000
Less: Balance b/f from previous year	- 33,750
	5,796,250

(c) Footnotes:
1. Introduction of a new source of revenue i.e. scrap metal Licenses.
2. Withdrawal of two revenue sources i.e. liquor Licenses and professional Licenses.
3. Reasons for material variations in actual receipts.
4. Details about revenue with collector's agents.

>>> Example 3

The following data were taken from the accounting records of the Town of Ole Meka General Fund after the accounts had been closed for the fiscal year ended 30 September 1991.

	Balances	Fiscal Year 1991	Changes	Balances
	1 October 1990	**Debit**	**Credit**	**30 Sept. 1991**
Assets	**Sh.**	**Sh.**	**Sh.**	**Sh.**
Cash	180,000	955,000	880,000	225,000
Taxes Receivable	20,000	809,000	781,000	48,000
Estimated uncollected tax	(4,000)	6,000	9,000	(7,000)
	196,000			296,000
Liabilities, Reserves & Funds Balances:				
Vouchers payable	44,000	880,000	889,000	53,000
Due to intra governmental Service fund	2,000	7,000	10,000	5,000
Due to Debt Service Fund	10,000	60,000	10,000	50,000
Reserve for encumbrances	40,000	40,000	47,000	47,000
Fund balance	100,000	20,000	61,000	141,000
	19,000	2,777,000	2,777,000	296,000

The following additional data is available:

(i) The budget for fiscal year 1991 provided for estimated revenues of Sh.1,000,000 and appropriations of Sh.965,000.

(ii) Expenditure totaling sh.895,000 in addition to those chargeable against Reserve for Encumbrances, were made.

(iii) The actual expenditure chargeable against Reserve for Encumbrances was Sh.37,000.

Required:

Show journal entries to record the above transactions in the books of Town of Ole Meka General Fund.

(20 marks)

Solution

TOWN OF OLE MEKA GENERAL FUND ----Journal Entries

S. No		Dr	Cr
		Sh.	Sh.
(i)	Cash	995,000	
	Revenue		995,000
	(Being revenue received)		
(ii)	Expenditure	858,000	
	Encumbrances	22,000	
	Bank		880,000
	(Being the record of payment made)		
(iii)	Tax receivable	28,000	
	Fund Balance		28,000
	(Being the record of the increase in tax receivable)		
(iv)	Fund Balance	3,000	
	Incollectable taxes		3,000
	Fund Balance	9,000	
	Vouchers		9,000
	(Being increase of vouchers payable)		
(v)	Fund Balance	3,000	
	Intra: government		3,000
	(Being the record of the net increase)		
(vi)	Fund Balance	40,000	
	Debt Servicing Fund		40,000
	(Being the record of net appropriation to debt service fund).		
(vii)	Encumbrances	15,000	
	Fund		15,000
	Fund	44,000	
	Encumbrances		44,000
	(Being the record of net changes in encumbrances)		
(viii)	Revenue	858,000	
	Expenditure		858,000
	(Being the record of expenditure incurred against the revenue).		
(ix)	Revenue	97,000	
	Fund		97,000
	(Being the transfer of net revenue to the Fund A/C).		

FINANCIAL STATEMENT

Town of Ole Meka

Assets	**Sh.**
Cash	225,000
Tax received	48,000
Estimated uncollected tax	(7,000)
	296,000

Fund Balances

Sh.		Sh.	
Uncollected Tax	3,000	Balance b/f	100,000
Voucher	9,000	Tax receivable	28,000
Intra	3,000	Reserve for Encumbrances	15,000
Debt fund	40,000	Reserve	97,000
Encumbrances	44,000		
Balance c/d	141,000		
	240,000		240,000

CHAPTER SUMMARY

The **objectives of the IPSASB** are to serve the public interest by developing high quality public sector financial reporting standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of financial reporting throughout the world.

The **public sector** is composed of the following:

- Central Government
- Local government
- Parastatals
- Charitable organisations

All Revenues for the government are recorded into a fund known as a **consolidated fund**. The consolidated fund account is kept by the treasury under the Ministry of Finance, and all revenues and grants received by the Government are paid into this account.

The purpose of a **special revenue fund** is to show that the revenue from such sources was used for a specific purpose only; and the governmental unit will then operate what is known as a special fund account to record the resources and liabilities for such an entity.

Encumbrances record the commitments that have been entered into but services are yet to be received. The purpose of recording the commitments is to ensure that the budgeted appropriations are not exceeded.

General funds are funds established to account for resources devoted to financing the general services which the governmental unit performs for its citizens.

CHAPTER QUIZ

1. The independence of Internal Audit in a public sector organisation is considered to be essential to its effectiveness.
Explain what is meant by independence in this context and give examples of circumstances which might impair independence.

2. Discuss the main reasons for the growth in public expenditure.

3.
(a) Explain the role and objectives of internal audit in a public sector organisation.

(b) What factors influence the size and organisation of an internal audit section in a Public Sector organisation?

ANSWER TO QUIZ QUESTIONS

1. As the internal auditor is appointed within the organisation he cannot be completely independent of the organisation but he must be sufficiently independent to allow him to carry out his duties in a manner which allows his professional judgment and recommendations to be effective and impartial.

In order to operate effectively, the internal auditor should:

2) Be independent of all staff whose operations are under review.

3) Not be involved in routine financial systems.

4) Have direct access to all department heads, chief executive and the management board.

5) Have full rights of access to records, assets and personnel and receive such information and explanation as are necessary for the performance of their duties.

The chief internal auditor should have the right to report under his own name on any aspect of the financial work including that of finance department.

Impairment of Independence

(a) Having an interest in business which is involved in any way with the audit.

(b) Having been previously involved e.g. as accountant in the operations; or

(c) Personal relationship e.g. a spouse or other relative of persons being audited.

2.
2) Increase in range and volume of state activity – inflation.
3) The effect of economic ideas and political theories – use of public expenditure by state as a weapon of economic control.
4) The effects of wars and social crises.
5) With the development of the state there tends to come an increased expectation by the public of more state activities: - Roads, transport, energy, water and sewerage services.
6) The introduction and maintenance of the Welfare State.
7) External involvement such as membership of OAU etc.
8) Internal involvement in industry and commerce including nationalisation and control of socially significant industries and commerce and support for industries incurring heavy research and development costs, particularly new technology industries.

3. The role and objectives of internal audit may vary between different parts of the Public Sector, depending on attitudes, statutory requirements, size etc. Definition of internal audit – Statement of internal audit practice.

> “An independent appraisal function within an organisation for the review of activities as a service to all levels of management. It is a control which measures, evaluates and reports upon the effectiveness of internal controls, financial and otherwise as a contribution to the effective use of resources within an organisation.

It is the responsibility of internal audit to review, appraise and report upon the following matters:

a) The soundness, adequacy and application of internal controls – internal controls can be said to comprise the whole system of controls established by management in order to

1) Safeguard its assets
2) Ensure reliability of records
3) Promote operational efficiency and
4) Monitor adherence to policies and directives.

b) The extent to which the organisation’s assets and interests are accounted for and safeguarded from losses of all kinds from:

Factors:

1) Fraud and other offences and
2) Waste, extravagance and inefficient administration, poor value for money and other causes. In recent years, increasing emphasis has been put on audits role in connection with avoidance of waste and obtain value for money.
3) The suitability and reliability of financial and other management data developed within the organisation.

Detailed procedures should exist for initiating, authorising, carrying through and recording transactions. These procedures will allow the principles of internal check and will be kept under review by internal auditor.

Factors:

1) Type of organisation
2) The size
3) The scope and objectives of internal audit
4) Managerial attitude to internal audit
5) The adequacy of internal control system

EXAM QUESTIONS

QUESTION ONE

Outline the differences between the financial objectives of:

1) Public Corporation i.e. state owned corporations, nationalised industries, and
2) Limited companies

QUESTION TWO

Outline the role played in Government accounting by:

(a) The Public Accounts Committee
(b) The controller and auditor general
(c) The government Ministries Accounting Officers.

QUESTION THREE

In relation to fund accounting, explain what is meant by the following special funds and explain fully how they are operated.

a) Revolving funds
b) Trust funds
c) Sinking funds

QUESTION FOUR

One of the principle differences between non-profit and commercial organisations is that they have different reasons for their existence. Consequently, non-profit making organisations follow some accounting principles which differ from accounting principles followed by commercial organisations.

You are asked to state which are the principles followed by non-profit making organisations and why you think they are more appropriate than corresponding principles applicable to commercial organisations.

QUESTION FIVE

(a) “Without the profit motive there is an inevitable lack of budget motive”. Do you agree?

(b) Explain the administrative and accounting controls used to achieve the budgeted level of expenditure by the Government Ministries.

CHAPTER EIGHT

STUDY TEXT

CURRENT ISSUES

CHAPTER EIGHT

CURRENT ISSUES

▶ OBJECTIVES

At the end of this chapter, the students should be able to understand:

- Accounting principles and conventions and desirable characteristics of good accounting information.
- Accounting regulation and standard setting
- Social responsibility accounting and environmental reports

▶ INTRODUCTION

Accounting theory has been defined as logical reasoning in the form of a set of broad principles that

- Provide a general frame of reference by which accounting practice can be evaluated and
- Guide the development of new practices and procedures

In general the function of a theory is to assist in the resolution of practical problems. Accounting theory embodies a system of rules, procedures and assumptions used to produce the financial statements. It tries to answer the following questions.

- What is the nature and purpose of financial reports?
- What are the corporate financial reports designed to achieve?
- What is the financial accounting theory that underlies the production of such statements?

Note that the above three questions are not easy to answer and that is why there is no single universally accepted basic accounting theory, it does not exist today and will never exist in the future.

A number of problems exist in selecting an accounting objective. These include:

- The selection of goals is a subjective decision based on certain perceived preference.
- Accountants have no universally accepted goal among themselves.
- Where such goals are identified, they tend to be too generalised to be of any profitable use.

However, the fundamental objective of corporate financial reports is to communicate economic measurements of information about the resources and performance of the reporting entity useful to those having reasonable rights to such information. Elsewhere, it has been stated that the basic objective of financial reports is to provide useful information for making economic decisions.

From above, the following questions should be adhered to when deciding on the objective of any financial report.

- Who are the users of the financial report?
- What decision does such people (users) make based on such financial reports?
- What type of information in those statements do they use?
- Can the information (e.g. profitability, cash flows, or liquidity) they use be improved?
- Can the information be provided cost effectively?

▶ DEFINITION OF KEY TERMS

Financial statements are a structured financial representation of the financial position of and the transactions undertaken by an enterprise.

Accounting principles refer to the fundamental beliefs, guides to action and a settled ground or basis of accounting conduct and practice.

Accounting policies are the specific accounting principles and the methods of applying those principles that are considered by a business concern to be the most appropriate in the circumstances to present financial statements.

▶ EXAM CONTEXT

In past examinations, the examiner has tested the students' knowledge in the following topics:

- Concepts of capital and capital maintenance
- Social responsibility accounting
- Environmental reports

Students should therefore understand these topics.

▶ INDUSTRY CONTEXT

This chapter is important because it tackles accounting principles and conventions which are necessary in preparation of financial statements.

Firms use these accounting principle and conventions to prepare their financial statements.

Firms also utilize the social responsibility accounting concept if they are involved in socially responsible activities.

8.1 MEASUREMENT OF INCOME, CAPITAL AND THE VALUATION OF ASSETS

FAST FORWARD: Financial statements form part of the process of financial reporting.

Financial statements

They are a structured financial representation of the financial position of and the transactions undertaken by an enterprise. The objective of general purpose financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. A complete set of financial statements normally includes:

- A balance sheet
- An income statement
- A statement showing either:
  - All changes in equity; or
  - Changes in equity other than those arising from capital transactions with owners and distribution to owners
- Cash flow statement and
- Accounting policies and explanatory notes

The board of directors and/or other governing body of an enterprise is responsible for the preparation and presentation of the financial statements.

Elements of financial statements

These are the broad classes into which financial effects of transactions and other events are grouped.

Financial position measurement elements in the balance sheet include:

- *Assets:* an asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.
- *Liabilities:* a liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of

a present obligation and the amount at which the settlement will take place can be measured reliably.

- *Equity:* This refers to the residual interests in the assets of the business .The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.

Performance measurements elements in the income statement include:

- *Income:* income is recognised in the income statement when increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.
- *Expenses:* expenses are recognised in the income statement when a decrease in future economic benefit related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events.

The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements.

Measurements of the elements of financial statements

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.

Measurement bases include:

- *Historical cost:* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
- *Current cost:* assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
- *Realisable (settlement) value:* assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of

cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

- *Present value:* assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The historical cost base is the most common measurement basis adopted by enterprises when preparing their financial statements. This is usually combined with other measurement bases. For example, inventories are usually carried at lower of cost and net realisable value, marketable securities and pension liabilities are carried at their present value.

8.2 CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

Concepts of capital

- Financial concept of capital: under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the assets or equity of the enterprise. Usually adopted by many enterprises.
- Physical concept of capital: under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

Concepts of capital maintenance and determination of profit

The concept of capital maintenance is concerned with how an enterprise defines the capital it seeks to maintain.

- Financial capital maintenance: a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.
- Physical capital maintenance: a profit is earned only if the physical productive capacity (or operating capability) of the enterprise (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

The concepts of capital maintenance define profit as the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a net loss.

The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept however does not require the use of a particular basis of measurement.

8.3 ACCOUNTING PRINCIPLES AND CONVENTIONS

FAST FORWARD: Accounting statements are prepared in conformity with accounting principles in order to place more reliance on them.

Accounting is the language of business. To make the language convey the same meaning to all people, accountants all over the world have developed certain rules, procedures and conventions, which represents a consensus view by the profession of good accounting practices and procedures and are generally referred to as Generally Accepted Accounting Principles (GAAP).

Accounting principles refer to the fundamental beliefs, guides to action and a settled ground or basis of accounting conduct and practice.

Accounting principles can be classified into two categories:

- Accounting concepts, and
- Accounting conventions

Accounting concepts

Accounting concepts may be considered as postulates i.e. basic assumptions or conditions upon which the science of accounting is based.

Accounting concepts

Business entity concept

This concept implies that a business is separate and distinct from the person who supplies capital to it. Irrespective of the form of organisation, a business unit has got its own individuality as distinguished from the person who own or control it. The accounting equation (i.e. assets = liabilities + capital) is an expression of the entity concept because it shows that the business itself owns the assets and in term owns the various claimants. Business is kept separate from the proprietor so that transactions of the business may also be recorded with him.

Money measurement concept

Money is the only practical unit of measurement that can be employed to achieve the homogeneity of financial data, accountants records only those transactions which can be expressed in terms of money though quantitative records are also kept. The advantages of expressing business transactions in terms of money is that money serves as a common denominator by means of which heterogeneous facts about a business can be expressed in terms of numbers (i.e. money) which are capable of additions and subtractions.

Going concern concept

It is assumed that a business unit has a reasonable expectation of continuing business at a profit for an indefinite period of time. A business unit is deemed to be a going concern and not a gone concern. It will continue to operate in the future. Transactions are recorded in the books keeping in view the going concern aspect of the business unit.

This assumption provides much of the justification for recording fixed assets at original cost (i.e. acquisition cost) and depreciating them in a systematic manner without reference to their current realisable value. It is useless to show fixed assets in the balance sheet at their estimated realisable values if there is no immediate expectation of selling them. Fixed assets are acquired for use in the business for earning revenues and are not meant for resale, so they are shown at their book values and not at their current realisable values. But when the concern is not a going concern and is to be liquidated, current realisable values of fixed assets become relevant.

Cost concept

A fundamental concept of accounting closely related to the going concern concept, is that an asset is recorded in the books at the price paid to acquire it and that this cost is the basis for all subsequent accounting for the asset. This concept does not mean that the asset will always be shown at cost but it means that cost becomes basis for all future accounting for the asset. Asset is recorded at cost at the time of its purchase but is systematically reduced in its value by charging depreciation.

Dual aspect concept

There must be a double entry to have a complete record of each business transaction, an entry being made in the receiving account and an entry of the same amount in the giving account. Every debit must have a corresponding credit and vice versa and upon this dual aspect has been raised the whole super structure of Double Entry System of accounting. The accounting equation (i.e. assets = equities (or liabilities + capital)) is based on dual aspect concept.

Accounting period concept

Under the going concern concept it is assumed that a business entity has a reasonable expectation of continuing business for an indefinite period of time. This assumption provides much of the justification that the business will not be terminated, so it is reasonable to divide the life of the business into accounting periods so as to be able to know the profit or loss of each such period and the financial position at the end of such a period. Normally accounting period adopted is one year as it helps to take any corrective action, to pay income tax, to absorb the seasonal fluctuations and for reporting to the outsiders. A period of more than one year reduces the utility of accounting data.

Matching concept

This concept is based on the accounting period concept. The most important objective of running a business is to ascertain profit periodically. The determination of profit of a particular accounting period is essentially a process of matching the revenue recognised during the period and the costs to be allocated to the period to obtain the revenue. It is, thus, a problem of matching revenues and expired costs, the residual amount being the net profit or net loss for the period.

Realisation concept

According to this concept, revenue is considered as being earned on the date at which it is realised i.e. on the date when the property in goods passes to the buyer and he becomes legally liable to pay.

Objective evidence concept

Objectivity connotes reliability, trustworthiness and verifiability, which means that there is some evidence in ascertaining the correctness of the information reported. Entries in accounting records and data reported in financial statements must be based on objectively determined evidence, without close adherence to this principle; the confidence of many users of the financial statements could not be maintained. Invoices and vouchers for purchases and sales, bank statements for amount of cash at bank, physical checking of stock in hand etc. are examples, of objective evidence, which are capable of verification. As far as possible, some objective evidence should support every entry in accounting records.

Accrual concept

Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

The essence of the accrual concept is that revenue is recognised when it is realised, that is when sale is complete or services are given and it is immaterial whether cash is received or not. Similarly, according to this concept, expenses are recognised in the accounting period in which they help in earning the revenue whether cash is paid or not. Thus to ascertain correct profit or loss for an accounting period and to show the true and fair financial position of the business at the end of the accounting period, we make record of all expenses and incomes relating to the accounting period whether actual cash has been paid or received or not. Therefore, as a result of the accrual concept, outstanding expenses and outstanding incomes are taken into consideration while preparing final accounts of a business entity.

Convention of consistency

Accounting rules, practices and conventions should be continuously observed and applied i.e. these should not change from one year to another. The results of different years will be comparable only when accounting rules are continuously adhered to from year to year.

Consistency also implies external consistency i.e. the financial statements of one enterprise should be comparable with one another. It means that every enterprise should follow same accounting methods and procedures of recording and reporting business transactions. The development of international and national standards is due to the convention of consistency.

Convention of full disclosure

According to this convention, all accounting statements should be honestly prepared and to that end full disclosure of all significant information should be made. All information which is of material interest to proprietors, creditors and investors should be disclosed in accounting statements. An obligation is placed on the accounting profession to see that the books of accounts prepared on behalf of others are as reliable and informative as circumstances permit.

Convention of conservatism or prudence

It is a policy of caution or playing safe and had its origin as a safeguard against possible losses in a world of uncertainty. It compels the businessman to wear a “risk-proof” jacket, for the working rule is: anticipate no profits but provide for all possible losses. For example;

- Closing stock is valued at cost or market price whichever is lower. If the market price is higher than the cost, the higher amount is ignored in the accounts and closing stock will be valued at cost and vice versa.
- Research and development expenses are usually charged as expenses of the period in which they are incurred but benefits of research and development will be realised in the future.
- Under the completed contract method, revenue from long term construction contract is recognised only when the contract is completed substantially
- In case of cash or delivery sales, revenue is recognised when cash is received by the seller or his agent and not on delivery of goods to the buyer.

Convention of materiality

Whether something should be disclosed or not in the financial statements will depend on whether it is material or not. Materiality depends on the nature and size of the amount involved in the transaction.

The term ‘materiality’ is a subjective term. The accountant should record an item as material even though it is of small amount if its knowledge seems to influence the decision of the proprietors or auditors or investors.

Fundamental accounting assumptions

The following are recognised by the International Accounting Standards Committee as fundamental accounting assumptions as per International Accounting Standards. They are reproduced below:

- Going concern: the enterprise is normally viewed as a going concern, that is, it is continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.
- Consistency: it is assumed that the accounting policies are consistent from one period to another
- Accrual: revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

If fundamental accounting assumptions are not followed in the preparation and presentation of financial statements, the fact should be disclosed. If these are followed, no specific disclosure is necessary. These are called fundamental because these are to be followed and their disclosure in the financial statements is required if these are not followed. Otherwise there is no conflict between accounting concepts and fundamental accounting assumptions. In fact, fundamental accounting assumptions are part of the basic accounting concepts.

Accounting policies

Accounting policies are the specific accounting principles and the methods of applying those principles that are considered by a business concern to be the most appropriate in the circumstances to present financial statements. Accounting policies represent choices among different accounting methods that can be used in recording financial transactions and preparing financial statements. International Accounting Standards Committee defines accounting policies thus:

> ‘Accounting policies encompass many principles, bases, conventions, rules and procedures adopted by managements in preparing and presenting financial statements. There are many different accounting policies in use even in relation to the same subject and judgment is required in selecting and applying those which are appropriate to the circumstances of the enterprises and are best suited to present properly its financial position and the results of its operation’.

Three considerations should govern the selection and application by management of the appropriate accounting policies and the preparation of financial statements:

- Prudence: uncertainties inevitably surround many transactions. This should be recognised by exercising prudence in preparing financial statements. Prudence does not, however, justify the creation of secret or hidden reserves.

- Substance over form: transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.
- Materiality: financial statements should disclose all items which are material enough to affect evaluations or decisions.

Five principles are laid down in the Companies Act Cap 486, and "conventions" to mean all other principles, which are conventionally recognised. The concepts include:

- Prudence
- Accruals
- Consistency
- Going Concern
- Separate valuation

The concepts and conventions may be thought of as the pieces of a Jigsaw. Although we can define the shape of each piece (as we can do for each in the list above), it does not necessarily follow that the pieces will either fit together or result in a complete picture even if we can put them all together. Nevertheless, if it could be done such a picture would amount to a complete and consistent theory of accounting, which could then be used as a basis for determining `good accounting practice'. In other words, we would, for the first time, have agreed guidelines on how to do financial accounting, with a consequent improvement in the consistency and hence in the usefulness of financial statements. The whole picture is usually referred to as a "CONCEPTUAL FRAMEWORK OF ACCOUNTING".

The conceptual framework has been defined as a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribe the nature, functions and limits of financial accounting and financial statements.

A number of advantages might arise from using a conceptual framework. For example:

- The conceptual framework might provide a "written constitution" for the professional standard committee that would help if set consistent IASs, and could help the standard setting programme to proceed in a coherent manner.
- It might provide a frame of reference for those who prepare financial statements, when dealing with a topic that was not subject of an IAS.
- The preparation of financial statements requires knowledge of specific accounting techniques and the exercise of judgment. A conceptual framework may be useful in distinguishing between areas of judgment and areas where rules should be followed.
- The existence of a conceptual framework might win the confidence of the users of financial statements by increasing their understanding of how and why they have been produced.

Although there may be substantial benefits to be gained through the use of a conceptual framework, it is not necessarily easy to apply such a tool in practice. Not only is it fragmentary, but it can often be internally inconsistent. There can be conflicts between different concepts and conventions when we try to use them. For example, the accrual and prudence of the Going Concern and Prudence. Note that according to IAS1, where the operation of the "accruals concept" is inconsistent with "prudence" then the latter prevails. Although it is only implied, the same prudence override applies the "going concern" and "consistency".

However desirable a conceptual framework, might be, there are several problems that inhibit its development.

- The variety of users that financial statements serve is so wide that no one framework is likely to meet all their needs.
- Accounting conventions that underlie financial reporting cannot be proved to be correct; they depend on consensus. Without consensus there cannot be an agreed conceptual framework, and it may not be possible to achieve consensus on wide issues, without falling to the level of platitudes.
- Whilst it may be argued that it would be desirable for the IASB to develop standard in accordance with an agreed conceptual framework, in reality thus may not happen. The development of an accounting standard may be influenced by factors other than a conceptual framework, for example existing practice and political pressures. An IAS that departs too far from existing practice may not be acceptable and the pressure exerted by interest groups may prevail over the arguments based on theoretical ideas.

8.4 USERS OF FINANCIAL ACCOUNTING REPORTS AND THEIR NEEDS

The framework identifies the following users of financial statements:

- Investors: concerned with the risk inherent in, and return provided by, their investments.
- Employees: concerned with their employer's stability and profitability and their ability to provide remuneration and other benefits
- Lenders: interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
- Suppliers and other trade creditors: information to determine whether amounts owing to them will be paid when due.
- Customers: information about the continuance of an enterprise.
- Government and their agencies: have interests in resource allocation and thus the activities of an enterprise. Also to be able to regulate activities of an enterprise, determine taxation policies etc.
- Public: needs information about trends and recent developments in the prosperity of the enterprise and the range of its enterprise.

Usually when financial statements meet the needs of investors, who are providers of risk capital, the needs of other users are also met. The management has the primary responsibility of preparing and presentation of financial statements of the enterprise about the financial position, performance and changes in the financial position of the enterprise.

8.5 DESIRABLE CHARACTERISTICS OF GOOD ACCOUNTING INFORMATION

- Understandability: information provided in financial statements should be comprehensible and understandable to its users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.
- Relevance: information has the quality of relevance when it influences the economic
- Materiality: the relevance of information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
- Reliability: information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.
- Faithful representation: to be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent.
- Substance over form: if information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
- Neutrality: to be reliable, the information contained in financial statements must be neutral, that is, free from bias.
- Prudence: prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.
- Completeness: to be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.
- Comparability: users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position.

8.6 ACCOUNTING REGULATION AND STANDARD SETTING

FAST FORWARD: The accounting profession is regulated worldwide. In many countries it is regulated by a private body, which is usually supported by the government.

STUDY TEXT

In the USA, the Securities and Exchange Commission set up in 1934 after the great depression regulates the financial reporting. The SEC delegated such regulation to the Financial Accounting Standard Board (FASB) and the American Institute of Certified Public Accountants (AICPA).

In Kenya, the Institute of Certified Public Accountants of Kenya (ICPAK) regulates the accounting profession through the Professional Standards Committee that issue the accounting standards.

In general, any regulatory framework derives from several sources. These sources include:

- Legislation
- Accounting standards
- Accounting principles and conventions
- Stock exchange rules

(a) Legislation

All companies incorporated in Kenya must comply with the requirements of the Companies Act (Cap 486), irrespective of their size. The Act imposes a requirement for all companies to prepare regular accounts and provides detailed rules on minimum information, which must be disclosed on production of financial reports.

The accounting obligation imposed upon companies is contained in section 149 of the Companies Act. Every company is required to prepare and submit the following financial statements to the Registrar of Companies and the general body of shareholders;

- Profit and Loss account
- Balance sheet

Subsection 1 of section 149 (Cap 486) states that, every balance sheet of a company must give a true and fair view of the state of affairs of the company as at the end of its financial year and every profit and loss of a company must give a true and fair view of the profit or loss for the financial year.

All listed companies must comply with the provisions of the Public Offers, Securities and Disclosure Regulations, 2002 of the Capital Markets Authority and the requirements of the Listing Manual of the Nairobi Stock Exchange. Broadly, the rules require the provisions of both greater and more frequent information that that required by law e.g. those companies listed on the NSE are required to publish an interim report which contains some minimum information. These interim reports must comply with the provisions of IAS 34 and the Regulations.

In addition, a company must comply with rules stipulated in the specific Acts under which it is operating, such as the Banking Act for banking companies, Insurance Act for insurance companies, Building Societies Act for Building Societies etc.

Accounting Standards

Companies must also comply with the requirements contained in the statement of accounting standards in their respective countries. Companies and their accountants in their reporting practices not only need to meet the requirements of the law but in order to satisfy the statutory external auditors need to follow the Generally Accepted Accounting Principles (GAAP) and accounting standards.

Accounting standards are methods of or approaches to preparing accounts which have been chosen and established by the bodies overseeing the accounting profession. They are essentially working rules established to guide accounting practices. Accounting standards usually consists of three parts:

- A description of the problem to be tackled
- A reasonable discussion of ways of solving the problem
- The described solution in line of decision or theory

The purpose of accounting standards has been narrowed to the following:

- To narrow the areas of differences and variety in accounting practice, especially because there are a variety of methods of preparing financial reports due to the diversity and complexity of business.
- To disclose accounting bases used because of a number of items reported in financial reports require subjective judgment or estimates.
- To disclose departures from established definitive accounting standards so that its effects can be isolated and analysed.

Advantages of Accounting Standards

- They reduce or eliminate confusing variations in the methods used to prepare accounts.
- They provide a focal point for debate and discussions about accounting practice.
- They oblige companies to disclose the accounting policies used in the preparation of accounts.
- They are a less rigid alternative to enforcing conformity by means of legislation.
- They have obliged companies to disclose more accounting information than they would otherwise have done if accounting standards did not exist.

Disadvantages of Accounting Standards include the following:

- A set of rules, which give backing to one method of preparing accounts, might be inappropriate in some circumstances.
- Standards may be subject to lobbying or government pressure.
- Some standards are not based on a conceptual framework of accounting.
- Until now, setting of standards has not directly involved user groups in the creation of such accounting standards.
- They tend to encourage rigidity in accounting practice.

Regulation of accounting profession

The question that has been extensively debated is whether or not the accounting profession should be regulated. This has been argued on the basis that companies have certain incentives that force them to report to interested parties without necessarily making them to do so through regulation. This necessitates the need to unregulated the accounting profession. The argument for and against an unregulated accounting profession is discussed here below:

Arguments for Unregulated Accounting Profession

1. Agency theory

It argues that since management is engaged in agency contracts with the owners of the company, they must ensure that information is supplied to the shareholders regularly.

Since the shareholders would like to monitor management and such monitoring costs like audit fees may have a direct bearing on the compensation paid to management; management is compelled to report regularly so as to enhance their image and improve their compensation. Thus firms will disclose all information voluntarily.

2. Competitive Capital Market

Because firms have to raise capital funds from a competitive environment in the capital markets, they will be compelled to disclose voluntarily so as to attract such funds from investors.

It is generally accepted that firms that report regularly in the capital market have an enhanced image and could easily attract funds from investors. Thus firms have an incentive to give regular financial reports otherwise they cannot secure capital at a lower cost. Thus regulating accounting will be imposing rules in a self-regulating profession.

3. Private contracting opportunities theory

It has been argued that users who need information may enter into a contract with private organizations that can supply them with such information. This will ensure users get detailed and specific information suiting their requirement instead of the general-purpose information provided by financial reports as regulated by the legislation. Such all-purpose data may be irrelevant to the users needs. Under such circumstances there is no need to regulate accounting profession.

Arguments Against Unregulated Accounting Reporting

Arguments in support of accounting regulation are usually based on the doctrine of `market failure'. Market failure refers to a situation where the market is unable to efficiently allocate resources because of imperfections that exist in that market or because the way the market is structured is poor.

Market failure occurs when the market is unable to provide information to those who are in need of it. Because of the existence of market failure in providing accounting information, it has been argued that the accounting profession should be regulated so as to serve its users effectively and efficiently.

Specific reasons why market failure occurs include the following:

The monopoly in the supply of such information:

The existence of monopoly in the supply of information about itself i.e. it is the only in control of the supply of the internal information, this introduces certain imperfections in the supply of such information. There will be restriction in the supply of absolute information and it may not be available to those who need it. Even if suppliers of such accounting information were to charge prices fears have been expressed that such prices will be prohibitive for most people.

Further doubts have been expressed on whether firms can supply all the necessary information, both positive and negative, especially where such firms operate in a competitive environment. This will be common in countries like Kenya where the capital markets are not developed. Thus there is an urgent need to make financial reporting mandatory through a regulatory framework.

Failure of Financial Reporting and Auditing

Financial reporting standards have failed to correct instances of public fraud through fraudulent reporting and this has been so because of laxity in regulating accounting practices. The existence of a variety of methods of doing one thing and too much flexibility in accounting practice, have enabled the management of firms to manipulate accounts to suit their needs.

Auditing itself has been inadequate and not geared towards detection of fraud because auditors hardly ever carry out 100% examination of records and transactions. Thus there is a serious need to control accounting practice through stringent standardization guidelines. This calls for a regulated accounting profession.

Public good characteristics of Accounting Information

Accounting information has characteristics of a public good. The moment accounts are released to one person; it cannot be restricted from getting to other persons. This implies that buying accounting information through private contracting will be virtually impossible because its supply cannot be restricted and thus they cannot make money out of it and it will be difficult to decide on the price to charge.

Problems created by the regulation of the accounting profession

In practice, regulation of any field leads to misallocation of resources because production is not geared towards the market forces of demand and supply.

Regulating accounting profession has led to the following problems:

1. Standard Overload

Because of overstatement of demand for standards, there has been a tendency to over produce standards. Many people who contribute during the standard setting process may not be active demanders of information to be supplied by such standards and very often, the professional standard committee takes into account the view of such people leading to the misallocation of resources.

This was the case in the USA prompting the SEC to exempt small companies from complying to certain standard requirements.

2. Politicisation of standard setting

Regulation is a political process intended to protect the conflicting interests of various user groups. This leads to dilution of accounting standards as they are compromised by being based on bargaining instead of technical suitability.

3. Social legitimacy

The standard setting process requires social legitimacy in order to be effective i.e. the regulating bodies should consist of persons representing various user groups of financial reports. The professional standard committee lacks the social legitimacy to set standards as most of its members are drawn from the accounting profession and not from the business and public community.

It is perceived that these accounting professionals know the needs of the business and public communities when using financial reports.

4. Economic consequences

Sometimes, regulations overburden companies with unnecessary regulations, which might have negative economic consequences. This is especially so when companies devise ways and means of avoiding certain regulations for one reason or another.

For instance, when IAS 17 on Accounting for leases was issued, requiring companies to capitalize certain leases and reflect it on the balance sheet as both asset and liabilities, so companies tended to restructure their leases so as to improve the debt structure. This means incurring unnecessary legal costs due to regulation.

Regulators

The accounting profession in the world (and even for individual countries) is governed or regulated by various bodies. These include:

The IASB

The IASB is an independent Private sector body. It was established in 2001 as part of The IASC Foundation. 19 trustees, who are responsible for appointing members of the IASB and securing it's funding govern the foundation. The IASB comprises of twelve fulltime and two part-time members. IASB is responsible for the development and approval of International Financial reporting Standards and related documents. The objectives of IASB are:

- To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions,
- To promote the use and rigorous application of those standards,
- And to work actively with national standard setters to bring about convergence of national accounting standards and IFRSs to high quality solutions.

The International Financial Reporting Interpretations Committee (IFRIC)

The IFRIC comprises twelve members and a non-voting chairman, all appointed by the Trustees. The role of the IFRIC is to prepare interpretations of IFRSs for approval by the IASB and provide timely guidance on financial reporting issues not specifically addressed in IFRSs. The IFRIC replaced the former Standings interpretations committee in 2002.

The Standards Advisory Council (SAC)

The Standards Advisory Council is appointed by the Trustees. It provides a formal Vehicle for participation by organizations and individuals with interest in international financial reporting. The objective of SAC is to give guidance to the IASB on priorities and on major standard setting project.

International Organization of Securities Commissions (IOSCO)

IOSCO has appointed a technical committee to review the work of the IASB, which has produced a comprehensive set of high quality standards for the purpose of cross border listing. Cross border listing is when a company in one country lists its share on another country's stock exchange. Many stock exchanges now accept IASs for cross border listing.

The European Commission (EC)

The European Commission is uniquely the only organization to produce international standards of accounting practice that are legally enforceable, in the form of directives which must be included in the national legislation of member states. The EC directed that by 2005 consolidated accounts of listed companies would be required to comply with international accounting standards. This means that most of the European countries (including UK) will adopt IASs and IFRSs. The EC works closely with IASB and has also set up a committee to investigate where there are conflicts between EU directives and IASs so that compatibility can be achieved. In turn the IASB has used the EC directives in its work.

International Federation of Accountants (IFAC)

IFAC represents the worldwide accountancy profession. The mission of IFAC is the development and enhancement of the profession to enable it to provide services of a consistently high quality in the public interest. It is non-profit making organization not attached to any government and members include most accountancy bodies in various countries. The IASB is an affiliate of IFAC.

The IASB also woks closely with the other intergovernmental bodies e.g. the United Nations Working group of experts on International Standards of Accounting and Reporting (UN IASR) and the working group in Accounting Standards of the Organization for Economic Co-operation and Development (OECD). The IASB also invites comments from national standard setting bodies on exposure drafts and some joint work projects have been carried out together.

The stock exchange rules

Where companies are listed on the stock exchange, they must comply with additional requirements laid down by the stock exchange. The rules require the provision of both greater and more frequent information than that required by law. For example, those companies listed on the Nairobi Stock Exchange, publish an interim report, which contains certain minimum information. The interim report must either be circulated to shareholders or published in at least one newspaper.

The development of International Financial Reporting Standards

Board representatives, member bodies, members of the consultative group, other organisations and individuals and the IASC staff are encouraged to submit suggestions for new topics which might dealt with in International Accounting Standards.

The procedure for the development of an IAS is as follows:

- The Board sets up a Steering Committee. Each Steering Committee is chaired by a board representative and usually includes representatives of the accountancy bodies in at least three other countries. Steering Committees may also include representatives of other organisations that are represented on the Board or the Consultative Group or that are expert in the particular topic.

- The Steering Committee identifies and reviews all the accounting issues associated with the topic. The Steering Committee considers the application of IASC's framework for the preparation and presentation of financial statements to those accounting issues. The Steering Committee also studies national and regional accounting requirements and practice, including the different accounting treatments that may be appropriate in different circumstances. Having considered the issues involved, the Steering Committee may submit a point outline to the Board.
- After receiving comments from the Board on the point outline, if any, the Steering Committee normally prepares and publishes a Draft Statement of Principles or other discussion document. The purpose of this statement is to set out the underlying accounting principles that will form the basis for the preparation of the Exposure Draft. It also describes the alternative solutions considered and the reasons for recommending their acceptance or rejection. Comments are invited from all interested parties during the exposure period, usually around three months. For revisions to an existing IAS, the Board may instruct the Steering Committee to prepare an Exposure Draft without first publishing a Draft Statement of Principles.
- The Steering committee reviews the comments on the Draft Statement of Principles and normally agrees to a Final Statement of Principles, which is submitted to the Board for approval and used as the basis for preparing an Exposure Draft of a proposed IAS. The Final Statement of Principles is available to the public on request, but is not formally published.
- The Steering Committee prepares a draft Exposure Draft for approval by the Board. After revision, and with the approval of at least two-thirds of the Board, the Exposure Draft is published. Comments are invited from all interested parties during the exposure period, a minimum of one month and usually at least three months, and
- The Steering Committee reviews the comments and prepares draft IAS for review by the board. After revision, and with the approval of at least three-quarters of the Board, the standard is published.

Consultative Documents

These are documents relating to accounting issued by the body overseeing the profession and they include the following:

- Discussion papers: this is a paper which sets out a discussion of the issues involved on an accounting topic as means of seeking public comment. Unlike exposure drafts, which must always be issued prior to a standard, discussion papers are optional. They are exploratory in nature and do not set out the text of a proposed standard.
- Statement of intent: this is a public statement issued by the accounting profession setting out a brief summary of how the profession intends to deal with a particular matter. It is intended to be much less detailed than an exposure draft. It attempts to focus its attention on the issues relating to a particular topic and on the accounting policies which are proposed.

Exposure drafts: these are compulsory before introducing a standard. They set out accounting procedures to be followed in a format similar to that of similar to that of the proposed standard.

8.7 SOCIAL RESPONSIBILITY ACCOUNTING

The concept of social responsibility underlies the debate about social responsibility accounting. Accounting is a way of measuring and reporting values that enable sound decision making. The question of for whom, how and when social responsibility report should be prepared is yet to be answered.

Like its 'parent' social responsibility, there is little agreement as to what constitutes social responsibility accounting.

The corporate report of 1975, issued by the Accounting Standard Committee of UK which identified seven groups of users of financial information as having a reasonable right to receive information from corporation, did recognise indirectly the need for social accounting. However, it did not specify the decision models of these several groups nor did it consider it practical to publish information of a social accounting in nature due to the absence of a generally accepted measurement technique.

The scope of corporate social responsibility

Ernest and Ernest (1975) identified six areas of corporate social responsibility.

(1) Environment
(2) Energy
(3) Fair business practices
(4) Human resources
(5) Community involvement
(6) Product

Environment

This area involves the environmental aspect of production covering pollution control in the conduct of business operations, prevention or repair of damage to the environment resulting from processing resources of the national environment and conservation of the natural resources.

The main emphasis is on the negative aspects of the organisations' activities. Thus, corporate social objectives are to be found in the reduction of the negative external social effect of industrial production and in adopting more efficient technologies to minimise the use of irreplaceable resources and the production of wastes.

Energy

This area covers conservation of energy in the conduct of business operations and increasing the energy efficiency of the company's product.

Fair business practices

This area is concerned with the relationship of a company to special interest groups, in particular it deals with employment and advancement of minorities, the use of clear English in legal terms and conditions to suppliers and customers and display of information on its product.

Human resources

This area is concerned with the impact of organisations' activities on the people who contribute the human resources of the organisation.

These include:

Recruiting practices

a) training programmes
b) experience building (job rotation)
c) job enrichment
d) wage and salary levels
e) fringe benefit plans
f) congruence of employees and organisations goals
g) mutual trust and confidence
h) job security
i) stability of work force
j) layoffs and recall practices
k) transfer and promotion policies
l) occupational health

Community involvement

It considers the impact of organisations' activities on individuals or groups of individuals outside the company. It involves solving of community problems, manpower support, health related activities, education and the arts and training and employment of handicapped persons.

Products

This area concerns the qualitative areas of a product e.g. the utility, durability, safety and serviceability as well as the effect on pollution. Moreover, it includes customers' satisfaction, truthfulness in advertising, completeness and clarity in labeling and packaging.

MODES OF DISCLOSURES

Descriptive approach

This approach merely lists corporate social activities and is the simplest and least informative. They are easy to prepare. However, most of the information discussed is of a qualitative nature rather than a financial nature. As such it would be subjected to value judgment about the firms social responses. It provides little scope for analysis and verifications due to the information being least informative. This appears to be the most prevalent form of social responsibility accounting.

Comparability of financial commitments to social activities overtime and across firms is impaired when firms adopt this approach.

Critical voices also have argued that many social descriptive are nothing but public relations gestures meant to ward off grass root attack by social activists and are adopted by companies which believe useful measurements of corporate social reporting cannot be developed or is difficult to develop.

Cost of outlay approach

In this approach corporate expenditure is listed on each social activity undertaken. It offers a contrast to the descriptive report in the sense that the descriptions of activities are quantified. It expands the scope of analysing the financial commitments to social activities and verifiability of the amounts recorded relative to the descriptive approach. Comparability of financial commitments to social activities over time and across firms is enhanced but limited to expenditure incurred. The main disadvantage to this approach is that no mention of the resulting benefit is made. This is because corporate expenditure is recorded in terms of the cash outlay, which is easily determined unlike social benefit, which is difficult to measure.

Cost benefit approach

This is an extension of cost of outlay approach. It discloses both costs and benefits associated with corporate social responsibility. It is assumed that firms employing this approach make use of ‘shadow prices’ developed by economists in evaluating the social costs and social benefits of proposed projects from the point of view of all losers and all beneficiaries within a nation.

This approach is the most informative approach but suffers from difficulties which exist in the measurement of the benefits. Critics argue that output measures in monetary terms are contrived (forced) and are not meaningful because the benefits are mainly of a qualitative nature because they are concerned with the quality of life.

In Kenya, it appears, companies highlight their social activities in their annual reports but few do so in financial terms.

Problems of social accounting (disclosure)

- The concept of social responsibility accounting raises initial problems of defining not only the users of such information but also their objectives in receiving such information. In identifying users of information as having different objectives from those identified in the Corporate Report (1975), poses complex problems of identifying what objectives such groups will have in social accounting information. The problem is aggravated by the inability to establish patterns of value judgments about the activities reported upon, and stability in the 'opinions' of the individuals, using social information, forming a group of users. If the objective is to maximise some form of public utility based upon sets of value judgments, it may be impossible to achieve that objective.
- Due to the inability to develop measurements of performance which everyone will accept that capture data in form permissive to social disclosure and analysis presents a problem. Thus, many disclosures are narrative form and often reflect only personal opinion of the chief executive officer.
- In the present institutional environment, most social responsibility disclosures are voluntary and unaudited. Although disclosures may be readily available or identifiable in firm's annual reports, management is free to use its own discretion in selecting information to be reported. It is possible for poorer performance to bias their selections in order to appear like better performers. Thus, social information becomes nebulous and highly subjective.
- Uncertainty to the meaning and extent of social responsibility appears to hinder agreement on the dimensions of measurement problem as the beginning stage in search for an appropriate measure. In Kenya, the Companies Act (CAP 486) which governs and regulates the activities of corporations makes no provision for the requirement of social disclosures in the annual reports of corporations. Neither does the Nairobi Stock exchange require the listed companies to file with them reports relating to social responsibility nor has ICPAK developed any standard that deals with the measurement and reporting of social responsibilities assumed by individual enterprises.

Implications of social accounting

- Presentation of accounting data is subject to two major parameters: the cost of providing such data and the benefits that accrue to the firm as a result of providing such data. In providing accounting data relating to social responsiveness, corporations will incur additional costs as a result of such an undertaking. Costs will manifest themselves in the form of additional personnel employed (competent in social accounting) or the training of existing personnel to equip them with the necessary skills and knowledge or replacement of existing staff with new staff that is knowledgeable as far as social accounting is concerned. Time used in the preparation of social disclosures, stationery and the cost of a social audit to verify the information as being "true and fair" are among many costs that the corporation will incur.
- Increased costs of providing accounting information have a negative effect on the earning ability of the corporations. This will result in the reduction of dividends and the price of common stock. Thus, maximisation of shareholders wealth will cease to be the primary goal rather it would be substituted by the objectiveness of satisfying all parties' needs which influxes the shareholders payout may decrease.
- It has been argued that social involvement benefits both the enterprises and the society.

Providing information reflecting the degree of social involvement of an organisation would provide a base upon which the public can evaluate the corporations social responsiveness. Where in the eyes of the society, a corporation is socially responsible, the corporate image of the firm would improve and the society would appreciate the enterprises' existence and would support it. On the other hand, a corporation that is socially irresponsible would see it gradually sinking into customers and public disfavour.

- Investment decisions will in future be influenced by the social involvement of organisations. As society's value and expectations change, so do the values of investors. Investors that are socially responsible would measure the performance of organisation not only in terms of the ability of the organisation to maximise shareholders wealth but also in terms of the degree to which the firm is socially responsible. Thus, measures of success will tend largely to be influenced by the extent to which organisations are socially responsible.
- Firms would have to ensure that in order for the objective of providing social disclosure to be realised, social information will be of value to the readers. Various approaches have been adopted by firms in making social disclosures. These includes the descriptive approach, the cost outlay approach and the cost benefit approach. Critics argue that output measures in monetary terms are contrived and are not meaningful, because the benefits are mainly of a qualitative nature for they are concerned with the quality of life. Thus, firms will have to strike a balance in using the approaches in such a manner that will ensure public understandability of social information.
- Adoption of measures that are used by economists in the measurement of social costs and social benefits would be an approach towards the economists' measurements of output and the calculation of Gross Domestic Product. This would ensure that accounting data is compatible in satisfying the needs of economist in the calculation of GDP. Such a calculation would not only be easy but there would always exist a reference (accounting data) that can be used to confirm the figures resulting form the calculation by the economist.
- In an effort to encourage social involvement, the government through the income tax department may provide special incentives and write offs for expenditure incurred as a result of social activities. Tax minimization through charitable contributions are among the effects that might be considered. Presently, donations made to research institutes are tax allowable in Kenya.
- The government, as the custodian of society's resources may in future forcefully require the disclosure of the efforts the organisation will have on the society. The Kenya government has shown concern in those firms that adopt technologies that not environment friendly.

All in all, businesses cannot afford to ignore the broader public demands. They must not only provide quantities of goods and services, but also contribute to the quality of life. In light of changing conditions and society expectations and despite the remoteness of some of the benefits, it is in the business interest as artificial citizens to recognise both economic and social obligations.

CONCLUSION

Social responsibility accounting stems from the concept of corporate social responsibility. It widens the scope for shareholders by recognising the society at large as being important users of financial statements. Supporters of social accounting argue that business is part of a large society (social system). As the public increasingly accepts this view, it judges each social unit as a business in terms of its contribution to society as a whole.

Like its ‘parent’ social responsibility, there is little agreement as to what constitutes social responsibility accounting. To undertake social accounting, accountants must reach a consensus as to what constitutes social responsibility. This maybe, in past, decided for the accountants by those to whom the information is directed. Once the problem of what accountants are measuring is settled, accountants must confront the question of how this behaviour can be measured. Costs may easily be quantified (although opportunity costs are not easily measured), but the more concern is that of the benefits of socially responsible behaviour. These are often not easily reduced to monetary terms. Accountants may choose to borrow the concept of ‘shadow pricing’ from the economists in an attempt to reduce the benefits of socially responsible behaviour to monetary term.

Enterprises need to be aware that social accounting like social responsibility is a new phenomenon in Kenya. They need to develop their own guidelines to assist in the reporting of their environment performance to the society. With the change in society values, businesses may find themselves compelled to undertake social accounting. Currently, we may have to satisfy ourselves with representing benefits in qualitative terms. However, this area shows much potential for progress and will undoubtedly become an important part of the audit field

8.8 ENVIRONMENTAL REPORTS

Introduction

The major areas of impact on (any) accountant’s job caused by consideration of environmental matters includes:

- Management accountant
- Investment appraisal: evaluation of environmental costs and benefits
- Incorporating new costs, capital expenditure and so on, in to budgets and business plans
- Undertake cost/benefit analysis of any environmental improvements
- Financial accountant
- The effect of revenue costs: site cleanup costs, waste disposal or waste treatment costs and so on, which will affect the profit and loss account
- Gauging balance sheet impacts, particularly liabilities, contingencies, provisions and valuations of assets
- The effect of environmental matters, and particularly potential liabilities, on a company’s relationship with bankers, insurers and major shareholders (institutional shareholders)
- Environmental performance evaluation in annual reports
- Project accountant
- Environmental audit of proposed takeovers, mergers and other planning matters
- Investment appraisal
- Internal auditor: environmental audit
- Systems accountant: effect on, and required changes to management and financial information systems

What is environmental accounting?

The following list encompasses the major aspects of environmental accounting.

- Recognising and seeking to mitigate the negative environmental effects of conventional accounting practices
- Separately identifying environmentally related costs and revenues within the conventional accounting systems
- Devising new forms of financial and non-financial accounting systems, information systems and control systems to encourage more environmentally benign management decisions
- Developing new forms of performance measurement, reporting and appraisal for both internal and external purposes
- Identifying, examining and seeking to rectify areas in which conventional (financial) criteria and environmental criteria are in conflict
- Experimenting with ways in which, sustainability may be assessed and incorporated into organisational orthodoxy

The whole environmental agenda is constantly changing and businesses therefore need to monitor the situation closely.

The means of codifying a company's attitude towards the environment is often the creation of a published environment policy document or charter. This may be internally generated or it may be adopted from a standard environmental charter such as the Valdez principles.

The Valdez principles

We adopt, support and will implement the principles of:

- Protection of the biosphere
- Sustainable use of natural resources
- Reduction and disposal of waste
- Wise use of energy
- Risk reduction
- Marketing of safe products and services
- Damage compensation
- Disclosure
- Environmental directors and managers
- Assessment an annual audit

The problem here, as with other similar principles or charters, is that the commitment required from companies is generally too high and the fear exists that the principles may have legal status which could have a sever effect on a company's liability. Adopting such a charter is one thing; implementing and monitoring it are more important and generally more difficult to achieve.

Environmental audit

Environmental auditing is exactly what it says: auditing a business to assess its impact on the environment or the systematic examination of the interactions between any business operation and its surroundings.

The audit will cover a range of areas and will involve the performance of different types of testing. The scope of the audit must be determined and this will depend on each individual organisation.

There are, however, some aspects of the approach to environmental auditing, which are worth mentioning especially within the European Countries.

- Environmental Impact Assessment (EIAs) are required, under EC directive, for all major projects which require planning permission and have a material effect on the environment. The EIA process can be incorporated into any environmental auditing strategy.
- Environmental surveys are a good way of starting the audit process, by looking at the organisation as a whole in environmental terms. This helps to identify areas for further development, problems, potential hazards and so forth.
- Environmental SWOT analysis. A 'strengths, weaknesses, opportunities, threats' analysis is useful as the environmental audit strategy is being developed. This can only be done later in the process, when the organisation has been examined in much more detail.
- Environmental quality management. This is seen as part of TQM (Total Quality Management) and it should be built in to an environmental management system.
- Eco-audit. The European commission has adopted a proposal for a regulation for a voluntary community environmental auditing scheme, known as the eco-audit scheme. The scheme aims to promote improvements in company environmental performance and to provide the public with information about these improvements. Once registered, a company will have to comply with certain on-going obligations involving disclosure and audit.
- Eco-labelling. Developed in Germany, this voluntary scheme will indicate those EC products, which meet the highest environmental standards, probably as the result of an EQM system. It is suggested that eco-audit must come before an eco-label can be given.
- BS 7750 environmental management systems. BS 7750 also ties in with eco-audits and eco-labelling and with the quality BSI standard BS 5750. achieving BS 7750 is likely to be a first step in the eco-audit process.
- Supplier audits, to ensure that goods and services bought in by an organisation meet the standards applied by that organisation.

Financial reporting

There are no international disclosure requirements relating to environmental matters, so any disclosures tend to be voluntary unless environmental matters happen to fall under standard accounting principles (e.g. recognising liabilities).

- In most cases disclosure is descriptive and unquantified
- There is little motivation to produce environmental information and many reasons for not doing so, including secrecy.
- The main factor seems to be apathy on the part of businesses but more particularly on the part of shareholders and investors. The information is not demanded, so it is not provided.

Environmental matters may be reported in the accounts of companies in the following areas:

- Contingent liabilities
- Exceptional charges
- Operating and financial review comments
- Profit and capital expenditure forecasts

The voluntary approach contrast with the position in the United States, where the SEC/FASB accounting standards are obligatory.

8.9 APPLICATION OF ACCOUNTING RESEARCH

Accounting research can be applied to determine solutions to various accounting problems and to aid in improving the current methods applied in accounting. Research can be applied in many situations including finding solutions to the accounting treatment of certain transactions in the financial statements, financial reporting for specialized institutions and improvements to accounting standards. One of the applications of accounting research has been the use of various models to predict company failures.

>>> Consider the following example on the Altman's Z score model.

One of the directors of Uwezo Ltd. had recently read an article on methods of predicting corporate failure. He was particularly interested in one of the methods, which combined five variables and calculated a Z-score by multiplying each variable by a discriminant coefficient.

The five variables (labelled X_1, X_2, X_3, X_4, X_5) were as follows:

X_1	=	net working capital/total assets	(%)
X_2	=	retained earnings/total assets	(%)
X_3	=	earnings before interest and taxes/total assets	(%)
X_4	=	market value of equity/book value of total debt securities	(%)
X_5	=	sales/total assets	(times)

The Z score was calculated using the following formula

Z score = 0.012 X 1 + 0.014 X 2 + 0.033 X 3 + 0.006 X 4 + 0.999 X 5

The score was interpreted on the basis that all companies with a score less than 1.81 were likely to fail; all companies with a score greater than 2.99 were unlikely to fail; companies with scores between 1.81 and 2.99 were likely to consist of companies that may fail.

The director avails to you the following information of Uwezo ltd.

(a) Trial balance as at 31st December 1999

	Dr '000'	Cr '000'
Ordinary shares of Sh. 10 each		72,000
10% cumulative preference shares of Sh. 10 each		20,000
General reserve		36,400
Profit as at 1.1.99		45,000
8% debentures		10,000
Profit for the year		75,600
Capital redemption reserve		5,800
Accounts payable		82,600
Accrued expenses		14,000
Deferred taxation1.1.1999		33,100
Investment income		280
Property, plant and equipment	220,000	
Investments	5,020	
Inventories	131,600	
Installment tax paid	15,000	
Accounts receivable	14,600	
Bank	8,560	
	394,780	394,780

(b) Profits accrued evenly throughout the year

(c) Provision is to be made for
   (i) The preference dividend
   (ii) The proposed ordinary dividend of 10%

(d) Tax on the current year's profit is estimated at Sh.38,000,000

(e) A transfer of Sh. 3,400,000 is to be made to the general reserve

(f) Sales for the year totalled Sh. 420,000,000 of which Sh. 20,000,000 was value added tax

(g) The market value of equity is calculated using a PE ratio of 5:1 applied to earnings before tax and investment income, but after debenture interest

Subsequently, he requests you:

(a) To briefly explain the possible reasons for the selection of each of the five variables that have been included in the formula.
(b) To calculate the Z score for Uwezo ltd, using the formula provided (round to two decimal places.
(c) To briefly give your own views, with supporting calculations of the company liquidity.

Solution

(a)

$$X_1 = \frac{\text{Net working capital}}{\text{Total assets}} \times 100$$

Net working capital is a measure of liquidity. Where current assets are more than current liabilities, it is assumed that an enterprise is able to meet its short-term obligations when they fall due. By expressing net working capital as a percentage of the total assets, one is determining the proportion of working capital to total assets where the percentage is high; this implies that the enterprise is highly liquid and least likely to go into liquidation. Conversely, if the percentage is low, this may imply that the firm is less liquid and more likely to go into liquidation since a high proportion of its assets are fixed assets.

$$X_2 = \frac{\text{Retained earnings}}{\text{Total assets}} \times 100$$

This variable measures the extent to which total assets have been financed by retained earnings. Firms that demonstrate high finance of their assets by equity through retention of earnings rather than borrowings are low geared and are more likely to survive than those that are highly geared.

$$X_3 = \frac{\text{Earnings before interest and taxes}}{\text{Total assets}} \times 100$$

This measures the return on capital employed. Enterprises that have a good return on their assets will most likely have funds available to finance their assets activities and are therefore unlikely to have liquidation problems.

$$X_4 = \frac{\text{Market value of equity}}{\text{Book value of total debt}} \times 100$$

This ratio measures the relative proportion by which the assets are financed by the owners and outsiders. Those firms that rely heavily on debt to finance their assets will have a low ratio and hence prone to liquidation.

$$X_5 = \frac{\text{Sales}}{\text{Total assets}}$$

This ratio measures the efficiency with which assets are utilised to generate sales. Firms that have a high turnover ratio are assumed to use their assets efficiently and are more likely to survive than those that have a low turnover.

STUDY TEXT

(b) (i) Net working capital

Current assets		Sh '000'
Inventories		131,600
Accounts receivable		14,600
Bank		8,560
		154,760
Current liabilities		
Accounts payable	82,600	
Accrued expenses	14,000	
Dividends – Preference	2,000	
- Ordinary	7,200	
Tax payable (38,000 – 15,000)	23,000	
		(128,800)
Net working capital		25,960

(ii) Total Assets

Property, plant and equipment	220,000
Investments	5,020
Current assets	154,760
	379,780

(iii) Retained earnings

Profit 1.1.99	45,000	
General reserve	36,400	
Profit for the year	75,600	
Investment income	280	
Tax	(38,000)	
Dividends	(9,200)	28,680
		110,080

(iv) Earnings before interest and taxes

Tutorial note: since the return on total assets is being measured and total assets include investment income is included.

Profit for the year	75,600
Interest: 8% X 10,000	800
	76,400
Investment income	280
	76,680

(v) Market value of equity

75,600 X 5 378,000

Z score

X1: $0.012 \times \frac{25,960}{379,780} \times 100 = 0.08$

X2: $0.014 \times \frac{110,080}{379,780} \times 100 = 0.41$

STUDY TEXT

X3: $0.033 \times \frac{76,680}{379,780} \times 100 = 0.67$

X4: $0.006 \times \frac{378,000}{20,000 + 10,000} \times 100 = 7.56$

X5: $0.999 \times \frac{400,000}{379,780} \times 100 = \underline{1.05}$

$\underline{9.77}$

(c)

Current ratio	1.20:1
Acid-test ratio	0.18:1

From the above two short-term liquidity ratios, the enterprise is at risk of being forced into liquidation. This is in contrast with the implication of the Z score which suggest that the risk of the enterprise failing is very remote.

CHAPTER SUMMARY

Financial statements are a structured financial representation of the financial position of and the transactions undertaken by an enterprise.

Assets: an asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.

Liabilities: a liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and he amount at which the settlement will take place can be measured reliably.

Equity: This refers to the residual interests in the assets of the business.

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried and carried in the balance sheet and income statement.

Accounting principles refer to the fundamental beliefs, guides to action and a settled ground or basis of accounting conduct and practice.

Accounting policies are the specific accounting principles and the methods of applying those principles that are considered by a business concern to be the most appropriate in the circumstances to present financial statements.

Accounting standards are methods of or approaches to preparing accounts which have been chosen and established by the bodies overseeing the accounting profession.

Environmental auditing: auditing a business to assess its impact on the environment or the systematic examination of the interactions between any business operation and its surroundings.

CHAPTER QUIZ

1. What are the financial position measurement elements in the balance sheet?
2. What are the performance elements in the income statement?
3. What are the measurement bases?
4. Identify the users of financial accounting reports.

ANSWERS TO THE CHAPTER QUIZ

1. Financial position measurement elements in the balance sheet include:

   Assets: an asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.

   Liabilities: a liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

   Equity: This refers to the residual interests in the assets of the business .The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.

2. Performance measurements elements in the income statement include:

(i) *Income:* income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

(ii) *Expenses:* expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.
Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events.

3. Measurement bases include:

- *Historical cost:* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
- *Current cost:* assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

- *Realisable (settlement) value:* assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

- *Present value:* assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

4. The framework identifies the following users of financial statements:

(a) Investors: concerned with the risk inherent in, and return provided by, their investments.
(b) Employees: concerned with their employer's stability and profitability and their ability to provide remuneration and other benefits
(c) Lenders: interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
(d) Suppliers and other trade creditors: information to determine whether amounts owing to them will be paid when due.
(e) Customers: information about the continuance of an enterprise.
(f) Government and their agencies: have interests in resource allocation and thus the activities of an enterprise. Also to be able to regulate activities of an enterprise, determine taxation policies etc.
(g) Public: needs information about trends and recent developments in the prosperity of the enterprise and the range of its enterprise.

PAST PAPER ANALYSIS

Concepts of capital and capital maintenance was tested in: 06/'07

Social responsibility accounting was tested in the following examinations:

12/'06

06/'05

02/'02

Environmental reports was tested in: 06/'05

EXAM QUESTION

QUESTION ONE

(1) The elements of financial statements are normally carried in the balance sheet and income statements at some predetermined monetary amount. Discuss the most common bases an enterprise may adopt in preparing their financial statements.

(2) The 'concept of capital maintenance' is primarily concerned with how an enterprise defines the capital that it seeks to maintain.

(3) Explain clearly the concepts of financial capital maintenance and physical capital maintenance.

(4) How is profit earned under each of the two concepts above?

CHAPTER NINE

SUMMARIES OF INTERNATIONAL STANDARDS AND INTERPRETATIONS [(IFRSs), (IASs) AND (IFRIC/ SIC)]

SUMMARIES

OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs), INTERNATIONAL ACCOUNTING STANDARDS (IASs) AND IFRIC/SIC INTERPRETATIONS AS OF 31st DECEMBER 2005

OVERVIEW OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSS)

Statements of International Accounting Standards issued by the Board of the International Accounting Standards Committee (IASC) between 1973 and 2001 are designated *"International Accounting Standards" (**IAS**).*

The International Accounting Standards Board (IASB) announced in April 2001 that its accounting standards would be designated *"International Financial Reporting Standards" (**IFRS**).* Also in April 2001, the IASB announced that it would adopt all of the International Accounting Standards issued by the IASC.

The Interpretations of International Accounting Standards issued by the International Financial Reporting Interpretations Committee (IFRIC) (formerly, the "Standing Interpretations Committee" (SIC)) do not have the same status as IAS, but, in accordance with IAS 1, Presentation of Financial Statements, paragraph 11, *"financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable interpretation of the Standing Interpretations Committee".*

IFRS and IAS Summaries

IASB publishes its Standards in a series of pronouncements called *International Financial Reporting Standards (IFRS)*. It has also adopted the body of Standards issued by the Board of the International Accounting Standards Committee (IASC). Those pronouncements continue to be designated *"International Accounting Standards" (IAS)*. This section provides summaries of the Standards issued and in force.

I. IFRS SUMMARIES

IFRS 1: First-time Adoption of International Financial Reporting Standards

Introduction:

IFRS 1 *First-time Adoption of International Financial Reporting Standards* was issued in June 2003 and applies to an entity whose first IFRS financial statements are for a period beginning on or after 1 January 2004. IFRS 1 also applies to each interim financial report, if any, that the entity presents under IAS 34 *Interim Financial Reporting* for part of the period covered by its first IFRS financial statements.

IFRS 1 applies when an entity adopts IFRSs for the first time by an explicit and unreserved statement of compliance with IFRSs.

Summary of IFRS 1:

In general, IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. In particular, in its opening IFRS balance sheet an entity must:

1. Recognise all assets and liabilities whose recognition is required by IFRSs;
2. Not recognise items as assets or liabilities if IFRSs do not permit such recognition;
3. Reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, that are a different type of asset, liability or component of equity under IFRSs; and
4. Apply IFRSs in measuring all recognised assets and liabilities. The transition provisions in other IFRSs do not apply to a first-time adopter's transition to IFRSs.

IFRS 1 grants limited exemptions from these requirements in specified areas where the cost of complying would be likely to exceed the benefits to users of financial statements. Exemptions exist in the following areas:

- Business combinations;
- Fair value or revaluation as deemed cost for certain non-current assets;
- Defined benefit employee benefit plans;
- Cumulative translation differences;
- Compound financial instruments;
- Assets and liabilities of subsidiaries, associates and joint ventures;
- Designation of previously recognised financial instruments;
- Share-based payment transactions; and
- Insurance contracts.

The IFRS also prohibits retrospective application of IFRSs in some cases, particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known.

IFRS 1 requires disclosures that explain how the transition from previous GAAP to IFRSs affected the entity's reported financial position, financial performance and cash flows.

IFRS 2: Share Based Payment

Introduction:

IFRS 2 *Share-based Payment* was issued in February 2004 and applies to annual periods beginning on or after 1 January 2005.

IFRS 2 prescribes the financial reporting by an entity when it undertakes a share-based payment transaction. It applies to grants of shares, share options or other equity instruments made after 7 November 2002 that had not yet vested at the effective date of the IFRS. IFRS 2 applies retrospectively to liabilities arising from share-based payment transactions existing at the effective date.

Summary of IFRS 2:

IFRS 2 requires an entity to reflect in its profit and loss and financial position the effects of share-based payment transactions, including expenses associated with share options granted to employees.

For equity-settled share-based payment transactions with employees (and others providing similar services), the measurement of the transaction amount is based on the fair value of the equity instruments granted. Fair value is measured at grant date. The valuation focuses on the specific terms and conditions of a grant of shares or share options to employees. In general, vesting conditions are not taken into account in the grant date valuation but the number of equity instruments included in the measurement of the transaction amount is adjusted so that, ultimately, the transaction amount is based on the number of equity instruments that vest.

The IFRS sets out requirements if the terms and conditions of an option or share grant are modified or if a grant is cancelled, repurchased or replaced with another grant of equity instruments. IFRS 2 also contains requirements for equity-settled transactions with other parties (i.e. other than employees and those providing similar services).

For cash-settled transactions, the good or services received and the liability incurred are measured at the fair value of the liability. The liability is remeasured to fair value at each reporting date and at the date of settlement, with changes in fair value recognised in profit or loss.

IFRS 2 also specifies requirements for transactions in which the terms of the arrangement provide either the entity or the supplier of goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

IFRS 2 specifies disclosures about share-based payment transactions.

IFRS 3: Business Combinations (Replaced IAS 22 Business Combinations)

Introduction:

IFRS 3 *Business Combinations* was issued in March 2004 and is applicable for business combinations for which the agreement date is on or after 31 March 2004.

IFRS 3 prescribes the financial reporting by an entity when it undertakes a business combination. A business combination is the bringing together of separate entities or businesses into one reporting entity. IFRS 3 does not apply to:

- Business combinations in which separate entities or businesses are brought together to form a joint venture;
- Business combinations involving entities or businesses under common control;
- Business combinations involving two or more mutual entities; and
- Business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

Summary of IFRS 3:

All business combinations are accounted for by applying the purchase method, which views the business combination from the perspective of the acquirer. The acquirer is the combining entity that obtains control of the other combining entities or businesses (the acquiree).

The acquirer measures the cost of a business combination as the aggregate of:

- The fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus
- Any costs directly attributable to the business combination. Any adjustment to the cost of the combination, that is contingent on future events, is included in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably.

The acquirer allocates the cost of the business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities at their fair value at the date of acquisition, except for non-current assets that are classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Such assets held for sale are recognised at fair value less costs to sell.

Goodwill, being the excess of the cost over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities, is recognised as an asset. Goodwill is subsequently carried at cost less any accumulated impairment losses in accordance with IAS 36 *Impairment of Assets*. If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities exceeds the cost of the combination, the acquirer:

- Reassesses the identification and measurement of the acquiree's identifiable assets,

liabilities and contingent liabilities and the measurement of the cost of the combination; and
- Recognises immediately in profit or loss any excess remaining after that reassessment.
- For business combinations that are achieved in stages;

IFRS 3 specifies the accounting treatment:

- Where fair values can only be determined provisionally in the period of acquisition;
- Where deferred tax assets are recognised after the accounting for the acquisition is complete; and
- For previously recognised goodwill, negative goodwill and intangible assets.

IFRS 3 also specifies disclosures about business combinations and any related goodwill.

IFRS 4: Insurance Contracts

Introduction:

IFRS 4 *Insurance Contracts* was issued in March 2004 and is applicable for annual periods beginning on or after 1 January 2005.

IFRS 4 prescribes the financial reporting for insurance contracts by any entity that issues such contracts. It applies to insurance contracts issued, reinsurance contracts held and financial instruments issued with a discretionary participation feature. It does not apply to:

- Product warranties issued directly by a manufacturer, dealer or retailer (IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*);
- Employers' assets and liabilities under employee benefit plans (IAS 19 *Employee Benefits*) and retirement benefit obligations reported by defined benefit retirement plans (IAS 26 *Accounting and Reporting by Retirement Benefit Plans*);
- Contractual rights or obligations that are contingent on the future use of or right to use a non-financial item, as well as lessee's residual value guarantees on finance leases (IAS 17 *Leases*; IAS 18 *Revenue* and IAS 38 *Intangible Assets*);
- Financial guarantees entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39;
- Contingent consideration payable or receivable in a business combination (IFRS 3 *Business Combinations*);
- Direct insurance contracts that an entity holds as a policyholder.

An entity need not apply some aspects of IFRS 4 to comparative information that relates to annual periods beginning before 1 January 2005.

Summary of IFRS 4:

IFRS 4 is phase I of the IASB's project on insurance contracts. An entity is temporarily exempt from some requirements of other IFRSs, including the requirement in IAS 8 to consider the

Framework in selecting accounting policies for insurance contracts. However, IFRS 4:

- Prohibits recognition as a liability of provisions for possible future claims under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions);
- Requires assessment of the adequacy of recognised insurance liabilities and recognition of any impairment of reinsurance assets;
- Requires an entity to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related reinsurance assets.

An entity may change its accounting policies for insurance contracts only if, as a result, its financial statements are more relevant and no less reliable, or more reliable and no less relevant. In particular, an entity must not introduce any of the following practices, although it may continue using accounting policies that involve them:

a) Measuring insurance liabilities on an undiscounted basis;
b) Measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services;
c) Using non-uniform accounting policies for the insurance contracts of subsidiaries;
d) Measuring insurance liabilities with excessive prudence.

There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts. When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets as at fair value through profit or loss'.

IFRS 4 specifies the following:

a) An entity need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.
b) An entity is required to unbundle (ie account separately for) deposit components of some insurance contracts.
c) An entity may apply shadow accounting (that is, account for both realised and unrealised gains and losses on assets in the same way relative to measurement of insurance liabilities).
d) Discretionary participation features contained in insurance contracts or financial instruments may be recognised separately from the guaranteed element and classified as a liability or as a separate component of equity.

IFRS 4 also specifies disclosures about:

a) The amounts in the entity's financial statements that arise from insurance contracts; and
b) The amount, timing and uncertainty of future cash flows from insurance contracts.

Some Frequently Asked Questions (FAQs) on IFRS 4 *Insurance Contracts*-July 2004

1. **Why do we need an IFRS on insurance contracts?**
The Board decided to develop an International Financial Reporting Standard (IFRS) on insurance contracts because:
- Before IFRS 4, there was no IFRS on insurance contracts, and insurance contracts were excluded from the scope of existing IFRSs that would otherwise be relevant (IFRSs on provisions, financial instruments, and intangible assets).
- Accounting practices for insurance contracts were very diverse, and also often differed from practices in other sectors.

2. **Why did the Board split this project into two phases?**
Few insurers report under IFRSs at present, but many more are expected to do so from 2005, particularly in the European Union and Australia. To enable insurers to implement some aspects of the project in 2005, the Board split the project into two phases. The Board completed phase I in March 2004 by issuing IFRS 4 *Insurance Contracts*. The Board's objectives for phase I were:
a) to make limited interim improvements to accounting for insurance contracts;
b) To require any entity issuing insurance contracts (an insurer) to disclose information about those contracts.

3. **How do IFRSs treat financial assets that insurers hold to back their insurance contracts?**
IFRS 4 does not change the measurement of financial assets held by insurers to back insurance contracts. These assets are within the scope of IAS 39, which identifies four categories of financial asset. In summary:
- financial assets classified as 'at fair value through profit or loss' (including all financial assets held for trading and all derivatives) are measured at fair value, and all changes in their fair value are included in profit or loss.
- Available-for-sale assets (i.e. those that do not fall into any of the other categories) are measured at fair value and changes in their fair value are reported in equity until the asset is derecognised or becomes impaired.
- Assets with a fixed maturity ('held-to-maturity investments') may be measured at amortised cost if the entity intends to hold them to maturity and shows that it has the ability to do so.
- Most loans and receivables may be measured at amortised cost.

4. **What is accounting mismatch?**
Accounting mismatch arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes. Specifically, accounting mismatch occurs if an entity uses different measurement bases for assets and liabilities.
It is important to distinguish accounting mismatch from *economic mismatch*. Economic mismatch arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions.

Is the IASB alone in not eliminating the accounting mismatch?

Extending the use of amortised cost would have created an inconsistency with US GAAP. The accounting mismatch described above has existed for some years in US GAAP, which requires insurers to account for their financial assets in broadly the same way as under IAS 39. Furthermore, the US Financial Accounting Standards Board (FASB) decided in January 2004 not to add to its agenda a project to reconsider US GAAP for investments held by life insurance companies.

Does the separate measurement of assets and liabilities ignore the importance of asset and liability management?

Asset and liability management is an important part of an insurer's risk management. IFRS 4 underlines this by requiring disclosures about it. However, the fact that an insurer invests premiums received in particular assets does not affect the fair value of the liability (unless the cash flows from the asset determine the amounts paid to policyholders).

A simple analogy may help to explain this. Three entities each issue one-year bonds for proceeds of 100. The bonds require a single payment of 105 in one year. The first entity invests the proceeds in one-year government securities bearing interest at 5%, payable annually. The second entity invests the proceeds in traded equity investments. The third entity invests the proceeds in a diversified portfolio of venture capital investments. The second and third entities believe (probably quite rationally) that the most likely outcome is that their assets will grow by more than 5% in 12 months. However, the fair value of the assets at inception is no more than 100. Similarly, the fair value of the liability is no less than 100 (assuming that the possibility of default is negligible).

Some insurers use asset-liability management programmes that involve investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities. Such programmes do not necessarily eliminate *economic* mismatch. For example, as discussed in paragraph 12, economic mismatch exists if an insurer acquires equity securities to back insurance liabilities providing benefits that are not contractually linked to those securities, even if those securities form part of a portfolio that provides an optimal trade-off between risk and return for those liabilities.

Can insurers find a way to explain the effect of the accounting mismatch?

IAS 1 and IAS 32 do not preclude a presentation identifying a separate component of equity to report a portion of the change (and cumulative change) in the carrying amount of fixed-maturity available-for-sale financial assets. An insurer could use such a presentation to highlight the effect on equity of changes in interest rates that (a) changed the carrying amount of assets but (b) did not change the carrying amount of liabilities that respond economically to changing interest rates.

Insurers may be particularly sensitive to equity reported in general purpose financial statements in some countries where this amount is used in assessing compliance with regulatory capital requirements. However, although insurance supervisors are important users of general purpose financial statements, those financial statements are not directed at specific needs of insurance supervisors that other users do not share. Furthermore, supervisors generally have the power to obtain additional information that meets their specific needs. In the Board's view, creating new exemptions from IAS 39 in this area would not have been the best way to meet the common needs of users (including insurance supervisors) of an insurer's general purpose financial statements.

What is shadow accounting?

In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities. When many of those models were constructed, unrealised gains and most unrealised losses were not recognised in financial statements. Some of those models were extended later to require some financial assets to be measured at fair value, with changes in fair value recognised directly in equity (i.e. the same treatment as for available-for-sale financial assets under IAS 39).

The Board's conclusions in relation to shadow accounting were as follows:

- In principle, gains and losses on an asset should not influence the measurement of an insurance liability (unless the gains or losses on the asset alter the amounts payable to policyholders). Nevertheless, the Board decided that it was not feasible to eliminate this practice in phase I.
- Shadow accounting permits all recognised gains and losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether:
    - the gains and losses are realised or unrealised and
    - unrealised gains and losses are recognised in profit or loss or directly in equity.
    This is a logical application of a feature of some existing models.
- Because the Board does not expect that feature of existing models to survive in phase II, insurers should not be required to develop temporary systems to apply shadow accounting.
- If an unrealised gain or loss on an asset triggers a shadow accounting adjustment to a liability, that adjustment should be recognised in the same way as the unrealised gain or loss.
- In some cases and to some extent, shadow accounting might mitigate accounting mismatch caused by using different measurement bases for assets and insurance liabilities. However, that is a by-product of shadow accounting and not its primary purpose.

When this happened, a practice sometimes known as 'shadow accounting' was developed with the following two features:

- A recognised but unrealised gain or loss on an asset affects the measurement of the insurance liability in the same way that a realised gain or loss does.
- If unrealised gains or losses on an asset are recognised directly in equity, the resulting change in the carrying amount of the insurance liability is also recognized in equity.

IFRS 5: Non-current Assets Held for Sale and Discontinued Operations (Replaced IAS 35 Discontinued Operations)

Introduction:

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* was issued in March 2004 and is applicable for annual periods beginning on or after 1 January 2005.

IFRS 5 prescribes the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. The measurement provisions of IFRS 5 apply to all non-current assets and disposal groups, except for:

- Deferred tax assets (IAS 12 *Income Taxes*);
- Assets arising from employee benefits (IAS 19 *Employee Benefits*);
- Financial assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*;
- Non-current assets that are accounted for in accordance with the fair value model in IAS 40 *Investment Property*;
- Non-current assets that are measured at fair value less estimated point-of-sale costs in accordance with IAS 41 *Agriculture*; and
- Contractual rights under insurance contracts as defined in IFRS 4 *Insurance Contracts*.

Summary of IFRS 5:

Assets held for sale

A non-current asset (or disposal group) is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. That is, the asset (or disposal group) is available for immediate sale and its sale is highly probable.

A non-current asset (or disposal group) classified as held for sale is measured at the lower of fair value less costs to sell and its carrying amount.

Any impairment loss on write-down of the asset (or disposal group) to fair value less costs to sell is recognised in profit or loss. Any gain on subsequent increase in fair value less costs to sell is also recognised in profit or loss, but not in excess of the cumulative impairment loss already recognised on the asset either in accordance with IFRS 5 or IAS 36 *Impairment of Assets*.

Discontinued Operations

A discontinued operation is a component of an entity that either has been disposed of or is held for sale. It may be a subsidiary, or a major line of business or geographical area. It will have been a cash-generating unit (or group of cash-generating units) as defined in IAS 36 *Impairment of Assets*.

Disclosures of discontinued operations include:

- Analysis of the post-tax profit or loss into revenue, expenses, pre-tax profit or loss, and the related income tax expense;
- The gain or loss recognised on measurement to fair value less costs to sell or on disposal, and the related income tax expense;
- Net cash flows attributable to operating, investing and financing activities;
- Assets held for sale separately from all other assets; and
- Liabilities of a disposal group held for sale separately from all other liabilities.

IFRS 6 Exploration for and Evaluation of Mineral Resources

Effective Date Annual periods beginning on or after 1 January 2006.

Objective To prescribe the financial reporting for the exploration for and evaluation of mineral resources.

Summary

- An entity is permitted to develop its accounting policy for exploration and evaluation assets under IFRSs without specifically considering the requirements of paragraphs 11 and 12 of IAS 8 – which specify a hierarchy of sources of IFRS GAAP in the absence of a specific standard. Thus an entity adopting IFRS 6 may continue to use its existing accounting policies.
- Requires an impairment test when there is an indication that the carrying amount of exploration and evaluation assets exceeds recoverable amount.
- Allows impairment to be assessed at a level higher than the "cash generating unit" under IAS 36, but measures impairment in accordance with IAS 36 once it is assessed.

II. IAS SUMMARIES

Framework for the Preparation and Presentation of Financial Statements

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 approved in 1989 by the IASB's predecessor, the board of IASC, and adopted by the IASB in April 2001. The *Framework* assists the IASB:

(i) in the development of future International Financial Reporting Standards and in its review of existing Standards; and

(ii) in promoting the harmonisation of regulations, financial reporting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Financial Reporting Standards.

In addition, the *Framework* may assist:

- National standard-setting bodies in developing national standards;
- Preparers of financial statements in applying International Financial Reporting Standards and in dealing with topics that have yet to form the subject of an International Financial Reporting Standard;
- Auditors in forming an opinion as to whether financial statements conform with International Financial Reporting Standards;
- Users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Financial Reporting Standards; and
- Those who are interested in the work of IASB, providing them with information about its approach to the formulation of International Financial Reporting Standards.

The *Framework* is not an International Financial Reporting Standard and does not define standards for any particular measurement or disclosure issue. In a limited number of cases there may be a conflict between the *Framework* and a requirement within an International Financial Reporting Standard. In those cases where there is a conflict, the requirements of the International Financial Reporting Standard prevail over those of the *Framework*.

IAS 1 Presentation of Financial Statements (revised 2003)

Effective Date: Annual periods beginning on or after 1 January2005.

Objective: To set out the overall framework for presenting general-purpose financial statements, including guidelines for their structure and the minimum content.

Summary:

Fundamental principles underlying the preparation of financial statements, including going concern assumption, consistency in presentation and classification, accrual basis of accounting, and materiality.

- Assets and liabilities, and income and expenses, may not be offset unless offsetting is permitted or required by another IFRS.
- Comparative prior-period information must be presented for amounts shown in the financial statements and notes.
- A complete set of financial statements should include a balance sheet, income statement, statement of changes in equity, cash flow statement, accounting policies and explanatory notes.
- The statement of changes in equity must show either:
  - all changes in equity; or
  - changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders.
- Financial statements generally to be prepared annually. If the date of the year end changes, and financial statements are presented for a period other than one year, disclosure thereof is required.
- Current/non-current distinction for assets and liabilities is normally required. In general post-balance sheet events are not considered in classifying items as current or non-current.

- IAS 1 specifies minimum line items to be presented on the face of the balance sheet, income statement, and statement of changes in equity, and includes guidance for identifying additional line items.
- IAS 1 specifies minimum note disclosures.
  These must include information about:
  - accounting policies followed;
  - the judgments that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements;
    and
  - the key assumptions concerning the future, and other key sources of estimation uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Interpretations SIC 29, Disclosure – Service Concession Arrangements

Disclosure is required if an entity agrees to provide services that give the public access to major economic and social facilities.

IAS 2 Inventories (revised 2003)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To prescribe the accounting treatment for inventories, including cost determination and expense recognition.

Summary:

Inventories are required to be stated at the lower of cost and net realisable value.

- Costs include purchase cost, conversion cost (materials, labour, and overhead), and other costs to bring inventory to its present location and condition, but not foreign exchange differences.
- For inventory items that are not interchangeable, specific costs are attributed to the specific individual items of inventory.
- For interchangeable items, cost is determined on either a FIFO or weighted average basis. LIFO is not permitted.
- When inventories are sold, the carrying amount should be recognised as an expense in the period in which the related revenue is recognised.

IAS 7 Cash Flow Statements (revised 1992)

Effective Date: Periods beginning on or after 1 January 1994.

Objective: To require the presentation of information about historical changes in an entity's cash and cash equivalents by means of a cash flow statement, which classifies cash flows during the period according to operating, investing, and financing activities.

Summary:

Cash flow statement must analyse changes in cash and cash equivalents during a period.

- Cash equivalents include investments that are short term (less than 3 months from date of acquisition), readily convertible to a known amount of cash, and subject to an insignificant risk of changes in value.
  Generally exclude equity investments.
- Cash flows from operating, investing, and financing activities must be separately reported.
- Cash flows for operating activities are reported using either the direct (recommended) or indirect methods.
- Cash flows arising from taxes on income are classified as operating unless they can be specifically identified with financing or investing activities.
- The exchange rate used for translation offshore transactions denominated in a foreign currency and the cash flows of a foreign subsidiary should be the rate in effect at the date of the cash flows.
- Aggregate cash flows relating to acquisitions and disposals of subsidiaries and other business units should be presented separately and classified as investing activities, with specified additional disclosures.
- Investing and financing transactions that do not require the use of cash should be excluded from the cash flow statement, but they should be separately disclosed.

IAS 8 Accounting Policies, Changes in Accounting Estimates, and Errors (revised 2003)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in estimates, and errors.

Summary:

Prescribes a hierarchy for choosing accounting policies:

- IASB standards and interpretations, taking into account any relevant IASB implementation guidance.
- In the absence of a standard, look to the requirements and guidance in IASB standards and interpretations dealing with similar and related issues; and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.
- Management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature, and accepted industry practices.

• Apply accounting policies consistently to similar transactions.
• Make a change in accounting policy only if it is required by a standard or interpretation or results in more relevant and reliable information.
• If a change in accounting policy is required by a standard or interpretation, follow that pronouncement's transition requirements. If none are specified, or if the change is voluntary, apply the new accounting policy retrospectively by restating prior periods. If restatement is impracticable, include the cumulative effect of the change in profit or loss. If the cumulative effect cannot be determined, apply the new policy prospectively.
• Changes in accounting estimates (for example, change in useful life of an asset) are accounted for in the current year, or future years, or both (no restatement).
• All errors should be corrected by restating comparative prior period amounts and, if the error occurred before the earliest period presented, by restating the opening balance sheet.
• Disclosures are required about accounting changes, changes in estimates, and error corrections.

Interpretations None.

IAS 10 Events After the Balance Sheet Date (revised 2003)

Effective Date Annual periods beginning on or after 1 January 2005.

Objective: To prescribe when an entity should adjust its financial statements for events after the balance sheet date.

Disclosures about the date when the financial statements were authorised for issue and about events after the balance sheet date.

Summary: Events after the balance sheet date are those events, both favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue.

• Adjusting events – adjust the financial statements to reflect those events that provide evidence of conditions that existed at balance sheet date (such as resolution of a court case after balance sheet date).

- Non-adjusting events – do not adjust the financial statements to reflect events that arose after the balance sheet date (such as a decline in market prices after year end, which does not change the valuation of investments at balance sheet date).
- Dividends proposed or declared on equity instruments after the balance sheet date should not be recognised as a liability at the balance sheet date. Disclosure is required.
- An entity should not prepare its financial statements on a going concern basis if events after the balance sheet date; indicate that the going concern assumption is not appropriate.
- An entity must disclose the date its financial statements are authorised for issue.

Interpretations None.

IAS 11 Construction Contracts (revised 1993)

Effective Date Periods beginning on or after 1 January 1995.

Objective To prescribe the accounting treatment for revenue and costs associated with construction

contracts in the financial statements of the contractor.

Summary • Contract revenue should comprise the amount agreed in the initial contract together with variations in contract work, claims, and incentive payments to the extent that it is probable that they will result in revenues and can be measured reliably.

- Contract costs should comprise costs that relate directly to the specific contract, costs that are attributable to general contract activity and that can be reasonably allocated to the contract, together with such other costs as are directly attributable to the customer under the terms of the contract.
- Where the outcome of a construction contract can be estimated reliably, revenue and costs should be recognised by reference to the stage of completion of contract activity (the percentage of Completion method of accounting).
- If the outcome cannot be estimated reliably, no profit should be recognised. Instead, contract revenue should be recognised only to the extent that contract costs incurred are expected to be recovered, and contract costs should be expensed as incurred.
- If it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised immediately.

Interpretations None.

IAS 12 Income Taxes (revised 2000)

Effective Date Periods beginning on or after 1 January 1998. Certain revisions effective for periods beginning on or after 1 January 2001.

Objective To prescribe the accounting treatment for income taxes. To establish the principles and provide guidance in accounting for the current and future income tax consequences related to:

- the future recovery (settlement) of carrying amounts of assets (liabilities) in an entity's balance sheet, and
- current period transactions recognised in the income statement or directly through equity.

Summary • Current tax liabilities and assets should be recognised for current and prior period taxes, measured at the rates applicable for the period.

- • A temporary difference is a difference between the carrying amount of an asset or liability and its tax base.
- • Deferred tax liabilities must be recognized for the future tax consequences of all taxable temporary differences with three exceptions:
- liabilities arising from the initial recognition of goodwill;
- liabilities arising from the initial recognition of an asset/liability other than in a business combination which, at the time of the transaction, does not affect either the accounting or the taxable profit; and
- liabilities arising from undistributed profits from investments where the enterprise is able to control the timing of the reversal of the difference and it is probable that the reversal will not occur in the foreseeable future.
- • A deferred tax asset must be recognized for deductible temporary differences, unused tax losses, and unused tax credits to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized, with this exception:
- the deferred tax asset arises from the initial recognition of an asset/liability, other than in a business combination, which at the time of the transaction, does not affect the accounting or the taxable profit.
- • Deferred tax liabilities (assets) should be measured at the tax rates expected to apply when the liability is settled or asset is realised, based on tax rates/laws that have been enacted or substantively enacted by the balance sheet date.
- • Discounting of deferred tax assets and liabilities is prohibited.
- • Deferred taxes must be presented as noncurrent items in the balance sheet.
- • IAS 12 specifies detailed disclosure requirements for income taxes.

Interpretations SIC 21, Income Taxes – Recovery of Revalued Non-Depreciable Assets

Measure the deferred tax liability or asset arising from revaluation based on the tax consequences from the sale of the asset rather than through use.

SIC 25, Income Taxes – Changes in the Tax

Status of an Enterprise or its Shareholders

The current and deferred tax consequences of the change should be included in net profit or loss for the period unless those consequences relate to transactions or events that were recognised directly in equity.

IAS 14 Segment Reporting (revised 1997)

Effective Date Periods beginning on or after 1 July 1998.

Objective To establish principles for reporting financial information by line of business and by geographical area.

Summary • IAS 14 applies to entities whose equity or debt securities are publicly traded and to entities in the process of issuing securities to the public. Also, any entity voluntarily providing segment information must comply with the requirements of IAS 14.

- An enterprise must look to its organisational structure and internal reporting system for the purpose of identifying its business segments and geographical segments.
- If internal segments are not geographical or products/service-based, then look to next lower level of internal segmentation to identify reportable segments.
- Guidance is provided on which segments are reportable (generally 10% thresholds).
- One basis of segmentation is primary and the other secondary.
- Segment information should be based on the same accounting policies as the consolidated group or entity.
- IAS 14 sets out disclosure requirements for primary and secondary segments, with considerably less disclosure for the secondary segments.

Interpretations None.

IAS 16 Property, Plant & Equipment (revised 2003)

Effective Date Annual periods beginning on or after 1 January 2005.

Objective To prescribe the principles for the initial recognition and subsequent accounting for property, plant, and equipment.

Summary • Items of property, plant, and equipment should be recognised as assets when it is probable that the future economic benefits associated with the asset will flow to the entity, and the cost of the asset can be measured reliably.

- Initial recognition at cost, which includes all costs necessary to get the asset ready for its intended use. If payment is deferred, interest must be recognised.
- In accounting subsequent to acquisition, IAS 16 allows a choice of accounting model:
  - Cost model: The asset is carried at cost less accumulated depreciation and impairment.
  - Revaluation model: The asset is carried at revalued amount, which is fair value at revaluation date less subsequent depreciation.
- Under the revaluation model, revaluations must be done regularly. All items of a given class must be revalued (for instance, all buildings). Revaluation increases are credited to equity. Revaluation decreases are charged first against the revaluation surplus in equity, and any excess against profit and loss. When the revalued asset is disposed of, the revaluation surplus inequity remains in equity and is not recycled through profit and loss.
- If the cost model is used, components of an asset with differing patterns of benefits must be depreciated separately.
- Under the cost model, depreciation is charged systematically over the asset's useful life. The depreciation method must reflect the pattern of benefit consumption.
  The residual value must be reviewed at least annually. If operation of an item of property, plant, and equipment (for example, an aircraft) requires regular major inspections, when each major inspection is performed, its cost is recognised in the carrying amount of the asset as are placement if the recognition criteria are satisfied.
- Impairment of property, plant, and equipment must be assessed under IAS 36.
- All exchanges of property, plant, and equipment should be measured at fairvalue, including exchanges of similar items, unless the exchange transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is reliably measurable.
- Disclosures include accounting policies; depreciation methods and lives; acquisitions, disposals, impairments, and reversals; amounts and details of revaluations; and commitments.

Interpretations None.

IAS 17 Leases (revised 2003)

Effective Date Annual periods beginning on or after 1 January2005.

Objective To prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

Summary • A lease is classified as a finance lease if it transfers substantially all risks and rewards incident to ownership. Examples:

- Lease covers substantially all of the asset's life.
- Present value of lease payments is substantially equal to the asset's fair value.
- All other leases are classified as operating leases.
- A lease of both land and buildings should be split into land and building elements. Land element is generally an operating lease. Building element is an operating or finance lease based on the criteria in IAS 17. However, separate measurement of the land and buildings elements is not required if the lessee's interest in both land and buildings is classified as an investment property under IAS 40 and the fair value model is adopted.
- Finance leases – Lessee's Accounting:
  - Recognise asset and liability at the lower of the present value of minimum lease payments and the fair value of the asset.
  - Depreciation policy – as for owned assets.
  - Finance lease payment – apportioned between interest and reduction in liability.
- Finance leases – Lessor's Accounting:
  - Recognise as a receivable at an amount equal to the net investment in the lease.
  - Recognise finance income based on a pattern reflecting a constant periodic rate of return on the lessor's net investment.
- Operating leases – Lessee's Accounting:
  - Recognise lease payments as an expense in the income statement on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern of benefit.
- Operating leases – Lessor's Accounting:
  - Assets held for operating leases should be presented in the lessor's balance sheet according to the nature of the asset.
  - Lease income should be recognised on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern of benefit.
- Lessors must spread initial direct costs over the lease term (immediate expensing prohibited).
- Accounting for sale and leaseback transactions depends on whether these are essentially finance or operating leases.

Interpretations SIC 15, Operating Leases – Incentives

Lease incentives (such as rent-free periods) should be recognised by both the lessor and the lessee as a reduction of rental income and expense, respectively, over the lease term.

SIC 27, Evaluating the Substance of Transactions Involving the Legal Form of a

Lease

If a series of transactions involves the legal form of a lease and can only be understood with reference to the series as a whole, then the series should be accounted for as a single transaction.

IFRIC 4, Determining Whether an Arrangement Contains a Lease

Arrangements that depend on a specific asset or convey the right to control a specific asset generally are leases under IAS 17.

IAS 18 Revenue (revised 1993)

Effective Date Periods beginning on or after 1 January 1995.

Objective To prescribe the accounting treatment for revenue arising from certain types of transactions and events.

Summary • Revenue should be measured at the fair value of the consideration received/ receivable.

- Recognition:
  - From sale of goods: When significant risks and rewards have been transferred to buyer, loss of effective control by seller, and amount can be reliably measured.
  - From sale of services: Percentage of completion method.
  - For interest, royalties, and dividends:

Recognised when it is probable that economic benefits will flow to the entity:

Interest – on a time proportion basis, taking into account the effective yield on the asset.
Royalties – on an accrual basis in accordance with the substance of the agreement.
Dividends – when shareholder's right to receive payment is established.

- Disclosure requirements include revenue recognition accounting policies.

Interpretations SIC 31, Revenue – Barter Transactions Involving Advertising Services

Recognise revenue from barter transactions involving advertising services only if substantial revenue is also received from non-barter transactions.

IAS 19 Employee Benefits (revised 2000)

Effective Date Periods beginning on or after 1 January 1999.

Certain revisions effective on or after 1 January 2001; other revisions effective for periods ending 31 May 2002.

Objective: To prescribe the accounting and disclosure for employee benefits, including short-term benefits (wages, annual leave, sick leave, annual profit sharing, bonuses, and non-monetary benefits); pensions; post-employment life insurance and medical benefits; and other long-term employee benefits (long-service leave, disability, deferred compensation, and long-term profit-sharing and bonuses).

Summary: Underlying principle: the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable.

- Short-term employee benefits (payable within 12 months) should be recognised as an expense in the period in which the employee renders the service.
- Profit-sharing and bonus payments are to be recognised only when the entity has a constructive obligation to pay them and the costs can be reliably estimated.
- Post-employment benefit plans (such as pensions and health care) are categorized as either defined contribution plans or defined benefit plans.
- Under defined contribution plans, expenses are recognised in the period the contribution is payable.
- Under defined benefit plans, a liability is recognised in the balance sheet equal to the net of:
    - the present value of the defined benefit obligation (the present value of expected future payments required to settle the obligation resulting from employee service in the current and prior periods);
    - deferred actuarial gains and losses and deferred past service cost; and
    - the fair value of any plan assets at the balance sheet date.
- Plan assets include assets held by a long term employee benefit fund and qualifying insurance policies.
- Long-term employee benefits should be recognised and measured the same way as post-employment benefits under a defined benefit plan. However, unlike defined benefit plans, the deferral of actuarial gains or losses and past service costs is prohibited.
- Termination benefits should be recognized when the entity is demonstrably committed to the termination of one or more employees before the normal retirement date or to provide termination benefits as a result of an offer made to encourage voluntary redundancy.
- Equity compensation benefits are covered by IFRS 2, not IAS 19.

Interpretations None.

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

Effective Date Periods beginning on or after 1 January 1984

Objective To prescribe the accounting for, and disclosure of, government grants and other forms of government assistance.

Summary • Recognise government grants only when there is reasonable assurance that the entity will comply with the conditions attached to the grants, and the grants will be received.

Non-monetary grants are usually recognized at fair value, though recognition at nominal value is permitted.

- Apply the income approach systematically (recognise income over periods necessary to match it with the related costs), and not the capital approach (credited directly to shareholders' equity).
- Income-related grants may either be presented as a credit in the income statement or deduction in reporting the related expense.
- Asset-related grants may be presented as either deferred income in the balance sheet, or deducted in arriving at the carrying amount of the asset.
- Repayment of a government grant is accounted for as a change in accounting estimate with different treatment for income and asset-related grants.

Interpretations SIC 10, Government Assistance – No Specific Relation to Operating Activities

Government assistance to entities that is aimed at encouragement or long-term support of business activities either in certain regions or industry sectors should be treated as a government grant under IAS 20.

IAS 21 The Effects of Changes in Foreign Exchange Rates (revised 2003)

Effective Date Annual periods beginning on or after 1 January 2005.

Objective To prescribe the accounting treatment for an entity's foreign currency transactions and foreign operations.

Summary: First, determine reporting entity's functional currency.

- Then translate all foreign currency items into the functional currency:
  - At date of transaction, record using the transaction-date exchange rate for initial recognition and measurement.
  - At subsequent balance sheet dates: use closing rate for monetary items; use

transaction-date exchange rates for non-monetary items carried at historical cost; and use valuation-date exchange rates for non-monetary items that are carried at fair value.
- Exchange differences arising on settlement of monetary items and on translation of monetary items at a rate different than when initially recognised are included in net profit or loss, with one exception: exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised in the consolidated financial statements that include the foreign operation in a separate component of equity; they will be recognised in profit or loss on disposal of the net investment.

- The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency using the following procedures:
  - assets and liabilities for each balance sheet presented (including comparatives) are translated at the closing rate at the date of that balance sheet;
  - income and expenses for each income statement (including comparatives) are translated at exchange rates at the dates of the transactions; and
  - all resulting exchange differences are recognised as a separate component of equity.
- Special rules for translating into a presentation currency the results and financial position of an entity whose functional currency is hyperinflationary.

Interpretations SIC 7, Introduction of the Euro

Explained how to apply IAS 21 when the Euro was first introduced.

IAS 23 Borrowing Costs

Effective Date: Periods beginning on or after 1 January 1995.

Objective: To prescribe the accounting treatment for borrowing costs.

Summary: Borrowing costs include interest, amortisation of discounts or premiums on borrowings, and amortisation of ancillary costs incurred in the arrangement of borrowings.

- Two accounting models are allowed:
  - Expense model: Charge all borrowing costs to expense when incurred.
  - Capitalisation model: Capitalise borrowing costs directly attributable to the acquisition or construction of a qualifying asset, but only when it is probable that these costs will result in future economic benefits to the entity, and the costs can be measured reliably. All other borrowing costs that do not satisfy the conditions for capitalization are to be expensed when incurred.
- A qualifying asset is one that requires a substantial period of time to make it ready for its intended use or sale. Examples include manufacturing plants, investment properties, and some inventories.

- If funds are borrowed generally and used for the purpose of obtaining the qualifying asset, apply a capitalisation rate (weighted average of borrowing costs applicable to the general outstanding borrowings during the period) to expenditure incurred during the period, to determine the amount of borrowing costs eligible for capitalisation.

- Disclosure includes the accounting policy adopted for borrowing costs.

Interpretations None

IAS 24 Related Party Disclosures (revised 203)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To ensure that financial statements draw attention to the possibility that financial position and results of operations may have been affected by the existence of related parties.

Summary: Related parties are parties that control or have significant influence on the reporting entity, including parent companies, subsidiaries, joint ventures, owners and their families, key management personnel, and post-employment benefit plans.

- Requires disclosure of:
  - Relationships involving control, even when there have been no transactions.
  - Related party transactions.
  - Management compensation.

- Examples of related party transactions that must be disclosed:
  - Purchases or sales of goods.
  - Purchases or sales of assets.
  - Rendering or receiving of services.
  - Leases.
  - Transfers of research and development.
  - Transfers under license agreements.
  - Transfers under finance arrangements (including loans and equity contributions).
  - Provision of guarantees or collateral.
  - Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

Interpretations None.

IAS 26 Accounting and Reporting by Retirement Benefit Plans

Effective Date: Periods beginning on or after 1 January 1998.

Objective: To specify the measurement and disclosure principles for the financial reports of retirement benefit plans.

Summary: Sets out the reporting requirements for both defined contribution and defined benefit plans, including a statement of net assets available for benefits and disclosure of the actuarial present value of promised benefits (split between vested and non-vested).

- Specifies the need for actuarial valuation of the benefits for defined benefits and the use of fair values for plan investments.

Interpretations None.

IAS 27 Consolidated and Separate Financial Statements (revised 2003)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To prescribe requirements for preparing and presenting consolidated financial statements for a group of entities under the control of a parent. To prescribe how to account for investments in subsidiaries, jointly controlled entities, and associates in separate financial statements.

Summary: A subsidiary is an entity controlled by another entity, known as the parent. Control is the power to govern the operating and financial policies.

- Consolidated financial statements are financial statements of a group (parent and subsidiaries) presented as those of a single economic entity.

- Consolidated financial statements must include all subsidiaries. No exemption for "temporary control" or "subsidiary that operates under severe long-term funds transfer restrictions".

- All entities in the group must use the same accounting policies.

- Reporting dates of subsidiaries cannot be more than three months different from the group reporting date.

- Minority interest is reported in equity in the balance sheet and is not deducted in measuring the group's profit or loss. However, group profit or loss is allocated between minority and the parent's shareholders on the face of the income statement.

- In the parent's separate financial statements: account for all of its investments in subsidiaries either at cost or as investments under IAS 39.

Interpretations SIC 12, Consolidation – Special Purpose Entities.

An enterprise should consolidate a special purpose entity (SPE) when, in substance, the enterprise controls the SPE.

IAS 28 Investments in Associates (revised 2003)

Effective: Date Annual periods beginning on or after 1 January2005.

Objective: To prescribe the investor's accounting for investments in associates over which it has significant influence.

Summary: Applies to all investments in which investor has significant influence unless investor is venture capital firm, mutual fund, or unit trust, in which case IAS 39 must be followed.

- Investor must use the equity method for al investments in associates over which it has significant influence.
- Rebuttable presumption of significant influence if investment held, directly and indirectly, is more than 20% of associate. • Under the equity method, the investment is initially recorded at cost. It is subsequently adjusted by the investor's share of the investee's post acquisition change in net assets. Investor's income statement reflects its share of the investee's post-acquisition profit or loss.
- Associate's accounting policies must be the same as those of the investor.
- Equity accounting is required in the separate financial statements of the investor even if consolidated accounts are not required, for example, because the investor has no subsidiaries. However, the investor does not apply the equity method when presenting separate financial statements prepared in accordance with IAS 27. Instead, the investor accounts for the investment either at cost or as investments under IAS 39.
- Requirement for impairment testing in accordance with IAS 36, Impairment of Assets. The impairment indicators in IAS 39 apply.

Interpretations None.

IAS 29 Financial Reporting in Hyperinflationary Economies

Effective: Date Periods beginning on or after 1 January 1990.

Objective: To prescribe specific standards for entities reporting in the currency of a hyperinflatio naryeconomy, so that the financial information provided is meaningful.

Summary: The financial statements of an entity that reports in the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the balance sheet date.

- Comparative figures for prior period(s) should be restated into the same current measuring unit.
- Generally an economy is hyperinflationary when there is 100% inflation over 3 years.

Interpretations None.

IAS 31 Interests in Joint Ventures (revised 2003)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To prescribe the accounting treatment required for interests in joint ventures (JVs), regardless of the structure or legal form of the JV activities.

Summary: Applies to all investments in which investor has joint control unless investor is venture capital firm, mutual fund, or unit trust, in which case IAS 39 must be followed.

- The key characteristic of a JV is a contractual arrangement to share control. JVs may be classified as jointly controlled operations, jointly controlled assets, or jointly controlled entities. Different recognition principles for each type of JV:
- Jointly controlled operations: Venturer recognises the assets it controls, and expenses and liabilities it incurs, and its share of income earned, in both its separate and consolidated financial statements.
- Jointly controlled assets: Venturer recognises its share of the joint assets, any liabilities that it has incurred directly, and its share of any liabilities incurred jointly with the other venturers, income from the sale or use of its share of the output of the joint venture, its share of expenses incurred by the joint venture, and expenses incurred directly in respect of its interest in the joint venture.
- Jointly controlled entities: Two accounting policy choices are permitted:
  - Proportionate consolidation. Under this method the venturer's balance sheet includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible.
    Its income statement includes its share of the income and expenses of the jointly controlled entity
  - Equity method as described in IAS 28.
- In the venture's separate financial statements, interests in joint ventures should be accounted for either at cost or as investments under IAS 39.

Interpretations SIC 13, Jointly Controlled Entities – Non- Monetary Contributions by Venturers

Recognition of proportionate share of gains or losses on contributions of non-monetary assets is generally appropriate.

S T U D Y T E X T

IAS 32 Financial Instruments: Disclosure and Presentation (revised 2003)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To enhance users' understanding of the significance of on-balance sheet and off-balance sheet financial instruments to an entity's financial position, performance, and cash flows.

Summary: Issuer's classification of an instrument either as a liability or an equity instrument:

- Based on substance, not form of the instrument.
- Classification is made at the time of issuance and is not subsequently altered.
- An instrument is a financial liability if the issuer may be obligated to deliver cash or another financial asset or the holder has a right to demand cash or another financial asset. An example is mandatorily redeemable preferred shares.
- An instrument that does not give rise to such a contractual obligation is an equity instrument.
- Interest, dividends, gains, and losses relating to an instrument classified as a liability should be reported as income or expense as appropriate.
- At issuance, an issuer must classify separately the debt and equity components of a single compound instrument such as convertible debt and debt issued with detachable rights or warrants.
- A financial asset and a financial liability should be offset and the net amount reported when, and only when, an entity has a legally enforceable right to set off the amounts, and intends either to settle on a net basis or simultaneously.
- Cost of treasury shares is deducted from equity, and re-sales of treasury shares are equity transactions.
- Costs of issuing or reacquiring equity instruments (other than in a business combination) are accounted for as a deduction from equity, net of any related income tax benefit.
- Disclosure requirements include:
  - Risk management and hedging policies.
  - Hedge accounting policies and practices, and gains and losses from hedges.
  - Terms and conditions of, and accounting policies for, all financial instruments.
  - Information about exposure to interest rate risk.
  - Information about exposure to credit risk.
  - Fair values of all financial assets and financial liabilities, except those for which a reliable measure of fair value is not available.
  - Information about derecognition, collateral, impairment, defaults and breaches, and reclassifications.

Interpretations IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments

These are liabilities unless the co-op has the legal right not to redeem on demand.

IAS 33 Earnings per Share (revised 2003)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To prescribe principles for determining and presenting earnings per share (EPS) amounts in order to improve performance comparisons between different entities in the same period and between different accounting periods for the same entity. Focus of IAS 33 is on the denominator of the EPS calculation.

Summary: Applies to publicly traded entities, entities in the process of issuing such shares, and any other entity voluntarily presenting EPS.

- Present basic and diluted EPS on the face of the income statement:
  - For each class of ordinary shares.
  - With equal prominence.
  - For all periods presented.
- In consolidated financial statements, EPS reflects earnings attributable to the parent's shareholders.
- Dilution is a reduction in EPS or an increase in loss per share on the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued when specified conditions are met.
- Basic EPS calculation:
  - Earnings numerator: Should be after deduction of all expenses including tax and minority interests, and after deduction of preference dividends.
  - Denominator: Weighted average number of shares outstanding during the period.
- Diluted EPS calculation:
  - Earnings numerator: The net profit for the period attributable to ordinary shares is increased by the after-tax amount of dividends and interest recognised in the period in respect of the dilutive potential Ordinary shares (such as options, warrants, convertible securities, and contingent insurance agreements), and adjusted for any other changes in income or expense that would result from the Conversion of the dilutive potential ordinary shares.
  - Denominator: Should be adjusted for the number of shares that would be issued on the conversion of all of the dilutive potential ordinary shares into ordinary shares.
  - Anti-dilutive potential ordinary shares are to be excluded from the calculation.

Interpretations None.

IAS 34 Interim Financial Reporting

Effective Date: Periods beginning on or after 1 January 1999.

Objective: To prescribe the minimum content of an interim financial report (IFR) and the recognition and measurement principles for an IFR.

Summary: Applies only when the entity is required or elects to publish an IFR in accordance with IFRSs.

- Local regulators (not IAS 34) mandate
- which entities should publish interim financial reports;
- how frequently; and
- how soon after the end of an interim period.

- An IFR is a complete or condensed set of financial statements for a period shorter than an entity's full financial year.
- Minimum components of an IFR are a condensed balance sheet, income statement, statement of changes in equity, cash flow statement, and selected explanatory notes.
- Prescribes the comparative periods for which interim financial statements are required to be presented.
- Materiality is based on interim financial data, not forecasted annual amounts.
- The notes in an IFR should provide an explanation of events and transactions significant to understanding the changes since the last annual financial statements.
- Same accounting policies as annual.
- Revenue and costs to be recognised when they occur, not anticipated or deferred.
- Change in accounting policy – restate previously reported interim periods.

Interpretations None

IAS 36 Impairment of Assets (revised 2004)

Effective Date 1 April 2004.

Objective To ensure that assets are carried at no more than their recoverable amount, and to prescribe how recoverable amount is calculated.

Summary: IAS 36 applies to all assets except inventories (see IAS 2, Inventories), assets arising from construction contracts (see IAS 11, Construction Contracts), deferred tax assets (see IAS 12, Income Taxes), assets arising from employee benefits (see IAS 19, Employee Benefits), financial assets (see IAS 39, Financial Instruments: Recognition and Measurement), investment property measured at fair value (see IAS 40, Investment Property), biological assets related to agricultural activity measured at fair value less estimated point-of-sale costs (see IAS 41, Agriculture).

- Impairment loss to be recognised when the carrying amount of an asset exceeds its recoverable amount.
- Recognise impairment loss through income statement for assets carried at cost; treat as a decrease in the revaluation surplus for assets carried at revalued amount.
- Recoverable amount is the higher of an asset's net selling price and its value in use.
- Value in use is 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.
- Discount rate is the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset. The discount rate should not reflect

risks for which future cash flows have been adjusted and should equal the rate of return that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset.

- At each balance sheet date, review assets to look for any indication that an asset may be impaired. If impairment is indicated, calculate recoverable amount.
- Goodwill and other intangibles with indefinite useful life must be tested for impairment at least annually, and recoverable amount calculated.
- If it is not possible to determine the recoverable amount for the individual asset, then determine recoverable amount for the asset's cash-generating unit. The impairment test for goodwill should be performed at the smallest group of cash generating units to which goodwill can be allocated on a reasonable and consistent basis.
- Reversal of prior years' impairment losses allowed in certain instances (prohibited for goodwill).
- Disclose impairment losses by class of assets and by segment (if applying IAS 14, Segment Reporting).
- Disclose reversal of impairment losses.

Interpretations None.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Effective Date: Periods beginning on or after 1 July 1999.

Objective: To prescribe appropriate recognition criteria and measurement bases for provisions, contingent liabilities, and contingent assets and to ensure that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

IAS 37 thus aims to ensure that only genuine obligations are dealt with in the financial statements. Planned future expenditure, even where authorised by the board of directors or equivalent governing body, is excluded from recognition, as are accruals for self-insured losses, general uncertainties, and other events that have not yet taken place.

Summary: Recognise a provision only when a past event has created a legal or constructive obligation, an outflow of resources is probable, and the amount of the obligation can be estimated reliably.

- Amount recognised as a provision is the best estimate of settlement amount at balance sheet date.
- Requires a review of provisions at each balance sheet date to adjust for changes in estimate.
- Utilise provisions only for original purposes. • Examples of provisions may include onerous contracts, restructuring provisions, warranties, refunds, and site restoration.
- Comprehensive disclosures, including descriptions and amounts, are required for each class of provision.
- Contingent liability arises when:
- there is a possible obligation to be confirmed by a future event that is outside the control of the entity; or
- a present obligation may, but probably will not, require an outflow of resources; or

- a sufficiently reliable estimate of the amount of a present obligation cannot be made (this is rare).
- Contingent liabilities require disclosure only (no recognition). If the possibility of outflow is remote, then no disclosure.
- Contingent asset arises when the inflow of economic benefits is probable, but not virtually certain, and occurrence depends on an event outside the control of the entity.
- Contingent assets require disclosure only. If the realisation of income is virtually certain, the related asset is not a contingent asset and recognition is appropriate.

Interpretations IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

Adjust the provision for changes in the amount or timing of future costs and for changes in the market-based discount rate.

IAS 38 Intangible Assets (revised 2004)

Effective Date: 1 April 2004.

Objective: To prescribe the accounting treatment for recognising, measuring, and disclosing all intangible assets that are not dealt with specifically in another IFRS.

Summary: Requires an entity to recognise an intangible asset, whether purchased or self-created, if:

- it is probable that the future economic benefits that are attributable to the asset will flow to the entity, and
- the cost of the asset can be measured reliably.

- Additional recognition criteria for internally generated intangible assets.
- All research costs are charged to expense when incurred.
- Development costs are capitalized only after technical and commercial feasibility of the resulting product or service have been established.
- Intangible assets, including in-process research and development (IPR&D), acquired in a business combination should be recognised separately from goodwill if they arise as a result of contractual or legal rights or are separable from the business.
- Internally-generated goodwill, brands, mastheads, publishing titles, customer lists, start-up costs, training costs, advertising costs, and relocation costs should not be recognised as assets.
- If an intangible item does not meet both the definition and the recognition criteria for an intangible asset, expenditure on the item is recognised as an expense when it is incurred, except if the cost is incurred as part of a purchase business combination, in which case it should form part of the amount attributed to goodwill at the date of acquisition.
- For the purpose of accounting subsequent to initial acquisition, intangible assets are classified as:

- Indefinite life: No foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. 'Indefinite' does not mean 'infinite'.
- Finite life: A limited period of benefit to the entity.

- Intangible assets with indefinite useful lives are not amortised but must be tested for impairment at each reporting date. If recoverable amount is lower than the carrying amount, an impairment loss is recognised. The assessment must also consider whether the intangible continues to have an indefinite life.
- Generally, the cost (residual value is normally zero) of an intangible asset with a finite useful life is amortised over that life. If the intangible asset has a quoted market price in an active market, an accounting policy choice of a revaluation model is permitted. Under the revaluation model, the asset is carried at revalued amount, which is fair value at revaluation date less subsequent depreciation.
- Normally, subsequent expenditure on an intangible asset after its purchase or completion is recognised as an expense. Only rarely can the asset recognition criteria be met.

Interpretations SIC 32, Intangible Assets – Web Site Costs

Certain initial infrastructure development and graphic design costs incurred in web site development may be capitalised.

IFRIC 3 Emission Rights

Tradable emissions allowances are intangible assets under IAS 38.

IAS 39 Financial Instruments: Recognition and Measurement (revised 2003 and 2004)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To establish principles for recognising, de-recognising, and measuring financial assets and financial liabilities.

Summary: All financial assets and financial liabilities, including all derivatives and certain embedded derivatives, must be recognized on the balance sheet.

- Financial instruments are initially measured at fair value on date of acquisition or issuance. Usually this is the same as cost, but sometimes an adjustment is required.
- An entity has an option of recognizing normal purchases and sales of securities in the market place consistently either at trade date or settlement date. If settlement date accounting is used, IAS 39 requires recognition of certain value changes between trade and settlement dates.
- For the purpose of measuring a financial asset subsequent to initial recognition, IAS 39 classifies financial assets into four categories:
  1. Loans and receivables not held for trading.
  2. Held-to-maturity (HTM) investments, such as debt securities and mandatorily

redeemable preferred shares, that the entity intends and is able to hold to maturity. If an entity sells any HTM investments (other than in exceptional circumstances), all of its other HTM investments must be reclassified as available-for-sale (category 4 below) for the current and next two financial reporting years.

3. Financial assets measured at fair value through profit and loss, which includes those held for trading (short-term profit taking) and any other financial asset that the entity designates (the "fair value option"). Derivative assets are always in this category unless they are designated as hedging instruments.
4. Available-for-sale financial assets (AFS) – all financial assets that do not fall into one of the other three categories. This includes all investments in equity instruments that are not measured at fairvalue through profit and loss. Additionally, an entity may designate any loans and receivables as AFS.

- Subsequent to initial recognition:
- All financial assets in categories 1 and 2above are carried at amortised cost subject to a test for impairment.
- All financial assets in category 3 above are carried at fair value, with value changes recognised in profit or loss.
- All financial assets in category 4 above (AFS) are measured at fair value in the balance sheet, with value changes recognised in equity, subject to impairment testing. If the fair value of an AFS asset cannot be measured reliably, the asset is carried at cost.
- After acquisition, most financial liabilities are measured at original recorded amount less principal repayments and amortisation. Three categories of liabilities are measured at fair value with value changes recognised n profit and loss:
- derivative liabilities;
- liabilities held for trading (short sales); and
- any liabilities that the entity designates, at issuance, to be measured at fair value through profit and loss (the "fair value option").
- Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The IAS 39 fair value hierarchy:
- Best is quoted market price in an active market.
- Otherwise use a valuation technique that makes maximum use of market inputs and includes recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models.• IAS 39 establishes conditions for determining when control over a financial asset or liability has been transferred to another party and, therefore, it should be removed from the balance sheet (derecognised). Derecognition is not permitted to the extent to which the transferor has continuing involvement in an asset or a portion of an asset it has transferred.
- Hedge accounting (recognising the offsetting effects of fair value changes of both the hedging instrument and the hedged item in the same period's profit or loss) is permitted in certain circumstances, provided that the hedging relationship is clearly defined, measurable, and actually effective. IAS 39provides for three types of hedges:
- Fair value hedge: If an entity hedges a change in fair value of a recognised asset or liability or firm commitment, the change in fair values of both the hedging instrument and the hedged item are recognised in profit or loss when they occur.
- Cash flow hedge: If an entity hedges changes in the future cash flows relating to a recognised asset or liability or a probable forecast transaction, then the change in fair

value of the hedging instrument is recognised directly in equity until such time as those future cash flows occur.

- A hedge of foreign currency risk in a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.
- Hedge of a net investment in a foreign entity: This is treated as a cash flow hedge.

Interpretations None.

IAS 39 Guidance

IAS 40 Investment Property (revised 2004)

Effective Date: Annual periods beginning on or after 1 January 2005.

Objective: To prescribe the accounting treatment for investment property and related disclosures.

Summary: Investment property is land or buildings held (whether by the owner or under a finance lease) to earn rentals or for capital appreciation or both.

- IAS 40 does not apply to owner-occupied property or property that is being constructed or developed for future use as investment property, or property held for sale in the ordinary course of business.
- Permits an entity to choose either the fair value model or cost model.
- Fair value model: Investment property is measured at fair value, and changes in fair value are recognised in the income statement.
- Cost model: Investment property is measured at depreciated cost less any accumulated impairment losses. Fair value of the investment property must still be disclosed.
- The chosen measurement model must be applied to all of the entity's investment property.
- If an entity uses the fair value model but, when a particular property is acquired, there is clear evidence that the entity will not be able to determine fair value on a continuing basis, the cost model is used for that property – and it must continue to be used until disposal of the property.
- Change from one model to the other is permitted if it will result in a more appropriate presentation (highly unlikely for change from fair value to cost model).
- A property interest held by a lessee under an operating lease can qualify as investment property provided that the lessee uses the fair value model of IAS 40. In this case, the lessee accounts for the lease as if it were a finance lease.
- Disclosures include:
- Method of determining fair value.
- Extent of use of independent valuer in determining fair value.
- Criteria that were used to classify property as investment property or not.
- Amounts recognised in profit and loss.

Interpretations None.

IAS 41 Agriculture

Effective Date: Periods beginning on or after 1 January 2003.

Objective: To prescribe accounting for agricultural activity – the management of the biological transformation of biological assets (living plants and animals) into agricultural produce.

Summary: Measure all biological assets at fair value less expected point-of-sale costs at each balance sheet date, unless fair value cannot be measured reliably.

- Measure agricultural produce at fair value at the point of harvest less expected point-of sale costs. Because harvested produce is a marketable commodity, there is no "measurement reliability" exception for produce.
- Change in fair value of biological assets during a period is reported in net profit or loss.
- Exception to fair value model for biological assets: if there is no active market at time of recognition in the financial statements, and no other reliable measurement method, then apply the cost model to the specific biological asset only. The biological asset should be measured at depreciated cost less any accumulated impairment losses.
- Quoted market price in active market generally represents the best measure of fair value of a biological asset or agricultural produce. If an active market does not exist,

IAS 41 provides guidance for choosing another measurement basis.

- Fair value measurement stops at harvest.
  IAS 2, Inventories, applies after harvest.
- Disclosures include:
- Description of an entity's biological assets, by broad category.
- Carrying amount of each category.
- Change in fair value during the period.
- Reconciliation of changes in the carrying amount of biological assets, showing separately changes in value, purchases, sales, harvesting.
- Basis for determining fair value

CHAPTER TEN

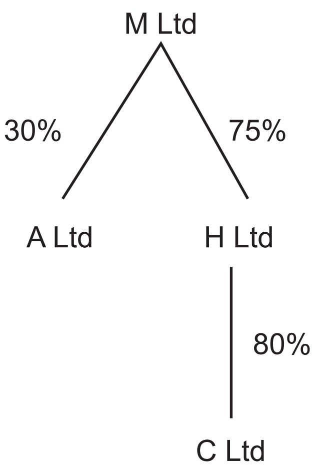
ANSWERS TO EXAM QUESTIONS

ANSWERS TO EXAM QUESTIONS

CHAPTER ONE

QUESTION ONE

Structure



Holdings in C Ltd

<u>Group</u>

75% x 80%	=	60%

<u>Minority</u>

Direct	20%
Indirect 25% x 80%	<u>20%</u>
	<u>100%</u>

Cost of control

Investment in H Ltd	165,000	Ordinary share capital 75% x 100,000	75,000
		Pre-acquisition dividend	
		Ordinary 75% x 5,000	3,750
		Preference 75% x 5,600	4,200
		Profit & Loss A/C 75% x 28,000	21,000
		General reserve 75% x 40,000	30,000
		Goodwill	31,050
			165,000
		Minority interest	
		20% x 10,200	20,400
	165,000	Ordinary share capital	
		60% x 80,000	48,000
		General reserve	24,000
		Profit & Loss A/C 60% x 16,000	9,600
	102,000		102,000

Consolidated Profit & Loss Account

UPS 20% x 6,000	1,200	M Ltd	98,500
COC – H Ltd	2,100	Dividend receivable	
UPS (PPE)	4,000	ordinary H Ltd 75% x 10,000	7,500
Minority Interest – H Ltd		Preference	4,200
(25% x 40,400)	10,100	Debenture interest	300
COC – C LTD	9,600	Depreciation adjustment	600
Minority Interest- C Ltd		H Ltd	44,400
40% x 100,000	40,000	C Ltd	100,000
Good will amortized		Investment in A Ltd	
31,050 x 20%	6,210	(30% x 30,000 – 21,000)	2,700
Pre-acquisition dividend	7,950		
C.B.S	158,140		
	258,200		258,200

Minority Interest

		H Ltd Ordinary share	25,000
		Preference shares	20,000
		General reserve	10,000
		Profit & Loss A/C	10,100
		Dividends –Ordinary	2,500
		Preference	1,400
		Depreciation adjustment	
Investment in C Ltd	20,400	(25% x 800)	200
		C Ltd	32,000
		Share capital	16,000
		General reserve	40,000
C.B.S	136,800	Profit & Loss A/C	
	157,200		157,200

Current assets

M Ltd	145,500	UPS	1,200
H Ltd	143,400	C.B.S	407,700
C Ltd	120,000		
	408,900		408,900

Property, Plant and equipment

M Ltd	250,000	UPS (20% x 20,000)	4,000
H Ltd	220,000	C.B.S	666,000
C Ltd	200,000		
	670,000		670,000

Provision for depreciation

Overcharge		M Ltd	60,000
(20% x 4000)	800	H Ltd	130,000
C.B.S	229,200	C Ltd	40,000
	230,000		230,000

Premium on acquisition

Cost of investment		26,100
Net Assets acquired	60,000	
Ordinary shares	6,000	
General reserve	21,000	26,100
Profit & Loss A/C	87,000	NIL
30% x		

j

Balance	26,100
Post-acquisition reserve	2,700
	28,800

M Limited and its Subsidiaries

Consolidated Balance sheet

As at 31 December 2001

Non – Current Assets	**Sh. Million**	**Sh. Million**
Property and equipment	666,000	436,800
Provision for depreciation	(229,200)	
Goodwill	31,050	24,840
Amortization	(6,210)	
		28,800
Investment in Associate	407,700	
Current Assets		
Current liabilities		
Trade payables	207,300	
Accrued debenture interest	900	
Proposed dividends	30,000	
	238,200	169,500
Net current Assets		659,940
		300,000
Ordinary share of Sh. 10 each		50,000
General reserve		158,140
Profit and Loss Account		508,140
		136,800
Minority interest		
Non – Current Liabilities		15,000
6% debentures (20,000----5,000)		659,940

QUESTION TWO

Aberdare Ltd & its subsidiaries

Consolidated balance sheet as at 31.3.99

		Sh.	Sh.
Non-current Assets			
Property, plant and equipment			2957
Intangibles:	Patents (10-1)	9	
	Goodwill	30	39
			2996
Current Assets			
Inventory		1074	
Accounts receivable		1542	
Cash		240	2856
TOTAL ASSETS			5852
Ordinary Share Capital			600
Revaluation reserve (60% x 260)			156
Retained Earnings			2390
Shareholder's Funds			3146
Minority Interest			1244
			4390
Current Liabilities			
Accounts payable		912	
Taxation		70	
Proposed dividends		480	1462
TOTAL EQUITY & LIABILITIES			5852

Workings:

Group PPE

	Sh.		Sh.
A	1280	Depreciation FV adj:	
B	920	Group P & L (36 X 3)	108
E	700	MI (64% X 3)	192
Coc: FV adj	21.6	Bal c/d	2957
MI: FV adj	38.4		
	2960		2960

GROUP A/c Receivable

	Sh.		Sh.
A	680	Due from E A	36
B	540	B	32
E	390	Bal c/d	1542
	1610		1610

COC

	Sh.		Sh.
Inv. in B	840	B: OSC (60% x 500)	300
		P & L (60% x 800)	480
		G/will -amortised	60
Inv. In E (60% x 750)	450	E OSC (36% x 500)	180
		P & L (36% x 460)	165
		FV adj	
		PPE (36% X 60)	21.6
		Inv. (36% x 20)	7.2
		Int. (35% x 10)	3.6
		Pre-acquisition due (36% x 100)	36
		Goodwill Amortized	6
		Bal c/d	30
	1290		1290

MI

	Sh.		Sh.
		B: OSC (40% x 500)	200
		P & L (40% X 1300)	520
		RR (40% X 260)	104
Inv. In E Ltd	300	E: OSC (64% X 500)	320
Depreciation - PPE	1.92	P & L (64% x 480)	307
Int	0.64	FV Adjustment	
Inventory sold	10.24	PPE (64% X 60)	38.4
		Inv. (64% x 20)	12.8
		Int. (64 x 10)	6.4
		Dividend from E	
Bal c/d	1244	(40% x 60% x 200)	48
	1556.8		1556.8

Group Inventory

	Sh.		Sh.
A	420	Group net Profit (36% x 16)	576
B	410	MI (64% x 16)	10.24
E	240		
Coc: FV adj	72		
MI: FV adj	12.8	Bal c/d	1074
	1090		1090

Group A/c Payable

		Sh.		Sh.
Due to	A	36	A	390
	B	32	B	380
Bal c/c		912	E	210
		980		980

Group Proposed Dividends

	Sh.		Sh.
MI 46% X 60%	48	A	300
Group Net Profit	150	B	250
Pre –acq (30% x 100) E	36	E	200
Post acq (36% x 100) E	36		
Bal c/d	480		
	750		750

Revaluation Revenue

	Sh.		Sh.
MI (40% X 260)	104	Bal b/d	260
Bal c/d	156		
	260		260

Group Retained Profit

	Sh.		Sh.
COC: P & L - B	480	A	1970
MI: P & L	520	B	1300
COC Goodwill Amount B	60	E	480
COC P & L - E	165.6	Dividends Receivable	
MI: P & L – E	307.2	From B	150
Depn. – FV adj		From E	36
PPE	1.08		
Intangible	0.36		
Inventory sold	5.76		
Goodwill Amortised	6		
Bal c/d	2390		
	3936		3936

Patents

	Sh.		Sh.
COC	3.6	Depreciation	
MI	6.4	Group Net Profits	0.36
		MI	0.64
		Bal c/d	9
	10		10

Retained Profits at Acquisition for E Ltd:

	Sh.
Bal c/d	480
Add back dividends	200
	680
Less: Profits for year	(240)
Bal b/d	440
Profits for the year	20
Retained profits at acq.	460

CHAPTER TWO

QUESTION ONE

(a) In IAS 17 context:

- Finance lease
  This is a lease that transfers substantially all the **risks** and **rewards** incident to ownership of an asset. Title **may or may not** eventually be transferred. (2 marks)

- Guaranteed residual value is:

  - In the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the **maximum amount that could,** in any event become payable).

  - In the case of the lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee. (2 marks)

- Contingent rent
  This is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g. percentage of sales, amount of usage, price indices, market rates of interest). (2 marks)

Alternatively: (Assuming interest quoted is paid).

(b) Using actual method.

	Shs. 'm'
Fair value of leased asset	16,320
Initial payment	(2,550)
Balance	13,770

Remaining installments over 7 months interest of 3.47 (6.94 x ½)

Year	Bal b/f	Interest	Installment	Depr.	Bal c/f
	Sh. 'm'	Sh. 'm'	Sh. 'm'	Sh. 'm'	Sh. 'm'
2005 1	13,770	478	2,250	1772	11,998
2005 2	11,998	416	2,250	1834	10,164
2006 1	10,164	353	2,250	1897	8,267
2006 2	8,267	287	2,250	1963	6,304
2007 1	6,304	219	2,250	2031	4,273
2007 2	4,273	148	2,250	2102	2,171
2008 1	2,171	75	2,250	2175	(4)

Payable (instalment) = $\dfrac{13{,}770}{\dfrac{1-(1+0.0347)^{-7}}{0.0347}} = 2250$

Change to P & L AC.

Year	Expenses Cost	Depreciation	Total
2005	894	4080	4974
2006	640	4080	4720
2007	367	4080	4447
2008	75	4080	4155

Balance Sheet Extract

Non – Current Assets

	Sh. 'm'	Sh. 'm'
Cost	16,320	16,320
Depreciation	4,080	8,160
	12,240	8,160
Obligations under finance lease		
Non-current liability	6,304	2,177
Current liability	3,860	4,133

(6 marks)

STUDY TEXT

(b) Silversands Manufacturing Company Ltd.

(i) Actuarial method

	Sh. '000'
Fair value of leased asset	16,320
Initial payment	2,550
"Amount borrowed"	13,770
Installment value	2,550
Number of installments	7

Year	Liabilities at beginning Sh. '000'	Rental Payment Shs. '000'	Sub-total Sh. '000'	Finance charge at 6.94% Sh. '000'	Liability at end Shs. '000'
2005	16,320	2,550	13,770	955.57	14,725.57
	14,725.57	2,550	12,175.57	845.07	13,020.64
2006	13,020.64	2,550	10,470.64	726.58	11,197.22
	11,197.22	2,550	8,647.22	600.10	9,246.32
2007	9,247.32	2,550	6,697.32	464.95	7,162.27
	7,162.27	2,550	4,612.27	320.11	4,932.38
2008	4,932.38	2,550	2,382.38	165.24	2,547.62
	2,547.62	2,550	(2.38)	2.38	NIL
		20,400		4,080	

$$\frac{\text{Fair value of leased asset}}{\text{Estimated useful life}} = \frac{16{,}320}{4}$$ gives Sh.4,080,000 depreciation P.A.

Charge to the profit and loss account

Year	Finance charge Sh. '000'	Depreciation Sh. '000'	Total	Charge against taxable profits Sh. '000'	Timing Difference Sh. '000'
2005	1,800.64	4,080	5,880.64	5,100	780.64 O
2006	1,326.68	4,080	5,406.68	5,100	306.68 O
2007	785.06	4,080	4,865.06	5,100	(234.94) R
2008	167.62	4,080	4,247.62	5,100	(852.38) R
	4,080	16,320	20,400	20,400	NIL

(ii) Extracts from published accounts

	2005 (b)(i) Sh. '000'	2006 (b) (ii) Shs. '000'
Profit and loss account		
Provision for deferred tax	406.13	135.32
Operating profits stated after charging:		
Depreciation on leased assets under finance leases	4,080	4,080
Interest payable on finance leases	1,800.64	589.9
Balance sheet		
Deferred taxation account	406.13	589.90
Non-current assets		
Cost	16,320	16,320
Depreciation to date	4,080	8,160
Net book value	12,240	8,160
Leasing Commitments		
Minimum leasing commitments		
2005	5,100	-
2006	5,100	5,100
2007	5,100	5,100
	15,300	10,200
Less: Finance allocated to future periods	2,279.36	905.42
	13,206.64	9,294.58
Current obligations under finance leases	3,603.32	4,371.55
* Non-current obligations under finance leases	9,417.32	4,922.52
* Contingent liability	2,279.36	905.42

Based on amount on premature cancellation of contract = Interest allocated to future periods or otherwise specifically stated in terms of the lease.

CHAPTER THREE

QUESTION ONE

(i) C**urrent service cost**

This is apart of a pension cost incurred due to the services rendered by employees in the current year.

It is calculated by the following formula

Service cost = pension % x 1 year x salary on date of retirement

The amount calculated above is discounted to the present date at an appropriate interest rate. Service is treated as an expense of the current period.

(ii) **Past service cost**
This is an increase in projected pension liability resulting from service already provided by employees. It is brought about by change in the way pension are determined especially change in pension benefits.

The whole amount is not treated as pension expense in the year it is determined but is expensed over the remaining average service years of the employees benefiting from the scheme.

(iii) **Vested employee benefits**
These are pension benefits employees have a right to receive even if their services were immediately terminated. Pension benefits that are not conditional on employment.
For benefits to be vested, employees must have served for some minimum number of years.

(b) **Calculation of annual pension expense**

NB. The accounting treatment of actuarial gains and losses has changed due to the revisions on IAS 19 'Employee benefits'. This is because IASB felt that, due to actuarial assumptions made in arriving at values of pension obligations and plan assets, actuarial gains and losses must arise. Therefore they are only recognized if they are significant. Significance is measured by using the 10% corridor rule. This rule requires only the actuarial gains and losses that exceed the higher of 10% of either Fair value of the plan assets or the Present Value of obligation at the start of the year.
In December 2004 additional amendments were made on the standard and this allows firms to recognize the full actuarial gains and losses but in a statement outside the income statement i.e. the statement of recognized gains and losses.

In summary this example requires the treatment of actuarial gains and losses using the old IAS 19 on Retirement benefit costs.

The solution is therefore prepared for information only but the example has been overtaken by events.

Deficiency = Sh. 600 million

Service life of employees = 8 years.

Therefore amortization of deficiency = Sh. 600m ÷ 8 = Sh. 75 million

Annual service cost = Sh. 30 million

Therefore total annual pension expense = Sh. 75m + Sh. 30m = Sh. 105m

Calculation of prepaid or accrued pension cost

Year	Contribution (Accrued)	Pension expense Prepaid/(accrued)	Prepaid	Cumulative
1998	180	105	75	75
1999	180	105	75	150
2000	180	105	75	225
2001	180	105	75	300
2002	30	105	(75)	225
2003	30	105	(75)	150
2004	30	105	(75)	75

	Sh 'm'	Sh 'm'	Sh 'm'	Sh 'm'
1998	180	105	75	75
1999	180	105	75	150
2000	180	105	75	225
2001	180	105	75	300
2002	30	105	(75)	225
2003	30	105	(75)	150
2004	30	105	(75)	75
2005	30	105	(75)	–

<u>**Hint**</u>

It is the cumulative period pension cost that would appear in the balance sheet prepared at the end of each year.

Calculation of annual pension expense

Surplus	=	Sh. 320 million
Remaining service life employees	=	10 years
Therefore amortization of surplus per year	=	Sh. 320 million ÷ 10 = Sh. 32 million
Annual service cost	=	Sh. 60 million
Therefore net pension expense	=	Sh. 60m – Sh. 32m= 28 m

Calculation of pre-paid or accrued pension cost

Year	Contribution	Pension Expense	Prepaid (accrued) Pension Cost	Cumulative/Prepaid (accrued) pension cost
	Sh.m	Sh.m	Sh m	Sh.m'
1996	-	(28)	(28)	(28)
1997	-	(28)	(28)	(56)
1998	-	(28)	(28)	(84)
1999	40	(28)	12	(72)
2000	40	(28)	12	(60)
2001	40	(28)	12	(48)
2002	40	(28)	12	(36)
2003	40	(28)	12	(24)
2004	40	(28)	12	(12)
2005	40	(28)	12	NIL

It is the cumulative accrued pension cost that would appear in the balance sheet.

CHAPTER FOUR

QUESTION ONE

(1)

Share capital and Premium

Cash book issue cost	2	Bal b/d share capital	300
		Bal. b/d share premium	84
Bal c/d		C.B	130
Share capital	400		
Share premium	112		
	514		514

(2) Dividend paid to minority

Minority interest

Subsidiary		Bal b/d	21
10% x 40	4		
Shareholders	4		
Bal c/d	13		
	21		21

(3)

Bank loan

Subsidiary	18	Bal c/d	52
Cash book	5		
Bal c/d	29		
	52		52

(4)

Tax paid

Deferred Tax Interest b/d	2	Deferred liability b/d	17
Tax recoverable	9	Current tax b/d	2
Current tax	-	Tax for the year	2
Deferred tax liability balance c/d	18	Tax recoverable	2
Subsidiary	1	Deferred tax Asset c/d	16
Deferred tax	13		
Cash	5		
	48		48

Finance lease

		Balance brought down	2
		Balance brought down	8
Cash book	8		
Balance c/d	2		
	10		10

Accumulated depreciation Account

Disposal	8	Balance b/d	135
Subsidiary	13	For the year	65
Balance c/d	161		
	200		200

Property, plant and equipment

Balance b/d	769	Disposal b/d	11
Cash	65	Subsidiary	118
		Balance c/d	705
	834		834

Goodwill arising on acquisition

20% x 90	=	18
Paid		28
Goodwill on subsidiary		10

Profit on disposal on property, plant and equipment

Proceed		9
Net book value		
Cash	11	
Depreciation	8	- 3
Profit		6

Inventories

Balance b/d	225	Subsidiary	27
		Decrease	40
		Balance	158
	225		225

Trade and other receivables

Balance b/d	134	Subsidiary	41
Increase	10	Balance c/d	103
	144		144

Trade and other payables

Subsidiary		38	Balance	188 – 5 =183
Decrease		34		
Balance	112 – 1	111		
		183		183

Interest paid

C-B- Finance lease	2	Balance b/d	5
CB – other	37	P & L	35
	1		
	40		40

Amortisation of goodwill

Goodwill arising on acquisition	10
Amortisation	5
Unamortized	5

Amortisation

Subsidiary	5	Balance b/d	25
		For the year	4
Balance c/d	24		
	29		29

Proceed from disposal of subsidiary

Net assets	
90% X 40	36
Goodwill unamortized	5
Profit on sale of subsidiary	19
	60

Proceeds from sale of subsidiary net of cash & cash equivalent disposable.

Proceeds	60	
Subsidiary cash & bank balance	3	
Bank overdraft	(61)	58
		118

Great Mountain consolidated cash flow statement for the period ended 31st March 2003

	Sh. million	Sh. million
Cash flow from operating activities		
Loss before tax		(46)
Adjusted for:		
Depreciation	65	
Amortisation	4	
Profit on sale of property, plant and equipment	(6)	
Interest expense	35	
Profit on sale of subsidiary	(19)	(79)
Operating profit before working capitals changes		33
Working capitals changes		
Decrease in inventory	40	
Trade and other receivable (increase)	(10)	
Trade and other payables (decrease)	(34)	
Decrease in provision for liabilities and changes	(1)	(5)

Cash generated from operations		
Interest on finance lease paid	(2)	
Interest on bank overdraft and other loans	(37)	(39)
		(11)
Tax paid		(5)
Net cash flow from operating activities		(16)
Cash flow from investing activities		
Proceeds from sale of subsidiary	118	
Proceeds from sale of property plant and equipment	9	
Purchase of property, plant and equipment	(65)	
Net cash from investing activities		62
Cash flow financing Activities		
Proceeds from issues of shares	130	
Payment of issue cost	(2)	
Repayment of bank loan	(5)	
Repayment of finance lease	(8)	
Net cash from financing activities		115
Changes in cash and cash equivalent		161
Cash and cash equivalent		161
Cash and cash equivalent beginning		
Cash and cash equivalent	5	
Bank overdraft	(246)	(241)
Cash and cash equivalent ending		(80)
Cash and cash equivalent	3	
Bank overdraft	(83)	(80)

CHAPTER FIVE

QUESTION ONE

(a)

1. Historical costs are presumed to represent objective measurement of prices in an arm's length transactions.
2. Historical costs are assumed to be verifiable since they represent the exchange value of goods and services at the time they were acquired by the enterprise. It is the price in a realized transaction.
3. Historical cost is usually used in computing gains or losses that reflect increases in retained earnings rather than an increase that represents a restatement of capital due in part to the changing value of the monetary unit.

4. Historical cost finds its foundation on the unit of measure assumption. Under this assumption money is assumed to be a stable unit of measure capable of acting as a common denominator of values.
5. Financial statements prepared under this convention provide a basis for determining the outcome of agency agreements with reasonable certainty and predictability because the data are relatively objective.

(b)

Financial statements prepared under the historical cost convention do not have regard for changes in price levels. It has thus been argued that they do not reflect financial realities. This has introduced some limitations to the utility that may be derived from the use of such statements. These limitations include:

a) Failure to disclose the current worth of an accounting entity.
This is because financial statements prepared under historical cost accounting are merely statements of historic facts.

b) Containing non-comparable items
The financial statements contain items, which are usually a composite of historical costs and current costs. For example, if a company constructed a building for a sum of Sh 5 million in 1985 and constructed a similar building in 2002 at a cost of Sh 40 million, the total cost of the buildings will be Sh 45m, thus two amounts are not comparable since Sh 5 million is a historical cost and Sh 40 million is a current cost.

The effect of non-comparative items can also be proved by looking at items in the income statement. For example from the following sales figures, there seems to be an increase in sales over a period of 3 years.

Year	Sales (Sh.)	Average Price Index
20X0	100,000,000	100
2001	150,000,000	200
2002	200,000,000	275

If the same figures are adjusted for price level change using 20X0 as the base year, the situation would be different assuming a price index of 300 at the end of 2002, the revised sales figures would be:

Year	Sales adjustments	Average Price Index
20X0	100,000,000 x 300/100	300,000,000
2001	150,000,000 x 300/200	225,000,000
2002	200,000,000 x 300/275	218,181,181

When the sales are adjusted for price level changes, there appears to be a constant decline in the sales trend.

c) Creation of problems at the time of replacement of assets.
According to conventional accounting, depreciation is charged on historical cost of

the asset. Problems may therefore arise when the asset is to be replaced and larger funds may be required on account of inflationary conditions. Thus the main purpose of providing for depreciation is defeated.

d) Mixing of holding and operating gains.
In conventional accounting, gains on account of holding inventories may be mixed up with operating gains. For example, a business purchased 100 units of a product at Sh. 6 per unit in 2001. It could sell only a half of these units in 2001. In the year 2002, it purchased another 100 units at Sh. 8 per unit and sold all 150 units at Sh. 10 per unit.

Under historical cost accounting, the profit for 2002 would be calculated as follows:

		Shs
Sales (150 x 10)		1,500
Less: cost of sales		
500 x 6	(300)	
100 x 8	(800)	(1,100)
Gross profit for the year		400

Of the Sh. 400 profit, however, Sh. 100 (50 x Sh. 2) is on account of holding the inventory. This is because if the units sold in the year 2002 were all bought in the year 2002, the cost of sales would be Sh 1,200 and the profit would have been Sh 300.

Historical cost accounting fails to make this distinction.

e) Failure to disclose gains on holding monetary liabilities and losses on holding net monetary assets.
Holders of fixed monetary assets loose in periods of inflation while holders of fixed monetary liabilities gain in periods of inflation.
Historical cost accounting does not make any attempt to recognize such losses and gains.

f) May lead to overtaxing of companies.
Under inflationary conditions, the reported profits are overstated and assets understated when accounts are prepared under historical cost convention. Over reporting of profits gives rise to a number of problems which includes heavy taxes, heavy dividends resulting ultimately to heavy financial strain on the company thus draining capital. Peter Drucker observed "There are costs of today and costs of tomorrow. I know of no business today that operates at a rate of return to meet the cost of tomorrow, with today's rate of inflation businesses are not making profits but only destroying capital.

(c)

The choice of the appropriate accounting measurement must be guided by the objectives of financial reporting derived from either the structure of accounting, the desire to be able to interpret financial statements in economic terms or from its value to users. The selection of the measurement bases exhibit different degrees of relevance and reliability. Management must seek a balance between relevance and reliability.

QUESTION TWO

Workings:

1.

DEPRECIATION ADJUSTMENT	Sh. 000
Current cost depreciation (800 x 275/250)	880
Historical cost depreciation	(800)
	80

2.

DISPOSAL OF PLANT ADJUSTMENT		Sh. 000
Proceeds from sale		3,900
Current cost value (6000 x 264/120)	13,200	
Depreciation (4,200 x 264/120)	(9,240)	(3,960)
Loss on disposal		(60)
Historical cost gain recognized		(2100)
		2,160

3.

COST OF SALES ADJUSTMENT	Sh. 000
Total change in value of stock	
Ending inventory	5,000
Beginning inventory	(7,200)
	(2,100)
Less: change due to volume	
Ending inventory 5,100 x 384/400	4,896
Beginning inventory (7,200) x 384/363	(7,617)
	621

4.

MONETARY WORKING CAPITAL ADJUSTMENT	Sh. '000 '
Total change in monetary working capital	
30.9.20X0 Trade receivables	8,000
Trade payables	(4,200)
	3,800
30.9.19X9 Trade receivables	6,300
Trade payable	(2,900)
	3,400
	400
Change due to operations	
30.9.20X0 (3,800 x 384/400)	3,648
30.9.19X9 (3,400 x 384 x 384/364.5)	(3,582)
	66
	334

GEARING ADJUSTMENT

	19X9 (Sh)	20X0 (Sh)
Average net borrowings	'000'	'000'
Current tax	2,300	-
Deferred tax	900	3,200
Debentures	-	6,000
Bank overdraft	-	900
	3,200	10,100
Cash at bank	(1,200)	-
	2,000	10,100
Average shareholders' funds		
Ordinary share capital	20X0	20X0
Retained earnings	8,400	12,000
INCREASE IN NON-MONETARY ASSETS		
Production plant		
1999: 1,800 x 240/120 – 1,800	1,800	
20X0: 15,200 x 275/250 – 15,200		1,520
Stock		
1999: 7,200 x 366/363 – 7,200	60	
20X0: 5,100 x 402/400 – 5,100	-	26
	12,260	15,546

Therefore Average net borrowings $\frac{2,000 + 10,100}{2}$

$= 6,050$

Average shareholders' funds = $\frac{12,260 + 15,546}{2}$

$= 13,903$

Gearing adjustment $\frac{6,050}{6,050 + 13,903}$ x (80 + 2,160 + 621 + 334)

$= 969$

Current Cost Reserve

Stock decrease	34	Balance b/d	3,680
Gearing adjustment	969	Depreciation adjustment	80
		Old plant (3,960 – 3,600)	360
		Cost of sales adjustment	621
		Monetary working capital adjustment	334
Balance c/d	5,592	New plant	1,520
	6,595		6,595
		Balance b/d	5,592

TCurrent Cost Profit and Loss Account

For the year ended 30 September 20X0

	Sh '000'	Sh '000'
Net profit before finance costs		6,200
Depreciation adjustment	(80)	
Adjustment on sale plant	(2,160)	
Cost of sales adjustment	(621)	
Monetary working Capital Adjustment	(334)	(3,195)
		3,005
Gearing Adjustment	969	
Deduct: Finance costs	(300)	669
Current cost profit before tax		3,674
Taxation		(2,300)
Retained Profit		1,374

Zetoxide Limited
Current Cost Balance Sheet As at 30 September

	19X9 Sh. '000'		20X0 Sh. '000'
Property plant & equipment			
Current cost: 6,000 x 240/120	12,000	16,000 x 275/250 =	17,600
Depreciation: (4,200) x 240/120	(8,400)	(800) x 275/250 =	(880)
1,800 x 240/120	(3,600)	15,200 x 275/250 =	16,720
Current Assets:			
Inventory 7,200 x 366/363	7,269	5,100 x 402/400 =	5,126
Trade receivable	6,300		8,000
Cash at bank	1,200		-
	14,760		13,126
Current Liabilities:			
Bank overdraft	-		900
Trade payables	2,900		4,200
Current tax	2,300		-
	5,200		5,100
	9,560		8,026
	13,160		24,746
Ordinary share capital:			
200,000 ordinary shares of Sh.10	2,000		2,000
Current Cost Reserve	3,680		5,592
Current Cost Retained Earnings	6,580		7,954
Shareholder's Funds	12,260		15,546
Non-Current Liabilities:			
Deferred tax	900		3,200
Debentures	-		6,000
	900		9,200
	13,160		24,746

CHAPTER SIX

(a) Calculation of amount that would be received by the shareholders.

(i) Statement showing how proceeds from sale of assets would be distributed.

Proceeds from:	**Sh. '000'**	**Sh. '000'**
Land and buildings		60,000
Motor vehicles	32,000	
Less: Bank overdraft	10,000	
		22,000
Fixtures and equipment		15,000
Stocks		12,500
Debtors		5,200
		114,700
Less: Liquidation costs		5,000
		109,700
Less: Debentures secured on floating charge		70,000
		39,700
Less: creditors		14,500
Less: Preference dividend arrears		9,000
$\frac{10}{100}$ x Sh.30m x 3yrs		16,200
Less: Payment to preference shareholders		16,200
		NIL

(ii) Amount received by shareholders

Preference shareholders

- Dividend arrears	9,000
- Payment for capital	16,200
	25,200

Ordinary shareholders would receive no payment as preference shareholders having priority over them would not be fully paid due to insufficient proceeds from sale of assets.

Determination of income that would be earned:

(i) Calculation of the number of ordinary shares that would be issued on reconstruction of the company.

Shares-issued to:	**No. of shares '000'**
Debenture holders (Shs. 50,000,000 ÷ Shs. 10)	5,000
Preference shareholders [Shs. (30,000,000 ÷ Sh. 10) x 2:5]	1,200
Preference shareholders ($\frac{10}{100}$ x Sh.30,000,000 x 3yrs x 5 ÷ 100)	450
Ordinary shareholders [(Shs. 50,000,000 ÷ sh. 10] ÷ 10)	500
	No. of shares
Shares issued for cash to:	
- Present preference shareholders ($\frac{1}{5}$ x Sh.4,850,000)	970
- Present ordinary shareholders ($\frac{4}{5}$ x Sh.4,850,000)	3,880
	12,000

Summary of shares received

	Debenture Holders '000'	**Preference Shareholders** '000'	**Ordinary shareholders** '000'
Shares issued for capital	5,000	1,200	500
Shares issued in settlement of dividend arrears		450	
Shares issued for cash		970	3,880
	5,000	2,620	4,380

(ii) Profit and loss account extract

	Shs. '000'
Expected profit before interest and tax	9,100
Less: Debenture interest ($\frac{8}{100}$ x Sh.20,000,000)	1,600
Profit before tax	7,500
Tax (30%)	2,250
Profit after tax	5,250
Dividends (80% of Shs. 5.25m)	4,200
Retained profit	1,050

STUDY TEXT

Dividend per share

$= \frac{\text{Sh. } 4{,}200{,}000}{20{,}000{,}000 \text{ shares}}$

= Shs. 0.35

(6 marks)

(b) Shida Ltd
Balance sheet as at 2/10/2004
(After Reconstruction Scheme)

	Shs. '000'	Shs. '000'
ASSETS		
Non-Current assets		
Land and buildings	60,000	
Motor vehicles	32,000	
Furniture and equipment	15,000	
		107,000
Current assets		
Stocks	24,500	
Debtors	5,200	
Bank	19,500	49,200
		156,200
EQUITY AND LIABILITY		
Capital and reserves		
Ordinary share capital	120,000	
Capital reserves	4,700	
		124,700
Non-current liability		
8% Debentures		20,000
Current liability		
Creditors		11,500
		156,200

Workings

CAPITAL REDUCTION A/C

	Shs. '000'		Shs. '000'
Goodwill	20,000	Land and buildings	12,000
Motor vehicles	5,000	Ordinary shares	50,000
Furniture and equipment	10,000	Preference shares	30,000
Stocks	5,500	Share premium	10,000
Debtors	1,300	Debentures	70,000
Profit and loss account	30,000		
Reconstruction costs	4,000		
Ordinary shares to:			
- ordinary shareholders	5,000		
- Preference shareholders	12,000		
-Preference shareholders	4,500		
- Debenture holders	50,000		
8% debentures	20,000		
Capital reserve (balancing)	4,700		
	172,000		172,000

ORDINARY SHARES ACCOUNT

	Shs. '000'		Shs. '000'
Capital reduction A/C	50,000	Balance b/d	50,000
		Capital reduction A/C	71,500
Balance c/d	120,000	Bank A/c	48,500
	170,000		170,000

BANK ACCOUNT

	Shs. '000'		Shs. '000'
Ordinary shares A/C	48,500	Balance b/d	10,000
		Reconstruction costs	4,000
		Creditors A/c	3,000
		Stock A/c	12,000
		Balance C/d	19,500
	48,500		48,500

STOCK ACCOUNT

	Shs. '000'		Shs. '000'
Balance b/d	18,000	Capital reduction A/c	5,500
Bank A/c	12,000	Balance c/d	24,500
	30,000		30,000

CREDITORS A/C

	Shs. '000'		Shs. '000'
Bank A/c	30,000	Balance b/d	14,500
Balance c/d	11,500		
	14,500		14,500

(14 marks)
(Total: 20 Marks)

CHAPTER SEVEN

QUESTION ONE

Financial objectives of commercial concerns:

- To maximise the value of the firms to its owners
- Determined by management team
- More financial than theoretical objective
- Management is concerned with firms and share valuation as an indication of the level of reward to shareholders group.

STUDY TEXT

- Management concentrate on the theoretical objectives – reporting on firm and share valuation helps management in decision making and policy formation process.

Public Corporations

Financial objectives are specified by government rather than determined by management.

Such objectives are difficult to specify in value terms as:

- There is usually no observable market value of claims on, or right to participate in the entity.
- It is difficult to identify the ownership group, whose value should be maximised.

Financial objectives are usually specified in 'non-value' financial terms such as target, sometimes better described as financial constraints.

Main difference in objectives of Commercial/Public Corporations:

1. The freedom of the entity's management determine the firm objectives.
2. The nature of objectives set – value or accounting measures.

Financial management should be integrated with the firm and designed to assist in meeting the firm's objectives.

Difference is due to considerable differences in the operation of firm.

- Technology
- Type of market

QUESTION TWO

Accounting has been described as a process whereby transactions of an operating entity are documented, classified and recorded for the purposes of accumulating and providing financial information essential to the conduct of designated activities. Government accounting is an essential element of the financial management function of government. In the main government accounting is directed towards satisfying the accountability and management requirements of officials responsible for the conduct of government activities and operations. It is therefore concerned with the proper recording of all receipts of government, with the maintenance of records that reflect the propriety of transactions and give evidence of accountability for assets and other resources available for use and with the classification of data in a way that provides useful information for control and effective and efficient management of government programme operations. Amongst the features of government accounting, are the specific roles played by the Public Accounts committee, the Controller and Auditor-General and the Ministries Accounting Officers to which we turn.

a) The Public Accounts Committee

- A standing committee of a few selected members of Parliament.
- Charged with reviewing financial matters of government.
- This is in line with the constitutional requirement that all financial matters in government are subject to consideration, approval and review by the legislature.
- The deliberations and recommendations of the Public Accounts Committee are based on the report on funds and accounts by the Auditor-General.
- The proceedings at the meeting are recorded verbatim, the Auditor-General's staff and those of accounting unit responsible for the deliberations reacting to the points raised in the report.
- Matters deliberated upon include serious ones concerning losses on a large scale, cases of thefts and Misappropriation, failure to observe regulations and ensure propriety of expenditure, cases of waste and other administrative inefficiencies which have led to wastage of funds and failure to obtain value for money.
- These serious matters require proper explanation on the part of the Accounting Officer and the reaction of the Public Accounts Committee in recommending surcharge of the principle of personal accountability of government officers handling public funds.
- The Public Accounts Committee's recommendations are then debated in Parliament which often insists that the government takes necessary corrective action which often is done.
- The role played by the Public Accounts Committee ensures that the government be made accountable for financial matters to the legislature. It is a control measure ensuring that public funds are protected and used only for purposes intended by Parliament. It curbs any tendency by public officers to be lax and wasteful in their handling and management of public funds. It ensures that proper accounting methods and procedures and controls are instituted to safeguard public funds.

b) The Controller and Auditor General is appointed by the President and reports to Parliament.

- He functions independently of executive council.
- He controls issues of funds from exchequer that is funds voted for use by Parliament and intended for by spending units to be withdrawn from the exchequer, must be sanctioned for by the controller who satisfies himself that there are adequate funds and that they will be used for the purpose intended by Parliament.
- He carries out both statutory and non statutory audit.
- The more serious audit queries known reference sheets are compiled in an audit report which is presented to Parliament for reviewing the government's financial management.
- The institution of the office of the Controller and Auditor-General plays a very effective role in the management of public funds.
- The Controller and Auditor-General plays the role of a watchdog and the fact that he reports to Parliament ensures that spending units are not lax in handling public funds.
- His independence in performance of his duties ensures that he is not subjected to undue influence by the executive. He carries out his duties without fear or favour, he expresses his opinion, qualifies his report and on the whole the powers conferred upon him by the exchequer and Audit Act, ensures the accountability of the executive to the legislature. Without any doubt, the role of the Controller and Auditor-General is very essential in ensuring proper financial management.

- Although the role may be that of making of the report to Parliament, his officers carry out continuous audit inspection on the records of accounting units of the government, this minimises incidents of fraud, thefts and other misappropriations.
- The recent creation of the Auditor-General for statutory boards underscores the importance the government attaches to the auditing function, it is indispensable.

c)

- The voted funds or the grants given by Parliament for use by the accounting officer should be properly handled to ensure regularity and propriety of expenditure.
- The accounting officer is appointed by the Permanent Secretary Treasury personally and under the principle of personal accountability.
- The letter of appointment spells out his duties and functions, emphasizing the fact he is answerable to the Public Accounts Committee on serious matters raised by the controller and Auditor-General.
- His responsibilities in management of public funds, safeguarding public property and running his accounting unit must be carried out with diligence, dedication, with due regard for efficiency and effectiveness.
- Amongst his duties are to organise his accounting unit to ensure that functions are carried out properly, to ensure that public property are safeguarded, to ensure that staff under him have the necessary technical skills for the proper performance of their duties, to plan and budget for the financial requirements of his unit as directed by Treasury, to instill cost-consciousness in the at all levels of management, to answer audit queries, to sign the appropriation accounts and so on.

The accounting officer

- The salient point of the role of the Accounting Officer is that he is personally held responsible for any undue happenings affecting public funds in his control. For example, should he differ with the Minister, his political head, on how to spend certain funds he has to obey the Minister's directives but should write to Treasury, giving details of the dispute. This will absolve him of blame should a query arise.
- Public servants handling public funds should be held wholly responsible. As head of his accounting unit, this requirement ensures that funds are not handled with laxity, that services are provided efficiently and effectively, that evidence is produced on how the funds were spent and last but not least, the taxpayers have got value for money with regard to the taxes they pay.

QUESTION THREE

One basic feature amongst others, of government accounting, is the concept of fund entities, which has its origin in the fact that financial powers of the executive are subject to the control of the legislature. There is for example, a constitutional requirement that government receipts from revenue and borrowing should be accumulated into a general fund (consolidated fund) for use of the government as a whole, and any withdrawals from fund be subjected to sanction by the legislature.

Provision has also been made for separate treatment of monies received by the government in a trustee capacity. These are known as trust funds from which withdrawals are made in accordance with specific statutory provisions. Funds may also be established by law from the proceeds of earmarked taxes, with provisions for using such receipts to attain specified programme objectives – either with or without prior grant of authority from the legislature. Additionally, in some cases a contingency fund may be created to enable advances to be made for meeting necessary and unforeseen expenditures, subject to subsequent authorisation by the legislature. Funds are also established by legislative action which grants authority to spend for specified purposes and objectives. Such funds are legal entities. Like the National Social Security Fund and the National Hospital Insurance Fund, they have their own resources which include property, receivables, investments and other accountable assets. Any liabilities are set off against the assets to determine the network of the fund. Such a fund therefore is an independent accounting entity. An example of a trust fund is the Widows and Children's Pension Fund to which all married Civil Servants must contribute a certain amount of their monthly salaries and on retirement or leaving the service, refunds are made.

Revolving Funds are also entities set up by legislative action to provide agencies with resources for the attainment of specified objectives. Government enterprises are usually set up in this manner. The initial appropriation is made out of the consolidated fund. The receipts generated in such funds are automatically used by the agency in accordance with the law that set up the fund. Annual legislative appropriations are not therefore required for the operation of such funds. However, the original financing required to the financing of a programme increase or an incurred deficit would be appropriated out of the central funds of the government. Similarly, any surplus that may result from the operations carried out under such authority should be deposited in the central fund as receipts of the government.

Sinking Funds are also entities set up by legislative action with the purpose of eventual liquidation or extinction of public debt. This requires annual appropriations into the fund thus building up the fund as maturation of the debt approaches, until the principal sum is repaid. There is necessity of investing the appropriations on a special account as the Sinking Fund is built up. Debt requiring such fund is known as Funded Debt. There is less use of these Funds these days as they entail tying down funds which would have been used elsewhere.

QUESTION FOUR

Types of non-profit making organisations are the Central Government. Local Authorities, Trade associations, welfare clubs, religious organisations, and so on, whose motive of existence is not profit but to advance the welfare of the members or some other.

Take the example of the government accounting system (which includes Local Government accounting). The accounts are maintained on a receipts and payments basis. Actual receipts of revenues and actual expenditures incurred are the basis of the financial statements. These statements are produces by each accounting unit, not by the government as a whole. Each unit is charged with the task of providing a service, a function during a financial year, of a current or development nature. Since authority to raise revenue and spend public funds is vested in the legislature, the accounting unit merely has to satisfy accountability requirements while assuming that services were actually rendered. Any shortfalls in revenue collections or amounts owed to or by the accounting unit are **not** debtors or **creditors** per se but are a mere reflection on the performance of the unit. Its financial position at the end of the year is known as a statement of assets and liabilities vis a vis other units or balances held on hand (its assets) and any unused funds (its liabilities).

Revenues to be collected by way of taxes, fees and charges, rates borrowing etc. are estimated for, and also how those revenues will be expended are also estimated for. It would be difficult to single out individual taxpayers as debtors or some unpaid bill at the end of the year as a creditor, since the functions of the state do not stop, but are continuous. The reason for having a financial year is to emphasize the constitutional requirement that Parliament is supreme in finance matters and the government must receive annual authority (by way of the Appropriation Act) to raise and expend public funds). In this case, it would appear that the receipts and payments basis of accounting is appropriate.

The other non-profit accounting system is the income and expenditure system of accounting. Welfare clubs, Members clubs and religious organisations and trade associations rely mainly on member's contributions and necessarily some members will default payment of their dues or the members may sometimes pay in advance. This is a clear case of creditors and debtors or accruals. A surplus or deficit may be reflect and a balance sheet drawn.

This income and expenditure accounting system would appear to be appropriate for such organisations in view of the fact that their area and scope of activities is limited, its assets are identifiable, and liabilities can be ascertained.

Although we have outlined the differences in approach between accounting in commercial and non commercial organisations, the dividing line is not straight and clear. It should be remembered that public sector accounting includes government commercial enterprises with a profit motive. More over, accounting by non-profit organisations is increasingly adopting practices similar to those employed in private industry. Such an operation involves setting up a "business type" financial system in which the relationship of receipts and expenditures and the financial results obtained continuously are highlighted for the attention of agency management and legislative review.

QUESTION FIVE

(a) Planning and control are two important management functions and accounting in the present day conceptions lays emphasis on these two functions.
In this sense, accounting is described as management accounting, which is any form of accounting which enables a business to be conducted more efficiently. This emphasis on accounting for efficiency, is in every area where accounting must be used, whether in an organisation with the profit motive or in non-profit motive organisations like the government.
Budgetary control refers to the use of budgets to control the activities of an organisation. Take the case of the government, the idea of budgetary control is in fact extensively used. Finance being such a scarce resource, no government can afford not to budget. Basically, the annual budget consists estimates of revenue and expenditure and each accounting unit or cost centre has to show its operational costs being limits beyond which no expenditure should be incurred without Treasury or Parliamentary approval. The government budget as whole should not be exceeded without parliamentary approval. All the estimates are broken up into minor budgets for ministries and/or departments. Vote control is in essence budgetary control and this is carried on without profit motive.

Therefore, we can emphasize that the profit motive is not necessary for the use of budgetary control.

(b) Budgeted levels of expenditure normally represent ceilings over and above which spending units of government must not go, without approval either by Parliament or Treasury.

It is both legally and administratively binding for the government to present expenditure estimates to Parliament.

The expenditure estimates are both of recurrent and development nature and pertain to one financial year.

Sitting as a committee of supply, parliament approves the estimates by way of the appropriation bill which is signed by the President to become an act.

CHAPTER EIGHT

QUESTION ONE

(a)

A number of different measurement bases are employed to different degrees and in varying combination in financial statements. They include the following:

(i) Historical Cost
Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(ii) Current cost
Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(iii) Realisable (settlement) value
Assets are carried at the amount of cash or cash equivalents that would currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(iv) Present value
Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

(b) Concepts of capital

(i) A financial concept of capital is adopted by most enterprises in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

(ii) Financial capital maintenance
Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from owners during the period. Financial capital maintenance can be measured in either normal monetary units or units of constant purchasing power.

(iii) Physical capital maintenance
Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period after excluding any distributions from owners, during the period.

REFERENCES

REFERENCES

GLOSSARY

GLOSSARY

Accountants report in a prospectus: These are reports prepared by independent reporting accountants as required by the appointing authority or by legislation

Accounting policies are the specific accounting principles and the methods of applying those principles that are considered by a business concern to be the most appropriate in the circumstances to present financial statements.

Accounting principles refer to the fundamental beliefs, guides to action and a settled ground or basis of accounting conduct and practice.

Accounting profit: is the profit reported to the shareholders. This profit is based on accounting concepts and principles.

Accounting standards are methods of or approaches to preparing accounts which have been chosen and established by the bodies overseeing the accounting profession.

Amalgamations occur where two or more companies wish to combine their businesses and a new identity for the combined business is sought.

Assets: an asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.

Associate: An enterprise in which an investor has significant influence but not control or joint control.

Borrowing costs: interest and other costs incurred by an enterprise in connection with the borrowingof funds.

Business segment: A component of an enterprise that:

(a) provides a single product or service or a group of related products and services and

(b) that is subject to risks and returns that are different from those of other business segments.

Capital Reconstruction - these are capital change schemes involving the formation of a new company with a different capital structure to salvage the assets of the existing company, which is then wound up.

Capital reduction – utilizes the credit released in a reduction of the share capital to write down asset values and write of accumulated losses

Capital Reorganizations - this is a plain reorganization involving the internal alterations of a company's capital, usually to make the company more appealing, for the issuing of new capital to raise funds and/or to avoid liquidation.

Carrying amount: is the net value at which the asset is included in the balance sheet (i.e. after deducting accumulated depreciation and any impairment losses).

Cash flow interest rate risk: The risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

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

Contingent asset: a possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Contingent liability: a possible obligation depending on whether some uncertain future event occurs, or a present obligation but payment is not probable or the amount cannot be measured reliably.

Control: The power to govern the financial and operating policies of an activity so as to obtain benefits from it.

Constructive obligation: arises if past practice creates a valid expectation on the part of a third party, for example, a retail store that has a long-standing policy of allowing customers to return merchandise within, say, a 30-day period.

Corporation tax: is the tax payable by a company as a result of generating profits from trading.

Cost of sales adjustment (COSA) is the additional cost of sales arising due to inflation. **Currency risk:** is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates.

Current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

Credit risk: The risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

Deferred tax: is the corporation tax that is likely to be incurred on the activities of a company during a particular period but, because of differences between the way activities are included in the accounting profit and taxable income, will be paid in another period.

Deferred Tax Accounting Method: Under this method, income tax is considered to be an expense incurred by the enterprise in earning income and is accrued in the same periods as the revenue and expenses to which it relates. The resulting tax effects of timing differences are included in the tax charge in the income statement and in the deferred tax balances in the balance sheet.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Depreciation adjustment is the additional depreciation arising due to increase in prices of goods.

Depreciation base: cost less estimated residual value.

Employee benefits: are all forms of consideration given by an entity in exchange for service rendered by employees.

Environmental auditing: auditing a business to assess its impact on the environment or the systematic examination of the interactions between any business operation and its surroundings.

Equity: This refers to the residual interests in the assets of the business.

Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Equity method: A method of accounting by which an equity investment is initially recorded at cost and subsequently adjusted to reflect the investor's share of the net profit or loss of the associate (investee).

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

External reconstruction – formation of a new company to take over all or part of the assets and liabilities of a company possibly in financial difficulties.

Fair value: the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

Financial instrument: A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial statements are a structured financial representation of the financial position of and the transactions undertaken by an enterprise.

Foreign operation: A subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

Free Cash flows: Is the Cash from operations less the amount of capital expenditures required to maintain the firm's present productive capacity.

Full deferral: requires that full tax effects of all timing differences are recognised as they arise. The approach is arithmetically accurate but can lead to the build up of large, meaningless provisions appearing on the balance sheet.

Functional currency: The currency of the primary economic environment in which the entity operates.

Gearing Adjustment: This is the gain due to the shareholders as a result of financing the assets through loans.

Geographical segment: A component of an enterprise that:

(a) provides products and services within a particular economic environment and
(b) that is subject to risks and returns that are different from those of components operating in other economic environments.

Group structure: The relationship between the holding company and the subsidiaries.

Gross investment in the lease: the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor.

Identifiability: An intangible asset is identifiable when it is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or as part of a package) or arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Impairment: a fall in the value of an asset so that its recoverable amount is now less than its carrying value in the balance sheet.

Intangible asset: An identifiable non-monetary asset without physical substance.

Interest cost is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

Interest rate risk: is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates.

Inventories: assets held for sale in the normal course of business.

Investor in a joint venture: A party to a joint venture and does not have joint control over that joint venture.

Joint control: The contractually agreed sharing of control over an economic activity such that no individual contracting party has control.

Joint venture: A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time.

Lease term: the non-cancellable period for which the lessee has contracted to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Lessee: this is a person, who under an agreement, obtains from another person (the lessor) the right to use, in return for rent, an asset for an agreed period of time.

Lessor: This is the person, who under an agreement conveys to another person (the lessee) the right to use in return for rent, an asset for an agreed period of time.

Liability: Present obligation as a result of past events. Settlement is expected to result in an outflow of resources (payment)

Liquid risk (or funding risk): The risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments.

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried and carried in the balance sheet and income statement.

Minimum lease payments*:* the payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with the residual value.

Monetary working capital adjustment represents the amount of additional (or reduced) finance needed for the monetary working capital as a result of changes in the input prices of goods and services used and financed by the business.

Multi – employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

a) Pool the assets contributed by various entities that are not under common control, and
b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

Net investment in the lease: the gross investment in the lease less unearned finance income.

Net Realizable Value: This is the estimated selling price in the ordinary course of business less the estimated costs of completion and processing costs.

Obligating event: is an event that creates a legal or constructive obligation and, therefore, results in an enterprise having no realistic alternative but to settle the obligation.

Operating capability of the business entity is its ability to replace assets as they are consumed or worn out or its ability to produce the same volume or value of goods i.e. the next year as in the current year.

Other long-term employee benefits are employee benefits (other than post employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

Parent: An entity that has one or more subsidiaries.

Partial deferral: requires that the income tax expense excludes the tax effects of certain timing differences when there is reasonable evidence that those timing differences will not reverse for some considerable period (at least 3 years) ahead.

Plan assets comprise:

a) Assets held by a long-term employee benefit fund; and
b) Qualifying insurance policies

Post-employment benefits are formal or informal arrangements under which an entity provides post employment benefits for one or more employees.

Price risk: is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all securities traded in the market.

Prospectus is a statement issued to prospective shareholders and debenture holders inviting them to subscribe for securities in the company.

Provision: A liability of uncertain timing or amount.

Qualifying asset: this is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Related party transaction is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

Related parties: parties are considered to be **related** if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.

Reportable segment: A business segment or geographical segment for which IAS 14 requires segment information to be reported.

Rights issue is regarded as an issue for cash at full market price and partly a bonus issue on the combined number of original and assumed rights shares.

Segment assets and segment liabilities: Those operating assets (liabilities) that are directly attributable or reasonably allocable to a segment.

Segment expenses: Expenses, including expenses relating to inter-segment transactions, that:

(a) result from operating activities and
(b) are directly attributable or reasonably allocable to a segment. This includes interest expense and related securities losses only if the segment is a financial segment (bank, insurance company, etc.).

Segment result: Segment revenue minus segment expenses, before deducting minority interest.

Segment revenue: Revenue, including inter-segment revenue, that is directly attributable or reasonably allocable to a segment. This includes interest and dividend income and related securities gains only if the segment is a financial segment (bank, insurance company, etc.).

Short –term employee benefits are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

Significant influence: Power to participate in the financial and operating policy decisions but not control them.

Subsidiary: An entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

Tax-adjusted profit: is the profit on which tax is assessed - taxable income (tax loss). This profit is determined in accordance with the rules laid down in the Income Tax Act upon which the provision for taxes payable is determined. This profit takes into account capital allowances, stock relief, disallowable expenditure and so on.

Taxes Payable Method: It ignores deferred tax and thus the income tax expense is normally equal to the provision for tax payable. The extent and potential tax effect of timing differences are sometimes disclosed in notes to the financial statements.

Temporary differences include differences between the fair values and the tax values of assets and liabilities acquired and the effect of revaluing assets and liabilities acquired and the effect of revaluing assets for accounting purposes.

Termination benefits are employee benefits payable as a result of either:

a) an entity's decision to terminate an employee's employment before the normal retirement date, or
b) an employee's decision to accept voluntary redundancy in exchange for those benefits.

The full provision method is based on the view that every transaction has a tax consequence and it is possible to make a reasonable estimate of the future tax consequences of transactions that have occurred by the balance sheet date.

The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Timing Differences: is items reported in the accounts in periods different from those in which they are reflected in tax computations. These differences originate in one period and reverse in one or more subsequent periods.

Unearned finance income: the difference between the lessor's gross investment in the lease and its present value.

Useful life: In the case of an operating lease either the period over which a fixed asset is expected to be used by the enterprise; or the number of production (or similar) units expected to be obtained from the asset by the enterprise. In case of a finance lease, the useful life of the asset is the lease term.

Value added is the difference between the value of the goods or services produced (i.e. sales revenue) and the value of goods and services purchased from outsiders (i.e. the cost of brought-in material and services).

Venturer: A party to a joint venture and has joint control over that joint venture.

Vested employee benefits are employee benefits that are not conditional on future employment.

INDEX

INDEX

A

Accounting concepts: 450

Accounting models: 295, 323, 324

Accounting policies: 106, 130, 218, 259, 446, 447, 454, 479, 565

Accounting principles: 445, 446, 450, 458, 479, 565

Accounting profit: 151, 565

Accounting research: 474

Accounting standards: 458, 459, 479, 565

Actuarial gains and losses: 170, 190, 196

Amalgamations: 565

Amortised cost: 114, 115, 118

Amortization: 256, 287, 528

Asset: 156, 170, 317, 451, 492, 507, 539

Assets: 8, 17, 22, 28, 33, 34, 44, 47, 52, 54, 55, 58, 61, 67, 68, 70, 77, 97, 137, 156, 169, 193, 195, 251, 252, 261, 298, 299, 305, 307, 310, 311, 313, 314, 316, 317, 318, 319, 342, 350, 351, 353, 367, 447, 448, 477, 478, 480, 488, 489, 494, 496, 502, 504, 511, 515, 516, 517, 518, 527, 528, 529, 533, 547, 557, 565, 571

Associate companies: 3, 60

B

Balance sheet: 14, 17, 22, 31, 45, 46, 50, 58, 61, 64, 72, 138, 161, 187, 301, 326, 367, 458, 528, 535, 550

Borrowing costs: 508, 565

Business combination: 7, 220

Business segment: 257, 258, 282, 565

C

Capitalisation: 344, 508

Capital maintenance: 293

Capital reduction: 331, 332, 334, 365, 366, 551, 566

Carrying amount: 89, 96, 111, 133, 521, 566

Cash flow: 62, 91, 105, 124, 125, 126, 134, 203, 245, 246, 249, 250, 255, 256, 282, 284, 447, 498, 519, 541, 542, 566, 568

Consolidated financial statements: 5, 7, 69, 510, 566

Consolidation: 4, 35, 39, 40, 511

Constructive obligation: 177, 566

Contingent assets: 517

Contingent liabilities: 474, 517

Control: 5, 23, 32, 33, 52, 55, 69, 510, 566

Corporation tax: 143, 144, 145, 152, 153, 156, 159, 191, 196, 566

Cost of sales adjustment: 293, 311, 312, 315, 323, 546, 547, 566

Credit risk: 105, 107, 134, 567

Currency risk: 105, 134, 566

Current purchasing power: 294, 297, 323, 325

D

Deferred tax: 144, 146, 148, 150, 151, 152, 153, 154, 157, 159, 161, 191, 196, 219, 227, 250, 314, 318, 326, 475, 501, 535, 539, 546, 547, 567

Defined benefit plans: 168, 173, 176, 187, 192, 567

Defined contribution plans: 168, 173, 175, 192, 567

Depreciation: 15, 18, 19, 46, 47, 50, 52, 53, 81, 83, 95, 152, 156, 157, 161, 242, 247, 250, 251, 253, 255, 284, 287, 293, 298, 299, 300, 304, 305, 307, 308, 309, 310, 311, 312, 314, 315, 317, 318, 323, 326, 504, 526, 529, 530, 532, 533, 534, 535, 540, 541, 545, 546, 547, 567

Depreciation adjustment: 293, 311, 315, 323, 526, 546, 547, 567

Depreciation base: 567

Disclosure: 96, 98, 128, 129, 132, 162, 165, 172, 223, 224, 260, 263, 269, 322, 458, 472, 497, 500, 505, 507, 509, 513

E

Earnings per share: 203, 204, 267, 268, 269, 270, 271, 272, 273, 274, 275, 276, 285

Employee benefits: 143, 144, 166, 168, 191, 197, 221, 536, 567

Environmental auditing: 473, 479, 567

Equipment: 31, 47, 48, 53, 54, 81, 82, 83, 246, 247, 307, 308, 310, 311, 344, 345, 346, 503

Equity: 12, 23, 25, 26, 34, 35, 69, 100, 103, 108, 119, 127, 130, 134, 163, 252, 278, 279, 280, 281, 307, 310, 314, 367, 448, 478, 480, 506, 511, 512, 567

Equity instrument: 100, 108, 134, 567

Equity method: 25, 34, 69, 512, 567

Exchange difference: 40, 41, 43, 45, 46, 69, 256, 508, 568

External reconstruction: 331, 333, 365, 568

F

Fair value: 7, 46, 79, 100, 107, 123, 124, 125, 186, 188, 189, 221, 487, 513, 519, 520, 521, 533, 534, 536, 568

Financial assets: 111, 113, 117, 119, 120, 121, 129, 130, 519

Financial instruments: 60, 77, 89, 104, 108, 109, 112, 117, 518

Financial statements: 446, 447, 478, 496, 543, 568

Foreign currency: 41, 92

Foreign operation: 4, 40, 69, 70, 568

Full deferral: 154, 191, 568

G

Gearing adjustment: 311, 318, 546

gearing ratio. *See* debt ratio

gearing ratios. *See* Liquidity ratios

Geographical segment: 257, 258, 282, 568

Goodwill: 8, 9, 10, 11, 16, 17, 18, 22, 23, 28, 31, 32, 39, 46, 49, 51, 52, 55, 59, 67, 68, 72, 92, 96, 227, 255, 256, 336, 339, 341, 344, 367, 488, 516, 526, 528, 529, 530, 531, 540, 541, 550

Government assistance: 507

Group structure: 3, 69, 70, 568

H

Hedging: 122, 123

I

Impairment: 8, 18, 28, 58, 60, 77, 89, 93, 95, 97, 119, 120, 133, 137, 138, 488, 494, 503, 511, 515, 569

Income statement: 10, 14, 16, 50, 61, 118, 121, 123, 124, 127, 187, 309

Index: 315, 316, 543

Inflation accounting: 293, 325

Intangible assets: 252, 517, 518

Interest cost: 169, 178, 190, 569

Interest rate risk: 105, 106, 134, 569

Inventory: 9, 14, 17, 22, 29, 31, 47, 49, 50, 52, 53, 54, 124, 227, 307, 308, 310, 311, 326, 342, 345, 349, 351, 529, 530, 531, 547

Investment property: 520

Investment ratios. *See* equity ratios

J

Jointly controlled entities: 512

Joint control: 33, 69, 569

Joint Venture: 99, 262, 284, 512

Joint venture: 4, 33, 69, 70, 569

L

Lease: 77, 78, 79, 80, 85, 89, 133, 248, 504, 505, 569

Lease term: 79, 133, 569

Lessee: 78, 133, 504, 569

Lessor: 78, 133, 504, 569

Liabilities: 17, 29, 52, 54, 68, 87, 161, 252, 307, 310, 313, 314, 447, 448, 449, 478, 480, 481, 489, 516, 517, 528, 529, 534, 547, 557

Liability: 100, 155, 156, 157, 158, 570

Liquidation: 347, 548

Liquid risk: 105, 134, 570

M

Market risk: 105, 132

Measurement: 7, 28, 162, 163, 164, 220, 447, 448, 479, 480, 494, 515, 570

Merger: 4, 36, 38, 70

Minimum lease payment: 79, 133, 570

Monetary working capital adjustment: 293, 311, 312, 315, 316, 323, 546, 570

Multi-employer plans: 174

N

Neo-classical: 297, 323, 324

Non-cancellable lease: 78

O

Obligating event: 570

Operating capability: 323, 570

Operating lease: 80, 84, 504

P

Parent: 3, 5, 69, 571

Partial deferral: 154, 191, 571

Party: 263, 264, 509

Past service cost: 170, 179, 183, 189, 190, 193, 196, 197, 536

Plant: 9, 12, 31, 41, 88, 246, 247, 327, 336, 339, 341, 342, 503, 527

Plan assets: 169, 184, 185, 506, 571

Post employment benefits: 195

Price risk: 105, 134, 571

Property: 6, 14, 17, 64, 65, 96, 221, 227, 228, 246, 247, 287, 326, 475, 477, 503, 527, 529, 539

Prospectus: 571

Provisions: 146, 264, 489, 516

Q

Qualifying asset: 571

R

Related party: 263, 265, 266, 267, 509, 571

Related party transaction: 263, 265, 509, 571

Reportable segment: 257, 283, 571

Rights issue: 203, 282, 571

S

Segmental reports: 204, 285

Segment expenses: 258, 283, 572

Segment revenue: 258, 260, 283, 572

Shares: 20, 54, 117, 268, 274, 275, 281, 307, 310, 311, 318, 335, 347, 353, 513, 549

Social responsibility accounting: 445, 446, 470, 481

Subsidiary: 3, 5, 10, 11, 52, 69, 70, 251, 538, 539, 540, 541, 572

T

Temporary difference: 144, 146, 191, 572

Termination benefits: 167, 168, 192, 195, 506, 572

Timing difference: 156, 157

U

Useful life: 79, 573

V

Venturer: 33, 69, 512, 573

Vested employee benefits: 168, 192, 197, 536, 573