Financial Accounting IV

PAPER NUMBER 16

Study Pack

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INSTRUCTIONS FOR STUDENTS

This study guide is intended to assist distance-learning students in their independent studies. In addition, it is only for the personal use of the purchaser, see copyright clause. The course has been broken down into eight lessons each of which should be considered as approximately one week of study for a full time student. However, some lessons especially lesson 4 and 8 require more time. Solve the reinforcement problems verifying your answer with the suggested solution contained at the back of the distance learning pack. When the lesson is completed, repeat the same procedure for each of the following lessons.

At the end of lessons 2, 4, 6 and 8 there is a comprehensive assignment that you should complete and submit for marking to the distance learning administrator.

SUBMISSION PROCEDURE

1. After you have completed a comprehensive assignment clearly identify each question and number your pages.
2. If you do not understand a portion of the course content or an assignment question indicate this in your answer so that your marker can respond to your problem areas. Be as specific as possible.
3. Arrange the order of your pages by question number and fix them securely to the data sheet provided. Adequate postage must be affixed to the envelope.
4. While waiting for your assignment to be marked and returned to you, continue to work through the next two lessons and the corresponding reinforcement problems and comprehensive assignment.

On the completion of the last comprehensive assignment a two-week period of revision should be carried out of the whole course using the material in the revision section of the study pack. At the completion of this period the final Mock Examination paper should be completed under examination conditions. This should be sent to the distance-learning administrator to arrive in Nairobi at least five weeks before the date of your sitting the KASNEB Examinations. This paper will be marked and posted back to you within two weeks of receipt by the Distance Learning Administrator.

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FINANCIAL ACCOUNTING IV COURSE DESCRIPTION

The course aims at equipping the candidate with the knowledge required to prepare, analyse and evaluate financial statements using International Financial Reporting Standards. It builds on the knowledge acquired from previous financial accounting courses and concentrates on advanced aspects of financial reporting.

We start by looking at the group financial statements covering all spects including group structures, foreign subsidiaries, Associates and jointly controlled entitites and finally disposal of subsidiary companies. Next is a look at the effects of inflation in financial staments and the accounting treatment of various assets and liabilities. We also consider the treatment of tax and employee benefits, specialized financia reporting, and theoritical framework of accounting and current issues.
Finally a revision aid is incorporated comprising of summary of IFRS, IFRIC and SIC reinforcing questions answers and CPA past paper questions with model answers to help students in their revision..

Recommended Study Texts:
Advanced Financial Accounting, Sixth Edition – Richard Lewis & David Pendrill
Financial Accounting, Second Edition – A.R. Jennings

Note:
Students are strongly advised to study all International Financial Reporting Standards and be conversant with their provisions.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs), INTERNATIONAL ACCOUNTING STANDARDS (IASs) & IFRIC/SIC SUMMARIES INDEX

I. IFRS Summaries

IFRS 1 First-time Adoption of International Financial Reporting Standards
IFRS 2 Share-based Payment
IFRS 3 Business Combinations
IFRS 4 Insurance Contracts
IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
IFRS 6 Exploration for and Evaluation of Mineral Resources
IFRS 7 Financial Instruments: Disclosures

II. IAS Summaries

Framework for the Preparation and Presentation of Financial Statements (the Framework)

IAS 1 Presentation of Financial Statements
IAS 2 Inventories
IAS 7 Cash Flow Statements
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10 Events After the Balance Sheet Date
IAS 11 Construction Contracts
IAS 12 Income Taxes
IAS 14 Segment Reporting
IAS 16 Property, Plant and Equipment
IAS 17 Leases
IAS 18 Revenue
IAS 19 Employee Benefits
IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
IAS 21 The Effects of Changes in Foreign Exchange Rates
IAS 23 Borrowing Costs
IAS 24 Related Party Disclosures
IAS 26 Accounting and Reporting by Retirement Benefit Plans
IAS 27 Consolidated and Separate Financial Statements
IAS 28 Investments in Associates
IAS 29 Financial Reporting in Hyperinflationary Economies

IAS 31 Interests in Joint Ventures
IAS 32 Financial Instruments: Presentation
IAS 33 Earnings per Share
IAS 34 Interim Financial Reporting
IAS 36 Impairment of Assets
IAS 37 Provisions, Contingent Liabilities and Contingent Assets
IAS 38 Intangible Assets
IAS 39 Financial Instruments: Recognition and Measurement
IAS 40 Investment Property
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III. IFRIC & SIC SUMMARIES (included under the relevant standard)

IFRIC
IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 4 Determining Whether an Arrangement Contains a Lease
IFRIC 5 Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6 Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment
IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies
IFRIC 8 Scope of IFRS 2

SIC
SIC-7: Introduction of the Euro
SIC-10: Government Assistance – No Specific Relation to Operating Activities
SIC-12: Consolidation – Special Purpose Entities
SIC-13: Jointly Controlled Entities – Non-Monetary Contributions by Venturers
SIC-15: Operating Leases - Incentives
SIC-21: Income Taxes – Recovery of Revalued Non-Depreciable Assets
SIC-25: Income Taxes – Changes in the Tax Status of an Entity or its Shareholders
SIC-27: Evaluating the Substance of Transactions Involving the Legal Form of a Lease
SIC-29: Disclosure – Service Concession Arrangements
SIC-31: Revenue – Barter Transactions Involving Advertising Services
SIC-32: Intangible Assets – Web Site Costs

LESSON ONE

GROUP ACCOUNTS

CONTENTS

1.1 Introduction and learning objectives
1.2 Basic Consolidation (IAS 27)
1.3 Group Structures
1.4 Associates (IAS 28)
1.5 Jointly controlled entity (IAS 31)
1.6 Merger Vs Acquisition accounting (IFRS 3)
1.7 Foreign Subsidiaries (IAS 21)
1.8 Discontinued operations – Disposal of Subsidiaries (IFRS 5)

INSTRUCTIONS

Required readings for this lesson are:

1. Relevant Standards included in parenthesis.
2. The Study Text below.
3. Attempt the reinforcing questions that follow.
4. Compare your answers with those given in Lesson 9.

1.1 INTRODUCTION & LEARNING OBJECTIVES

This chapter begins by revising the 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 included.

When you have studied this chapter you should be able to do the following.

- 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.

1.2 BASIC CONSOLIDATION (IAS 27)

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.

A parent is required to present consolidated financial statements in which it consolidates its investments in subsidiaries.
However the parent company need not present consolidated financial statements in the following circumstances:

1. 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;
2. the parent's debt or equity instruments are not traded in a public market;
3. 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
4. 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.

The consolidation process

Intragroup balances, transactions, income, and expenses should be eliminated in full. Intragroup 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 like 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.

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 values 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 recognized 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 values of the subsidiary identifiable assets, liabilities and contingent liabilities.
No amortization 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:

1. Closing inventory was Sh.24, 200,000 in Mtito and Sh.19,200,000 in Andei.
2. The turnover and expenses in Andei accrued evenly over the year; the rate of gross profit was constant throughout the year.
3. 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.
4. Between 1 May 1996 and 30 September 2005, Mtito sold gods 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. At 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.
5. 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 instalment tax on the preceding year basis.
6. The directors have proposed that Mtito should pay a final dividend of Sh.6 million and Andei Sh.3 million.
7. 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 then three set 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)	(19,200)	
	373,300	333,600	467,300
Gross profit	213,300	146,400	271,300
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)
: Proposed	(6,000)	(3,000)	(6,000)
Retained profit: Yr	10,080	8,820	9,020
Retained profit: b/f	121,960	77,180	121,960
Retained profit: c/f	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 100/6 = 48m

Group sales = (586,600 + 5/12 X 480,000) – 48,000
Group cost of sales =
373300 + (5/12 X 333600) – 48,000 + VP
where VP = (1/6 X 48,000 – 30,000) = 3,000

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

Dividend income



Total dividend payable by Andei = 6,000

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



Pre acq
7/12 X 4,800
= 2,800

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

Dividend rec'able = 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	8,820	86,000
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
Non-Current Assets	**Sh.'000'**	**Sh.'000'**	**Sh.'000'**
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:

Income statements for the year ended 31 March 2000.

	Ademo Ltd Sh.m	**Afro Ltd Sh.m**	**Piki Ltd 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
Non current liabilities			
10% loan stock	500	200	0
Current liabilities			
Trade and other payables 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 sh. 602 million when the retained profits of Afro Ltd was sh. 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. 24 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
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)

	Sh.	Retained Profits 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

4. Retained Profit b/f

Ademo	Afro Sh.	Piki Sh.	Sh.
Balance b/f	610.00	420.00	
Less pre acqusition	(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

5. Minority interest in the balance sheet

	Afro Shm	Piki 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

(iii) 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:

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. "000"	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "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	(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		-
General reserve			6,000	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.

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.200,00 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)	4,750	
Receivables(W6)	6,500	
Cash (2.7 + 1.4 + 1.14 + 0.2)	5,400	
		16650
		39656
EQUITY AND LIABILITIES		
Share capital		15,000
Sh.100 ordinary shares fully paid		7,780
General reserve (W5)		2,328
Retained Profits (W4) (300 + 2,028)		25,108
		6,048
Minority interest (W3)		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:		1/6		25%
Direct	60%			33%
Indirect			(60% x 55%)	58%
Minority Interest	40%	5/6		42%

2. **Cost of Control**

	Sh.'000'		Sh.'000'
Investment in Storm:		Share of Storm equity	
Ordinary	3,400	Ordinary share capital (60% x 5000)	3,400
Preference	600	General reserves (60% x 1000)	600
Share of retained losses		Preference share capital (1/6x3,000)	500
(60% x 500)	300	Goodwill I	200
	4,300		4,300
Investment in Thunder		Share of Thunder equity	
(60% x 1,900) by Storm	1,140	Ordinary share capital (58%x2,000)	1,160
Rain spent in Thunder	1,000	Profit b/f (58% x 300)	174
		Goodwill II	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		Storm Ltd: Equity	
(40% x 1900)	760	Ordinary share capital (40% x 5000)	2,000
Storm Ltd Profit & Loss		Preference share capital (5/6 x	2,500
40% x 800)	320	3000)	1,200
Consolidated balance sheet	6,048	General reserve (40% x 3000)	
		Thunder Ltd: Equity	840
		Ordinary share capital (42% x 2000)	-
		Preference share capital	420
		General reserve (42% x 1000)	
		Thunder Ltd Profit & Loss	158
		(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	
MI (40% x 3000)	1,200	Rain	6,000
Thunder: MI (42% x 1,000)	420	Storm	3,000
Consolidated balance sheet	7,780	Thunder	1,000
	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

(iv) 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.

Associates Companies (IAS 28)

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

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

1.3 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:

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 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 organisation 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.

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 amortization of the associate's depreciable or amortizable 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 amortized 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, unrealized 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 recognizing 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 recognized 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 recognizing its share of those profits only after its share of the profits equals the share of losses not recognized.

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:

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

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
		-	-

	448	362	147	Interest on debentures	(42)	
Current Liabilities	189	109	45	Profit before tax	190	180	180
Payables	7	3	2	Taxation	(72)	(40)	(20)
Tax	63	40	40	Profit after tax	118	140	160
Proposed Divs	259	152	87	Dividends	63	40	40
	189	210	60	proposed			
	1,155	490	280	Retained profits	55	100	120
Net current assets				For the year	120	190	(40)
	700	200	200	Brought forward	175	290	80
	175	290	80	Carried forward			
OSC of Sh.10 each	875	490	280				
	280						
Retained earnings	1,155						
S/holders Funds							
15% Debentures							

Additional information:

1. Amua Limited has not yet accounted for dividends receivable from either its subsidiary or its associated company.
2. 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.

Solution:
Amua Ltd and it's 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	
Dividends:	63
Final	(63)
Bal as at 30.4..99	219.6

Amua Ltd and it's 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		
Non current liabilities		98
15% debentures		
		280
		1,297.6
Current liabilities	298	
Payables	10	
Tax payable	63	
Proposed dividends Group	8	
Dividend to MI		379
TOTAL EQUITY AND LIABILITIES		**1676.6**

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	5	8
		C/d	95	6
	227			227

Goodwill (Premium) in Associate

	Sh.M.	Sh.M
Investment (56 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 venturers and investors, regardless of the structures or forms under which the joint venture activities take place, 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.

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: 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 are 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 I 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

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 klimited 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 $\frac{6}{12}$ 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.		b/f Sh.	yr Sh.	c/f Sh.
E Ltd	2480	(280)	2200	F Ltd	580	60	640
Div Receivable F	-	45	45	Div Receivable (40% X 70)	-	28	28
H	-	30	30				
Re-acquisition div H Ltd (50% x 100 x $\frac{6}{12}$)	-	(25)	(25)	Re-acquisition div 40% x 120 x $\frac{3}{12}$	-	(12)	(12)
				Re-acquisition profits	(120)	-	(120)
Goodwill amortisee F	(80)	-	(80)		460	76	536

H		(5)	(5)	Share of E 75%	345	57	402
Difference on Consolidation	(460)	-	(460)	H Ltd			
	1940	(235)	1705	60 x 50% x $\frac{6}{12}$	-	15	15
I Ltd	1200	400	1600	G Ltd			
Share of E 92%	1104	368	1472	8 x $\frac{9}{12}$ x 40% x 75	-	18	18

Difference on Consolidation

	Sh.
Par value of shares issued (138 x10)	1380
Less Par value of share received (92 x 10)	920
	460

Example 7
The financial positions of J Limited, a company quoted on the Nairobi Stock Exchange, K Limited, L Limited, M Limited and N Limited (also quoted on the Nairobi Stock Exchange) are as follows:

		J Ltd. Sh. million	K Ltd. Sh. million	L. Ltd. Sh. million	M Ltd. Sh. million	N Ltd. Sh. million
PPE	: Cost	437	264	295	198	504
	Depreciation	(189)	(92)	(108)	(62)	(101)
		248	172	187	136	403
Goodwill:	Net book value		30	20		
Investment in K. Ltd. (75%)		375				
Investment in L Ltd. (30%)			132			
Investment in M. Ltd. (50%)		150				
		773	334	207	136	403
Current assets:						
Stock		463	310	390	218	540
Debtors		317	290	315	182	430
Cash		78	20	45	110	90
		858	620	750	510	1,060
Current liabilities:						
Creditors		188	170	150	126	203
Taxation		15	10	17	20	25
Proposed dividends		410	100	160	200	250
		613	280	327	346	478
		245	340	423	164	582
		1,018	674	630	300	985
Ordinary share capital (Sh. 10 shares)		500	300	200	100	500
Share premium account		50	60	50	80	-
Profit and loss account		468	164	180	120	485

	1,018	524	430	300	985
Debentures (K-15%: L-16%)		150	200		
	674	630			

Additional information:

1. J Ltd. purchased 75% of the ordinary share capital of K Ltd. on 1 December 1995, when the balance on the profit and loss account of K Ltd. was Sh. 80 million. The goodwill in the balance sheet of K. Ltd. arose on 30 November 1995, when K Ltd. purchased unincorporated business: this goodwill is being amortised on a straight line basis over 4 years.
2. K Ltd. purchased 30% 0f the ordinary share capital of L Ltd. on December 1994, when the balance on the profit and loss account of L Ltd. was Sh. 90 million. Exactly one year later, L Ltd. also purchased an unincorporated business: the goodwill that arose on the purchase is being amortised on a straight line basis over 3 years. The balance on the profit and loss account of L Ltd. on 1 December 1995 was Sh. 140 million.
3. J ltd. and another quoted company, Ounga Limited each bought 50% of the share capital of M Ltd. on 31 May 1997. J Ltd. and Ounga Ltd. have joint control of M Ltd.: both companies are to account for the joint venture using proportionate consolidation combining items on a line-by-line basis. M Ltd.'s profit after tax in the year to 30 November 1997 was Sh. 220 million.
4. On 31 October 1997, the directors of J Ltd. issued 32 million ordinary shares of Sh.10 for 48 million shares of Sh.10 each in N Ltd. just before this date; the shares in J Ltd. were trading on the exchange at Sh. 60 each, and the shares of N Ltd. were trading at Sh. 38 each.
   The registrar of companies has given his approval for the merger method of accounting to be used. The share issue has not yet been recorded in the books of J Ltd.
5. Included in the stock of J Ltd. is Sh. 12 million worth of goods purchased from M. Ltd., which cost M Ltd. Sh. 8 million. The unrealised profit is to be accounted for in accordance with International Accounting Standard 31. These goods had been purchased in September 1997.
6. At 30 November 1997, J Ltd. owes M Ltd. Sh.12 million; K Ltd. owes J Ltd. Sh.13 million; and L Ltd. owes K Ltd. Sh.20 million. All the current accounts between the companies are in balance.
7. No company paid interim dividends in the year ended 30 November 1997; neither J Ltd. nor K Ltd. have yet accounted for dividends receivable.
8. The group considers that goodwill on consolidation has been impaired at the rate of 20% per annum from the date of acquisition.

Required:
The consolidated balance sheet of the group as at 30 November 1997 in accordance with relevant International Financial Reporting Standards. **(Total: 25 marks)**

Solution

J Ltd and its subsidiaries
Consolidated Balance sheet as at 30 November 1997

	Sh m	Sh m	Sh m
Non Current Assets			
Property, Plant & equipment: Cost			1,304
Depreciation			(413)
			891
Goodwill: On consolidation			54
Investment in Associate:			138
			1083
Current Assets			
Inventory		1,420	
Receivables		1,089	
Receivable from Associate		20	
Dividend receivable (Assoc.)		48	
Cash		243	2820
			3903
Financed by			
Ordinary share capital			820
Merger Reserve			160
Share premium			50
Profit and loss account			1436.6
			2,466.1
Minority interest			176.4
15% Debentures			150
			2793
Current Liabilities			
Payables		605	
Taxation		60	
Dividend to Minority		35	
Proposed dividend		410	1,110
			3903

COC –K

	Sh m		Sh m
J: Investment	375	K: OSC	225
Goodwill: K	45	Share premium	45
		Profit & Loss	60
		Goodwill	90
	420		420

COC – M

	Sh m		Sh m
J: Investment	150	M: OSC	50
		Share premium	40
		Pre aq. Div	50
To P & L	45	P&L	55
	195		195

P&L (working)

		Sh m		Sh m
GW Amortised:	K	36	J	468
GWA	L	4.5	Div Received: K	75
UPCS		2	Div. Received: M	50
			Div. Received: N	240
			Div. Received: L	36
			Profit K	63
			Goodwill written back	22.5
			Profit L	9
			Profit M	5
			Goodwill	45
Bal c/d		1436.6	Net P&L	465.6
		1,479.1		1,479.1

Investment in Associate company		
Shares of Net assets		123
Share of goodwill in Assoc.		6
Goodwill on aq.	15	
Goodwill on amortisation	(6)	9

138

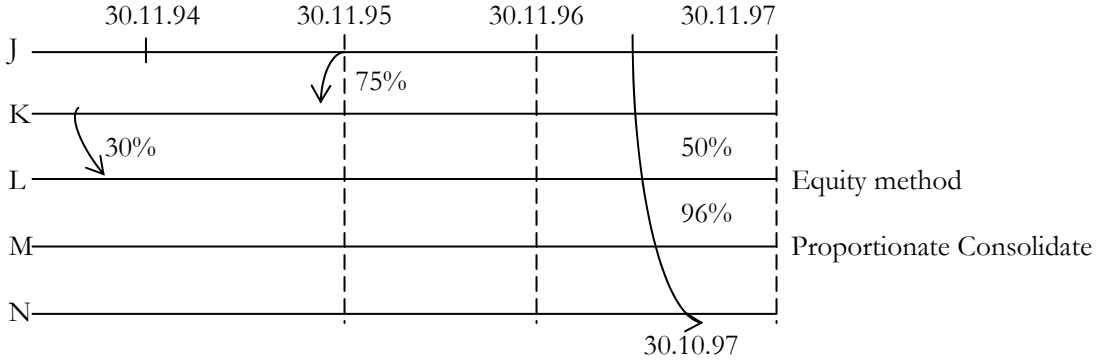
Minority Interest

	Sh m		Sh m
Goodwill K			
(25% x 60)	15	K: OSC	75
Goodwill		Share premium	15
Amortised	15	P&L	41
		Goodwill written	
		Back	75
		L: OSC	3
		M: OSC	20
		P&L	19.4
Bal c/d	176.4	K: DWSL	12
	192.4		192.4

Merger Reserve

	Sh m		Sh m
J. Invest	320	M:OSC	480
Balance c/d	160		
	480		480

31.5..9



Investments in L Ltd

At acq			30.11.97	
	100%	30%	100%	30%
GW	60	18	20	6
N Assets	330	99	410	123
	390		430	
OSC	200		200	
Share Premium	50		50	
P&L	140		180	

	390		430	
Goodwill		15	W/off (15 – 6)	9
		132		138

1.7 FOREIGN SUBSIDIARIES (IAS 21)

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. 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.

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.

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

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,

(iv) 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**

Item	**Rate**
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)
Debtor/cash/creditors/loans	Year end (closing rate)

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.

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).

(i) 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 acqusition (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 liabilties		
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			1/11	

expense		(242.00)		(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

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

(ii) 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 proposel	(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

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

Step 2 Translation of subsidiary's Balance Sheet

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

1.8 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

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) (v) 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 carefull 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 carefull 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 diposal (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) After classification as held for sale. 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) 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 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 classified as held for sale, must be presented separately on the face of the balance sheet.
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

Defintition. 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 ofsubsidiary 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	UAL	UCL	UDL
	Sh. million	Sh. million	Sh. million	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	UAL	UCL	UDL
	Sh. million	Sh. million	Sh. million	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.

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

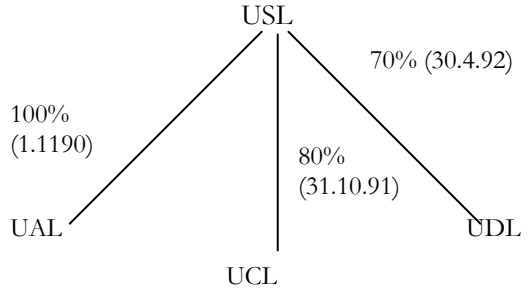
Property, plant and equipment	1,040
Investment in associates	104
Current assets	446
	1,590

Financed by	500
Share capital	693
Profit and loss A/C	135
Minority interest	
Share holders funds	1328
Current liabilities	262
	1590

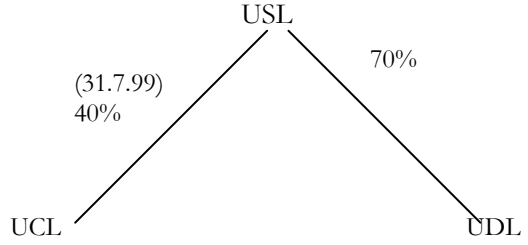
Workings

(i) Structures.

(a) Before disposal



(b) After disposal



(ii) Gain / Loss on disposal

(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)
- Dividend earned but sold 10

(b)

	UAL Sh/Millions	**UCL Sh/Millions**
Proceeds	162	169
Dividends foregone	-	(10)
	162	159
Less Net assets sold		
Share capital	50	100

Profit and loss Account B/f	280	140
Profit for the period		
UAL (30 X 8/12)	(20)	-
UCL (20 X 9/12)	-	15
	310	255
UAL 100% x 310	(310)	-
UCL 40% x 255	-	(102)
Gain (loss on disposal)	(148)	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 Account	38	110	100
	88	210	300
UAL 100%	(88)	-	-
UCL 80%	-	(168)	-
UDL 70%	-	-	(210)
Goodwill	80	40	60

	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	12	
UDL: 30% x 110	33	
Profit attrie to members of group		(45)
Dividend: - Interim paid		118
Proposed		(50)
Retained earnings for the yr		(50)
		18

			Sh. Millions
Retained earning 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

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

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

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

Additional information:

1. The general reserve of all the companies were 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)

QUESTION THREE

Umma Ltd. A public company quoted on the Nairobi Stock Exchange, owns 80% of Ugeni Ltd. A public company which is situated in a foreign country, Timoa. The currency of this country is Trim(TR). Umma Ltd. acquired Ugeni Ltd. on 30 April 1999 for Ksh.220 million when the retained profits of Ugeni Ltd. were TR 610 million. Ugeni Ltd. has not issued any shares since acquisition. The following financial statements relate to the two companies.

Balance sheet at 31 December 2000

	Umma Ltd Ksh. 'million'	Ugeni Ltd TR 'million'
Non Current assets		
Tangible assets	945	1,890
Investment in Ugeni Ltd	270	-
Net current assets:	735	645
Creditors failing due after one year	(375)	(1,115)
	1,575	1,420
Share capital	330	240
Share premium	350	80
Profit and loss account	895	1,100
	1,575	1,420

Profit and loss account for the year ended 31 December 2000

	Umma Ltd	Ugeni Ltd
	Ksh. 'million'	TR 'million'
Turnover	1,650	3,060
Cost of sales	(945)	(2,550)
Gross profit	705	510
Administrative and distribution cost	(420)	(51)
Income from Ugeni Ltd.	8	-
Interest payable	(22)	(102)
Operating profit before tax	271	357
Taxation	(79)	(153)
Profit on ordinary activities after tax	192	204
Dividends paid	(20)	(52)
Retained profits for the year.	172	152

Additional information:

1. During the year, Ugeni Ltd. sold goods to Umma for TR 104 million and made a profit of TR 26 million on the transaction. All of the goods, which were exchanged on 30 June 2000 remained unsold at the year end. At 31 December 1999 there were goods sold by Ugeni Ltd. to Umma Ltd held in the stock of Umma Ltd. These goods were valued at Ksh.6 million on which Ugeni Ltd. made a profit of Ksh.2 million.
2. Ugeni Ltd. paid the dividend for the year ended 31 December 2000 on 30 June 2000. No other dividend was proposed for the year. The tax effect has been accounted for and may be ignored.
3. The fair value of the net assets of Ugeni Ltd. at the date of acquisition was TR 1,040 million. The fair value increment all due to tangible fixed assets has not however been incorporated in the books of Ugeni Ltd.
4. Goodwill does not influence with changes in the exchange rate and is to be impaired at 33.3333333% per annum. Treat this goodwill as an asset of the holding co.
5. Tangible non current assets are depreciated over five years on a straight-line basis with a full year's charge provided in the year of acquisition.
6. A loan of Ksh.50 million was raised by Ugeni Ltd. from Umma Ltd on 31 May 2000. The loan is interest free and is repayable in 2009. The loan is included in the cost investment in Ugeni Ltd. An amount of TR 65 million had been paid to Umma Ltd on 31 December 2000 in part settlement on the loan. The amount had not been received by Umma Ltd. and had not been included in its financial statements as at 31 December 2000.
7. The following exchange rates are relevant for translation:

Trims (TR) to the K Shilling:	
30 April 1999	4.0
31 December 1999	4.6
1 January 2000	4.7
31 May 2000	5.3
30 June 2000	5.2
31 December 2000	5.0
Weighed average for 2000	5.1

8. The group policy is to issue the net investment method and average rates in the profit and loss account.

Required:

(a). Consolidated profit and loss account for the year ended 31 December 2000 (11 marks)
(b). Consolidated balance sheet as at 31 December 2000 (10 marks)
(c). Statement for the movement in consolidated reserves for the year ended 31 December 2000 (4 marks)

(Total: 25 marks)

QUESTION FOUR

P. Limited is a company quoted on the Nairobi Stock Exchange. Its area of operations is capital equipment. It purchased 80% of the ordinary share capital of Q Limited on 1 January 1998. Q Limited is a leading producer of cement and lime in the area. P. Limited purchased 75% of the ordinary share of the capital of R Limited on 1 January 1999. R. Ltd. is a leading producer of decorative coatings. This market has suffered a major decline since the investment was made. A suitable purchaser bought the complete shareholding on 31 August 2002. The proceeds of the sale were used to repay debt on 31 August 2002. The financial statements of the companies for the year ended 31 December 2002 are as follows:

Income statement
For year ended 31 December 2002

	P Ltd. Sh. million	Q Ltd Sh million	R Ltd, Sh. million
Sales	5,400	4,800	3,600
Cost of sales	(2,700)	(3,200)	(2,400)
Gross profit	2,700	1,600	1,200
Expenses	(1,800)	(900)	(900)
Operating profit	900	700	300
Dividend received	390	-	-
Finance cost	(75)	-	-
Profit on disposal of subsidiary	200	-	-
Profit before tax	1,415	700	300
Tax	(250)	(210)	(90)
Profit after tax	1,165	490	210

Balance Sheet
As at 31 December 2002

	P Ltd. Sh. million	Q Ltd Sh. Million	R Ltd, Sh million
Non-current assets:			
Property plant &	1,320	980	1,100
equipment	680		
Investment in subsidiary	2,000		
	730	570	480
Current assets	2,730	1,550	1,580
	500	500	400
Ordinary share capital	1,510	640	710
Retained earnings	2,010	1,140	1,110
Shareholders funds	100	-	-
Non-current liabilities	620	410	470
Current liabilities	2,730	1,550	1,580

Additional information:

1. P. Ltd. had purchased its shareholdings in Q Ltd and R Ltd. when the balances of retained earnings were Sh.100 million and Sh.200 million respectively. Neither Q Ltd nor R. Ltd has issued any ordinary shares since they were acquired by P Ltd. The fair values of the identifiable net assets of both Q Ltd. and R Ltd were equal to their carrying values at the dates of acquisition. The investment in R. Ltd had cost P. Ltd. Sh.570 million.
2. P. Ltd impairs goodwill that arises on the acquisition of a subsidiary at 10% per annum. No Impairment is changed in the year in which the investment is sold. No impairment losses have occurred in respect of their investment.
3. P Ltd., Q Ltd. and R Ltd. had paid dividends of Sh.500 million, Sh.300 million and Sh.200 million respectively on 31 July 2002.
4. There is no tax charge on the sale of the investment in R. Ltd.
5. P. Ltd, Q Ltd and R Ltd. are managed as three separate business segments. The group 's primary segment reporting format is business segments. The board of directors of P Ltd decided to sell the shares in R Ltd when they met on 14 February 2002 to review the performance of the three companies for year ended 31 December 2001. There were no impairment losses in any of the

assets of R Ltd prior to its sale. The directors did not announce the plan to sell R Ltd because they thought this would adversely affect the price at which they could sell the subsidiary. A public announcement was made on 31 August 2002.

6. The directors want the amount of the revenue, expenses, pre-tax profit and the tax expense of the discontinuing operation to be shown in separate column of the income statement and the amount of the cash flow attributable to the operating, investing, financing activities of the discontinuing operation shown in a separate column of the cash flow statement.

Required:

(a). Define, in the context of International Accounting Standard (IAS) 35, what is meant by "the initial disclosure event" with respect to a discounting operation. (3 marks)

(b). In the context of P Ltd. state the day of initial disclosure event.

(c). State four items of information (other than those included in note 6 above.) which should be included in the financial statements in relation to the discounting operation (4 marks)

(d). The financial statements of all the group companies for the year ended 31 December 2001 were authorized for issue on 11 March 2002. Should the financial statement for the year ended 31 December 2001 disclose any information about the plan sale of R Ltd.

(e). Prepare the income statement of the group for the year ended 31 December 2002, with separate columns for "continuing Operation" "Discounting operation" and "Enterprise as a whole" Sales, cost of sales and expenses in R Ltd accrue evenly over the year. The accounting policy note in the financial statements include the following clause: Operating results of subsidiaries sold during the financial year are included up to the date effective control ceased. There were no inter-company transactions. (7 marks)

(f). Prepare the group balance sheet as at 31 December 2002. (6 marks)

(g). A statement of changes in equity as at 31 December 2002 showing only one column for 'retained earnings'. (3 marks)

(Total: 25 marks)

NOW CHECK YOUR ANSWERS WITH THOSE GIVEN IN THE LESSON 9 OF THE STUDY PACK

LESSON TWO

ACCOUNTING FOR PRICE LEVEL CHANGES

CONTENTS

2.1 Capital maintenance
2.2 Accounting models
2.3 Approaches to Inflation Accounting
2.4 Current purchasing power
2.5 Current value accounting
2.5.1 Economic value method
2.5.2 Net realizable value
2.5.3 Current replacement cost
2.6 Holding Gains and Losses
2.7 Adjustments to current cost accounting
2.7.1 Depreciation adjustment
2.7.2 Cost of sales adjustment
2.7.3 Monetary working capital adjustment
2.7.4 Gearing adjustment
2.8 Summary
2.9 Reinforcing questions
2.10 Comprehensive Assignment

INSTRUCTIONS

- Required Reading for this lesson are as follows:
  - The International Accounting Standard No.15 and No. 29
  - Lewis/Pendril Chapters 3,4,5,6 and 7 Pages 53 - 272
  - Jennings Chapter 9 Page 442 - 473
  - Read the study text below
- Attempt reinforcing questions at the end of the lesson
- Compare your solutions with those given in lesson 9

NOTE: 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 understandard the effects of inflation on financial statements.

2.1 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.

2.2 CAPITAL MAINTENANCE

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 minimium 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 year end adjustment to profit. The estimations of accurals 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 judgements. 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.

2.3 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.

2.4 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

2.5 CURRENT PURCHASING POWER (CPP) ACCOUNTING

- It is also referred to as the General Price Level Approach.
- It requires that historical cost based amounts be translated to the current purchasing power equivalent using the general price level index.
- 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

	Year 1	Year 2
Assets	Kshs	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 - $\frac{195,000 \times 110}{}$ = KShs 214,500

100

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.

2.6 CURRENT VALUE ACCOUNTING

- 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 KShs	Year 2 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

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 x 110/100)		5,500
Total real holding gain		250
General price-level adjusted Historical cost on 31.12.X0	KShs5,500	
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		
Nature	**Real**	**Monetary**	**Total**
	KShs	**KShs**	**KShs**
Realized	25	50	75
Unrealized	225	450	675
Total	250	500	750

A more detailed example follows to illustrate the computation of holding gains and losses.

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
Lot 1	KShs 240,000	3	KShs 260,000
Lot 2	120,000	2	140,000
Lot 3	40,000	1	60,000
	400,000		460,000

At 31.12.1990

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		400,000
Cost of sale (W1)		(249,140)
Gross profit		150,860
Operating Expenses		
Selling and Administration	(100,000)	
Depreciation Expense (W2)	(49,000)	149,400
Net income from normal operations		1,460
Add: Purchasing power Gain (W3)		14,240
Net income for the year		15,700
Dividends		(10,000)
Retained profits		5,700

Workings:

W1 - Cost of sales

	Amount HCA	Adjustment factor	Adjusted amount
	KShs	**KShs**	**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	260/200	x	10%	=31,200
Lot 2	120,000 x	260/220	x	10%	=13,866
Lot 3	40,000 x	260/240	x	10%	= 4,334
			Total		49,400

W3. Purchasing Power Gain/Lossses

		31/12/99	**31/12/00**
		KShs	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			
Equipment	(W1)		513,000
Acc. Depreciation	(W2)		(145,390)
			367,610
Current Assets			
Inventory	(W3)	163,020	
Accounts Receivable	(W4)	20,000	
Cash	(W4)	110,000	293,020
			980,630
Equity			

Ordinary Shares	(W5)	216,000	
Retained Earning	(W6)	31,160	
Holding Gain	(W7)	93,470	340,630
			660,630
Liabilities			
Bonds Payable	(W4)		300,000
Accounts Payable	(W4)		20,000
			980,630

Workings

W1 - Equipment

	Initial cost	Adjust Factor	Adjusted Amount
Lot 1	240,000 (270/260)	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

$$(140{,}000 \times \frac{270}{260}) = \text{KShs } 145{,}390$$

W3 - Inventory - 31.12.90

$$(160{,}000 \times \frac{270}{265}) = \text{KShs } 163{,}020$$

W4 - Monetary Assets and liability remain the same

W5 - Ordinary Shares

$$(200{,}000 \times \frac{270}{250}) = \text{KSh } 216{,}000$$

W6 - Retained Earnings

$$(30{,}000 \times \frac{270}{260}) = \text{KShs } 31{,}160$$

W7 - Holding Gain/Loss

Non monetary items	General Price Level Adjusted Amount KShs	Historical Cost KShs	Difference 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

2.7 ADJUSTMENTS TO CURRENT COST ACCOUNTING

Current cost accounts are usually produced by making adjustments to Historical cost accounts. The following adjustments are be 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 exceed 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	31/12/20X8
	Kshs '000'	**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 (150 x 227.5 / 130)	262.5
Depreciation adjustment	112.5

ii. Cost of sales adjustment (COSA)

Historic cost	Index Adj. Kshs`000'		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. Kshs`000'		Current cost 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) * $\frac{872,500}{\text{Kshs.872,500} + \text{Kshs.1,762,450}}$

$\frac{872,500}{872,500 + 1,762,450}$

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 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 202.4 / 197.9 = Kshs. 818,200

Opening stock should be based on the index on 31.12.X8

Thus Kshs.600,000 x 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
Balance cf	828.2	MWCA	56.0
	.	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		500
Current cost adjustment		
Depreciation	(112.5)	
COSA	(89.4)	
MCWA	(56.0)	(257.9)
Current cost operating profit		242.1
Gearing adjustment	85.4	
Less: interest payable	(100.0)	(14.6)
Current cost profit before tax		227.5
Taxation		(70.0)
Current cost profit after tax		157.5
Dividends		30.0
Retained profit-current cost		127.5

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

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 criticize 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 Acts.
     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 distribute 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 a 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 activitiy.

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 therefrom. 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.

2.9 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 judgement 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 judgement 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

REINFORCING 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
		9,200
	900	
		23,200
	11,300	

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)**

QUESTION THREE

Mastersmoke Limited, a quoted company has a subsidiary company which operates in the country of Zango, in which a very high rate of inflation exists. The currency unit in the country is the Fran. Prior to incorporating the accounts of the subsidiary into those of Mastersmoke, the chief accountant asked his assistant to adjust the local currency financial statements in accordance with IAS 21 – Accounting for the effects of changes in Foreign Exchange Rates. The assistant produced a current cost set of accounts, shown below. The chief accountant requests you to correct these accounts to a set of current purchasing power accounts.

Current cost profit and loss account for the year ended 30 September 20X7

	F million	F million
Sales		5,360
Historical cost profit		1,550
Current cost operating adjustments:		
Depreciation	(120)	
Cost of sales	(90)	
Monetary working capital	(74)	(284)
Current cost operating profit		1,266
Gearing adjustment	45	
Interest	(100)	(55)
		1,211
Taxation		(580)
		631
Dividends		(350)
Current cost retained profit		281
Current cost reserve as 30 September 1996		680
Movements for the year:		
Fixed assets	1,200	
Backlog depreciation	(540)	
	660	
Stock	10	
Cost of sales adjustment	90	
MWC adjustment	74	
Gearing adjustment	(45)	789
At 30 September 20X7		**1,469**

Current cost balance sheet as at 30 September

		20X7 F million	20X6 F million
Fixed asset:	Current cost	4,200	3,000
	Depreciation	(2,100)	(1,350)
		2,100	1,650
Current assets:	Stock	690	380
	Debtors	940	640
	Cash	80	60
		1,710	1,080
Current liabilities:	Creditors	(470)	(320)
	Tax	(20)	(10)
	Proposed dividend	(350)	(300)
		(840)	(630)
Net current assets		870	450
		2,970	2,100
Ordinary share capital		500	500
Current cost reserve		1,469	680
Current cost retained earnings		601	320
Shareholders funds		2,570	1,500
20% loan stock		400	600
		2,970	2,100

Additional Information:

- Inflation adjusted accounts have not been prepared previously for the subsidiary.
- The subsidiary operates an integrated production plant, purchased as a single unit, in rented premises. Expenses for the year (excluding interest and depreciation) occurred evenly over the year and totalled F 1,410 million. Purchases, which totalled F 2,880 million also occurred evenly over the year.
- Stock represented two months' average purchases: debtors relate only to sales and represent two months' sales: creditors relate only to purchases and represent two months' purchases.
- Interest on the loan stock was paid on 31 March and 30 September. F200 million of the loan stock was redeemed on 31 March.
- Taxation in Zango is payable on an instalment basis with 96.5% of the current year's tax being payable half way through the accounting year, the remainder is payable one year later.
- Appropriate price indices are as follows:

	Plant Index	**Stock**	**Retail Price Index**
Issue of shares and purchase of plant	120	110	110
20X6: July end	191	170	174
August end	195	180	183
September end	200	190	192
20X7: July end	267	215	228
August end	273	220	233
September end	280	230	242
11.9.X6/X7 Average year	N/A	210	217

The chief accountant has asked you to use the retail price indices to restate all the appropriate balance sheet figures.

Required:

The subsidiary company's current purchasing power profit and loss account for the year ended 30 September 20X7 and the balance sheet as at that date, together with a reconciliation of the gain or loss on the net monetary position **(20 marks)**

QUESTION FOUR

a) Some figures for the upper-income consumer price index in Nairobi are as follows:

June 20X2 – 211.12: June 20X3 – 244.27: June 20X4 – 385.09: June 20X5 – 494.96: October 20X5 – 488.25. Kenya Advanced Technology (KAT) Limited is applying to have its shares listed on the Nairobi Stock Exchange: A Singapore-based venture capital fund is interested in KAT Ltd, and would like to see a set of accounts prepared in accordance with International accounting Standards ((IAS). The finance director of KAT Ltd has asked you whether on the basis of the foregoing figures, there is any requirement to comply with IAS29 – Financial Reporting in Hyperinflationary Economics.

Required:

What would be your reply? Justify your answer. (3 marks)

The historical accounts of KAT Limited are as follows:

Profit and Loss Account for the year Ended 30 June 20X5
Balance Sheets as at 30 June

	Sh. million	Sh. million		20X4 Sh. million	20X5 Sh. million
Sales		800	Fixed Assets:		
Opening stock	40		Cost	400	400
Purchases	425		Depreciation	(80)	(120)
	465		Current Assets:		
Closing stock	(60)	405	Stock	40	60
Gross profit		395	Debtors	90	132
Administration, selling &			Cash	12	18
distribution	(200)			142	210
Depreciation	(40)		Current Liabilities:		
Loan Interest	(50)		Creditors	24	36
		(290)	Proposed dividend	20	25
Net Profit		105		44	61
Taxation		44	Net current assets	98	149
Profit after taxation		61		418	429
Dividends			Ordinary share capital	100	100
Interim paid	(25)		Profit & Loss Account	18	129
Final Proposed	(25)	(50)	Shareholders' Funds	218	229
Retained Profit for the year		**11**	Medium Term loan	200	200
				418	**429**

Notes:

- The company was formed on 1 July 20X2: all the fixed assets were purchased on that date; 10 million Ordinary Shares of Sh.10 each were issued on that date; a loan of Sh. 350 million was raised on that date, but Sh. 150 million has been repaid between 1 July 20X2 and 30 June 20X3.
- Stock represents 1½ months purchases; all sales are on credit terms – debtors are given 2 months credit; all purchases are on credit terms – creditors give 1 month credit.
- Interest is paid in 2 equal instalments, on 30 December and 30 June each year.
- Taxation is computed on the current year basis and is paid: 50% on 31 December 25% on 31 March and 5% on 30 June.
- The Interim Dividend was paid on 31 March 20X5
- Other items of income and expense (as appropriate) arise evenly over the year.

Required:

Profit and Loss Account for the year ended 30 June 20X5 and the Balance Sheets as at 30 June 20X4 and 20X5 in terms of the measuring unit current at 30 June 1995 using the consumer price indices given in the first part of the questions as month-end indices and assuming that the consumer price index rose at a steady rate during intervening periods, rounding to the nearest shillings million

(17 marks)

(Total: 20 marks)

QUESTION FIVE

a) In its accounts for the current year, Future Ltd had opening stock valued at Kshs.12,500 and closing stock valued at 17,600. Purchases and sales were Kshs.100,000 and Kshs.200,000 respectively. Appropriate stock index numbers were 100 at the beginning of the year and 110 at the end of the year. The average index for the year was 105.

Required:

i) Compute following current cost accounting principles, the gross profit both on the historical cost and current cost basis;
ii) Show the double-entry adjustment recommended in the historic revenue account to adjust it to current cost (8 marks)

b) The following entry appeared in the balance sheet of Rising Value Ltd. for the financial year ended 31 March 1992 for furniture and fittings.

Historical cost	Accumulated Depreciation Based on Historical Cost	Net Book Value
Kshs.	Kshs.	Kshs.
5,200	3,400	1,800

The furniture and fittings were acquired as follows:

	Cost	Accumulated Depreciation March 1992
	Kshs.	Kshs.
During year ended March 1988	3,000	2,400
During year ended March 1991	2,200	1,000

Depreciation charged in the current year Profit and Loss Account on furniture and Fittings was Kshs.1,400 (Kshs.900 on 1998 purchase and Kshs.500 on 1991 purchases).

Relevant specific price indices were 150 for 1988, 200 for 1991 and 225 at 31 March 1992.

Required

i) Calculate and state the depreciation charge for furniture and fittings based on current cost accounting principles to be entered in the 1992 Profit and Loss Account. how the entry for the assets furniture and fittings in the current cost accounting balance sheet as at 31 March 1992 state the amount credited to Current Cost Reserve in that balance sheet for furniture and fittings. (12 marks)

(Total: 20 marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

COMPREHENSIVE ASSIGNMENT NO.1

TO BE SUBMITTED AFTER LESSON 2

To be carried out under examiation conditions and sent to the Distance Learning Administrator for marking by Strathmore University.

TIME ALLOWED: 3 HOURS **ATTEMPT ALL FOUR QUESTIONS**

QUESTION ONE

Income statements for the year ended 30 September 2003

	RKL	**RSAL**
	Ksh. million	**S.A. Rand million**
Revenue	1,320	120
Cost of sales	(600)	(60)
Gross profit	720	60
Expenses	(290)	(24)
Operating profit	430	36
Investment income	176	-
Finance cost	(21)	-
Loss exchange	(70)	-
Profit before tax	515	36
Tax	(122)	(12)
Net profit	393	24
Dividends:		
Interim paid in the years	-	20
Final proposed	100	-
	100	20

Rose Kenya Limited (RKL) exports roses to the flower auctions in Holland where its roses are consistently rated A1. In order to reduce over-reliance on single supply source, RKL purchased 80% of the ordinary share capital of Roos South Africa Limited (RSAL) on 1 January 2003. Both companies make up their accounts to 30 September each year. Neither company has any trade with the other. Both companies compete for market share in the auctions in Holland. The operations of RSAL are carried out with a significant degree of autonomy from those of RKL.

The following are the draft financial statements of the two companies prepared in Kenya Shillings (Ksh.) for RKL and South African Rand (S.A. Rand) for RSAL.

Capital employed:	**Ksh. million**	**S.A. Rand million**
Share capital	100	16
Retained earnings	454	28
Proposed dividends	100	-
Shareholders' funds	654	44
Non-current liabilities:		
Deferred tax	19	11
Borrowings	220	-
	239	11
	893	55

Additional information:

1. RKL financed part of the purchase price paid for the investment in RSAL by taking out a south African Rand denominated loan in south Africa at the time of purchase of the shareholding in RSAL. The amount of the loan was S.A Rand 20 million. The rate of interest on the loan is 10% fixed. Interest on the loan to 30 September 2003 has been paid in full.
2. Rates of exchanges between the Kenya Shilling (Ksh.) and the South African Rand (S.A. Rand) at different dates are as follows:

	S.A. Rand	**Ksh.**
1 October 2000: Date of purchase of property, plant and equipment by RSAL	1	12.00
1 October 2002	1	7.40
1 January 2003	1	7.50
30 September 2003	1	11.00
Average for the year to 30 September 2003	1	9.50
Average for nine months to 30 September 2003	1	10.00
15 September 2003: Date RSAL paid its interim dividend	1	11.00

3. Trading by RSAL takes place evenly over the year. When demand is low on the auctions in Holland, domestic demand is high, and this evens out trading conditions.
4. The directors of RKL regard the S.A. Rand denominated loan as a hedge against the investment in RSAL. No capital repayments have been made nor are any foreseen in the grace period to 31 December 2005. The exchange loss on this loan should be accounted for in accordance with IAS 21 – The effects of Changes in Foreign Exchanges Rates.
5. Goodwill on the acquisition of RSAL is treated as an asset of RKL. The fair values of the identifiable assets and liabilities of RSAL on 1 January 2003 approximate book values. Goodwill is amortised on the straight-line basis over 5 years from the date the subsidiary is acquired.
6. The dividend paid by RSAL is deemed to relate to the twelve month period ended 30 September 2003. The directors of RKL state that the foreign exchange difference on the dividend paid of pre-acquisition net income should be deferred in the entirety until the foreign exchange entity is disposed of completely at some future date.

Required:

(a) The consolidated income statement of RKL and RSAL for the year ended 30 September 2003 in accordance with International Financial Reporting Standards (IFRSs). (8 marks)

(b) The consolidated statement of changes in equity for the year ended 30 September 2003 showing columns only for retained earnings and proposed dividends. (5 marks)

(c) The consolidated balance sheet as at 30 September 2003 in accordance with IFRSs, but in the same format as that of RKL. (12 marks)

(d) The effect on the reported profit for the year ended 30 September 2003 and the balance sheet as at 30 September 2003. if the goodwill arising on the acquisition is treated as an asset of the foreign entity. (5 marks)

NOTEIn all cases, ignore all adjustments relating to deferred tax. Goodwill amortisation should be shown as a separate line item charged in arriving at operating profit. Your answer should be correct to one decimal place. (Total: 30 marks)

QUESTION TWO

BZT Ltd. which deals in farm implements, prepares its financial statements using both the historical cost accounting method and the inflation adjusted accounting method.

Provided below are the historical cost accounting comparative balance sheets prepared as at 31 December 2002 and 2003 and the trading profit and loss account for the financial year ended 31 December 2003.

	Balance sheet as at December	
	2003	**2002**
	Sh. "000"	**Sh. "000"**
Assets:		
Non-current assets:		
Buildings	815,000	600,000
Machinery and equipment	200,000	350,000
	1,015,000	950,000
Current assets:		
Stock	420,000	340,000
Debtors	270,000	230,000
Bank balance and cash in hand	210,000	180,000
	900,000	750,000
Total assets.	1,915,000	1,700,000
Equity and liabilities:		
Capital and reserves:	600,000	500,000
Ordinary share capital	300,000	200,000
Share premium	490,000	380,000
Retained profit	1,390,000	1,080,000
Non-current liability:		
10% debentures	300,000	400,000
Current liabilities:		
Trade creditors	185,000	200,000
Proposed dividend	40,000	20,000
	225,000	220,000
Total equity and liabilities	1,915,000	1,700,000

Trading profit and loss account for the year ended 31 December 2003

		Sh. "000"
Sales:		3,600,000
Stock – 1 January 2003		340,000
Purchase		2,780,000
		3,120,000
Less:	Stock – 31 December 2003	420,000
	Cost of sales	(2,700,000)
	Gross profit	900,000
	Selling and distribution costs	(215,000)
	Administration costs	(180,000)
	Depreciation	(185,000)
	Debenture interest	(35,000)
		(615,000)
Operating profit		285,000
Profit on disposal of equipment		45,000
Profit before tax		330,000
Tax		(120,000)
Profit after tax		210,000
Dividends:	Paid	(60,000)
	Proposed	(40,000)
		(100,000)
Retained profit for the year		110,000
Retained profit brought forward		380,000
Retained profit carried forward		490,000

Additional information:

1. Sales, purchases, selling and distribution costs and administration costs occurred evenly during the year ended 31 December 2003.
2. Debenture interest is paid semi-annually on 30 June and 31December. Debentures amounting to Sh. Sh.100, 000, 000 were redeemed on 1 July 2003.
3. The company sold equipment with a net value of Sh.100, 000,000 on 30 September 2003 at a profit of Sh.45, 000,000. No depreciation was provided on this equipment for the year ended 31 December 2003.
4. On 31 March 2003, the company purchased a building at Sh.350, 000,000. A full year's depreciation was provided on this newly purchased building at the rate of 10% per annum. Depreciation was provided on the other assets as follows:

	Sh.
Old buildings	100,000,000
Machinery and equipment	50,000,000

5. The company issued new ordinary shares at premium on 31 March 2003. The old shares were issued at the time of incorporation of the company when the general retail price index (RPI) was 100.
6. The closing stocks represent one month's purchases.
7. Tax was paid in two equal instalments on 30 June and 31 December 2003, while interim dividends were paid on 30 September 2003.
8. The general retail price index moved uniformly in the year.

9. Relevant indices were as follows:

		Retail price index
Date of purchase of:	Old buildings	105
	New building	122
	Machinery and equipment including that sold in the year	110
30 November 2002		119.5
31 December 2002		120
31 March 2003		123
30 June 2003		126
30 September 2003		129
30 November 2003		131.5
31 December 2003		132
Average index for the year ended 31 December 2003		126.

Required:

The following financial statements using the current purchasing power accounting method:

(a) Trading and profit and loss account for the year ended 31 December 2003. (13 marks)
(b) Balance sheet as at 31 December 2003. (12 marks)
(Total: 25 marks)

QUESTION THREE

(a). In the context of Current Cost Accounting (CCA), briefly explain the meaning of the following terms.
(i). Monetary working capital adjustment (2 marks)
(ii). Gearing adjustment (2 marks)

(b). Identify any four limitations of current cost accounting. (4 marks)

(c). The summarized accounts of Tosha Ltd. prepared on the historical cost basis for the year ended 31 December 2002 were as follows.

Profit and loss account for the year ended 31 December 2002.

	Sh. million
Operating profit	355
Interest payable	(60)
Net profit before taxation	295
Corporation tax	(150)
Net profit after taxation	145
Retained profit – 1 January 2002	180
Retained profit – 31 December 2002	325

Balance sheet as at 31 December

	2001		2002	
	Sh. 'million'	**Sh. 'million'**	**Sh. 'million'**	**Sh. 'million'**
Fixed assets (cost)		1,000		1,000
Less: Depreciation		250		375
		750		625
Current assets:				
Stock (December purchase)	600		900	
Cash in hand	30		50	
	630		950	
Current liabilities:				
Corporation tax payable	(100)		(150)	
Net current assets		530		800
		1,280		1,425
Finance by:				
Share capital (Sh.100 par value)		700		700
Retained earnings		180		325
15% debentures		400		400
		1,280		1,425

The directors of Tosha Ltd. Intended to publish supplementary accounts based on current cost accounting.

Additional information:

1. Sales, purchases and other expenses accrued evenly during the year.
2. Tosha Ltd. purchases and sells all goods on an immediate cash basis
3. The fixed assets were purchased on 1 January 2000 and are depreciated on straight line basis over a period of a eight years assuming a nil residual value. The depreciation charge for year ended 31 December 2002 was accordingly Sh.125,000,000.
4. The following price indices are provided for the company's stock and fixed assets.

	Stock	**Fixed assets**
1 January 2000	-	100
Average for December 2001	130	-
31 December 2001	132	120
Average for year 2002	136	124
Average for December 2002	144	-
December 2002	145	132

5. The company's stock turnover on average once a month.

Required:

(i). Current cost profit and loss account for the year ended 31 December 2002 (6 marks)

(ii). Current cost balance sheet as at 31 December 2002 (6 marks)

(The monetary working capital adjustment is not applicable to the affairs of Tosha Ltd.)

(Total: 20 marks)

QUESTION FOUR

Mifupa Ltd. offered to acquire 75% of the issued share capital of Nyama ltd. on 1 April 1999. The offer became final on 1 May 1999. The total coat of acquisition was Sh.177,000,000. The net assets of Nyama Ltd. as at 1 April 1999 and 1 May 1999 were Sh.130,590,000 and Sh.137,560,000 respectively. Mifupa Ltd. had acquired 25% of Mshipa Ltd. many years ago. On 1 September 1999 it acquired the remainder of the share capital, the consideration of which was Sh.112,000,000. The net assets of Mshipa Ltd. as at that date was Sh.74,000,000. Mshipa Ltd. on 2 September 1999 acquired 40% of Ngozi Ltd. The consideration paid was Sh.28,980,000. The net assets of Ngozi Ltd. as at 1 January 1999 were Sh.55,500,000.

The income statements of the four companies for the year ended 31 December 1999 were as follows:

	Mifupa Ltd. Sh. '000'	**Nyama Ltd. Sh. '000'**	**Mshipa Ltd. Sh. '000'**	**Ngozi Ltd. Sh. '000'**
Turnover	3,237,840	687,760	136,800	102,600
Cost of sales	2,238,624	489,312	92,160	69,120
Gross profit	999,216	198,448	44,640	33,480
Expenses	248,736	54,368	10,240	7,680
Operating profit	750,480	144,080	34,400	25,800
Dividend income	1,440	-	-	-
Interest income	4,800	2,000	-	-
Profit before tax	756,720	146,080	34,400	25,800
Taxation	269,600	61,000	15,600	11,700
Profit after taxation	487,120	85,080	18,800	14,100
Dividends				
Ordinary				
Interim	(22,000)	(960)	(480)	(270)
Final	(2,000)	(480)	(240)	(270)
Preference	(480)	-	-	-
Retained profit for the year	462,640	83,640	18,080	13,560

Additional information:

1. Interim dividends were paid by all companies on 1 July 1999.
2. Nyama Ltd. had sold to Mifupa Ltd. in the post-acquisition period, machinery at Sh. 1,260,000. The machinery had coat Nyama Ltd. Sh.1,500,000 on 1 January 1997. It is the group's policy to provide a full year's depreciation on machinery at the rate of 10% on cost in the year of purchase but not in the year of sale, and to carry group assets at their original cost to any number of the group. Any gain or loss on the sale of machinery was adjusted against expenses.
3. It is the group's policy to amortise any goodwill that arises on the acquisition of a subsidiary or an associate over five years using the straight line approach. Show the amortisation charge as a separate line item.
4. Profits are to be assumed to have accrued evenly throughout the year.

Required:

The consolidated income statement of the Mifupa group for the year ended 31 December 1999. A reconciliation schedule is required. **(25 MARKS)**

LESSON THREE

ACCOUNTING FOR ASSETS AND LIABILITIES (PART A)

CONTENTS

3.1 Property, plant and equipment (IAS 16)
3.2 Borrowing Costs (IAS 23)
3.3 Government grants (IAS 20)
3.4 Accounting for Leases (IAS 17)
3.5 Investment properties (IAS 40)
3.6 Inventories (IAS 2)
3.7 Reinforcing Questions

INSTRUCTIONS

- The required reading for this topic is as follows:
    - The relevant international Financial Reporting Standards
    - Read the Study Text below
- Attempt reinforcing questions at the end of the lesson
- Compare your solutions with those given in Lesson

3.1 PROPERTY PLANT AND EQUIPMENT (IAS 16)

The objective of IAS 16 is to prescribe the accounting treatment for property, plant, and equipment. The principal issues are the timing of recognition of assets, the determination of their carrying amounts, and the depreciation charges to be recognised in relation to them.

Property, plant and equipment should be recognised when (a) it is probable that future benefits will flow from it, and (b) its cost can be measured reliably.

Property, plant and equipment is initially recognised at cost. Subsequent to initial recognition, property, plant and equipment is carried either at:

- Cost, less accumulated depreciation and any accumulated impairment losses, or
- Revalued amount, less subsequent accumulated depreciation and any accumulated impairment losses. The revalued amount is fair value at the date of revaluation. The choice of measurement is applied consistency to an entire class of property, plant and equipment. Any revaluation increase is credited directly to the revaluation surplus in equity, unless it reverses a revaluation decrease previously recognised in profit or loss. Any revaluation decrease is recognised in profit or loss. However, the decrease is debited directly to the revaluation surplus in equity to the extent of the credit balance in revaluation surplus in respect of that asset.

Depreciation is applied on a component basis. That is to say, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. The depreciable amount of an asset is allocated on a systematic basis over the useful life of the asset. Impairment is recognised in accordance with IAS 36 *Impairment of Assets.*

- Depreciation:
    - Long-lived assets other than land are depreciated on a systematic basis over their useful lives.
    - Depreciation base is cost less estimated residual value.
    - The depreciation method should reflect the pattern in which the asset's economic benefits are consumed by the enterprise.
    - If assets are revalued, depreciation is based on the revalued amount.
    - The useful life should be reviewed periodically and any change should be reflected in the current period and prospectively.
    - Significant costs to be incurred at the end of an asset's useful life should either be reflected by reducing the estimated residual value or by charging the amount as an expense over the life of the asset.

- Revaluations (allowed alternative):
    - Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.
    - If an item of PP&E has been revalued, the entire class to which the asset belongs must be revalued (for example, all buildings, all land, all equipment).
    - Revaluations should be credited to equity (revaluation surplus) unless reversing a previous charge to income.
    - Decreases in valuation should be charged to income unless reversing a previous credit to equity (revaluation surplus).

- If the revalued asset is sold or otherwise disposed of, any remaining revaluation surplus either remains as a separate component of equity or is transferred directly to retained earnings (not through the income statement).
- If an asset's recoverable amount falls below its carrying amount, the decline should be recognised and charged to income (unless it reverses a previous credit to equity).

The gain or loss on derecognition of an item of property, plant and equipment is the difference between the net disposal proceeds, if any, and the carrying amount of the item. It is included in profit or loss.

IAS 16 specifies disclosures about property, plant and equipment, viz:

- Reconciliation of movements.
- Capital commitments.
- Items pledged as security.
- If assets are revalued, disclose historical cost amounts.
- Change in revaluation surplus

Example
An 80% subsidiary company of Chai Limited, the Kericho Tea Company Limited, incurred expenditure of Sh. 200 million in constructing a tea factory and farmworks over a 2 year period to 31 May 1985. These assets were used for the first time on 1 June 1985. They are depreciated in equal instalments over their useful life of 20 years to a nil residual value.

On 31 May 1993, these assets were revalued at Sh. 360 million by Hysons Tabenga and company, Registered valuers. There was no change in the estimate of their useful life. The assets were depreciated in accordance with Kenya Accounting Standard No. 5. On 31 May 1997, the assets were again revalued; it was found that there had been a diminution in value of the assets to Sh. 160 million.

Required:

(a) Write the appropriate accounts in the books of the Kericho tea Company Limited from 1 June 1985 to 1 June 1997 in accordance with Kenyan Accounting Standard No. 17.
(b) Show the entries in the Property, plant and equipment schedule for the year ended 31 May 1997 and in the Movement on Group Reserves for the year: these assets are included in the titled "Land, Development, Building and Farmworks." (7 marks)

(Total: 15 marks)

Solution
(a) **The Kericho Tea Company Limited**

PPE

	Sh.M		Sh.M
1985		1997	200
June 1 Bal b/f	200	May 31 Reval Res	
		1997	
1993		May 31 Bal c/d	
May 31 Reval Res	160		160
	360		360
1997 June			
Balance c/d	160		

Depreciation on Fixed Asset Account

	Sh.M		Sh.M
1993		1986	
May 31 Revaluation Reserve A/c	80	May 31 P&L	10
		1987-1993	
		May 31 P&L Ac	
		7x10	70
	80		80
1997 May 31		1994 May 31	
Revaluation		P&L A/c	
Reserve a/c	120	360x1/12	30
		1995 – 1997	
		May 31 P & L A/c	
		30 x 3	90
	120		120

Revaluation Reserve Account

	Sh.M		Sh.M
1997		1993	
May 31 FA A/c	200	May 31 Depreciation A/c	80
		May 31 Fixed Asset A/c.	160
			240
		1997	
		May 31:	
May 31 Bal c/d	160	Dep. A/c	120
	360		360
1997			
June Bal b/d	160		

(b)

Group PPE Schedule:	Land Development
Cost or Valuation	Buildings and Farm work
	Sh. Million
At 1 June 1996	360
Revaluation reserve	(200)
At 31 May 1997	160
Accumulated Depreciation	
At 1 June 1996	90
Charge for the year	30
Revaluation reserved	(120)
At 31 May 1997	NIL
Net Book Value	
At 1 June 1996	270
At 31 May 1997	160

	Group Revaluation Reserve Sh. 'M'
Revaluation reserve	(128)

	Minority Interest Sh. 'M'
Revaluation reserve	(32)

3.2 BORROWING COSTS (IAS 23)

Introduction

IAS 23 'Borrowing costs' defines borrowing costs as interest and other costs incurred by an enterprise in connection with the borrowing of funds.
A qualifying asset is also defined therein as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Borrowing costs may include:

- Interest on bank overdrafts and short-term and long-term borrowing
- Amortisation of discounts or premiums relating to borrowings
- Amortisation of ancillary costs incurred in connection with the arrangement of borrowings
- Finance charges in respect of finance leases recognised in accordance with IAS 17, Leases, and
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as adjustment to interest cost.

Examples of qualifying assets are inventories that require a substantial period of time to bring them to a saleable condition, manufacturing plants, power generation facilities and investment properties.
Other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Accounting for borrowing costs

The recommended accounting treatment for borrowing costs as per IAS 23 'Borrowing Costs' is that they should be recognised as an expense in the period in which they are incurred regardless of how the borrowings are applied.
An allowed alternative treatment is that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. However, other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing costs eligible for capitalisation

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

To the extent that funds are borrowed generally and used for purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a

capitalisation rate to the expenditures on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during the period.

Commencement of capitalisation

- The capitalisation of borrowing costs, as part of the cost of a qualifying asset should commence when:
- Expenditures for the asset are being incurred
- Borrowing costs are being incurred; and
- Activities that are necessary to prepare the asset for its intended use or sale are in progress.

Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities.

Disclosure

- The financial statements should disclose:
- The accounting policy adopted for borrowing costs
- The amount of borrowing costs capitalised during the period; and
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation

Example 1

Madden Ltd., a December year-end company, was involved in several long-term construction or asset purchase activities during 20X0.

On 1.1.X0, a Sh. 500,000 advance payment was made to Clair Co. for equipment to be delivered to Madden on 1.7.X0. The equipment was delivered as scheduled and the final Sh. 500,000 payment was made on that date. Madden borrowed the Sh. 500,000 advance payment and the Sh. 500,000 final payment at a 12% rate of interest.

On 1.4.X0, a construction was started on an addition to the current plant facilities. The addition was to be completed on 1.3.X4 at an estimated cost of Sh. 10,000,000. Cash payments made during 20X0 relating to the construction project were as follows.

1 May 20X0	1,200,000
1 July 20X0	400,000
1 August 20X0	900,000
1 October 20X0	5,000,000
1 November 20X0	600,000
	8,100,000 < 10,000,000

Madden Ltd. established a line of credit for the construction project that allowed the company to borrow up to Sh. 10,000,000 at a 13% rate of interest during 20X0 and 20X1. Total interest costs incurred during 20X0 amounted to Sh. 500,000.

Required
Calculate the total interest to be capitalised for 20X0 in the books of Madden Ltd, assuming that the company has a policy of capitalising borrowing costs where appropriate.

Solution 1

Step 1: Identify qualifying assets
A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. Both the assets described in the example are qualifying assets.

Step 2: Calculate general borrowing rate

Not applicable in this case.

Step 3: Sort out dates
Capitalisation of borrowing costs should commence when:
Activities have been undertaken to make the assets ready for their intended use
Expenditure has been incurred in connection with the assets
Interest has been incurred

The capitalisation period begins for each asset on the date that all conditions necessary for interest capitalisation have been initiated.

Equipment:
The capitalisation period begins on 1.1.20X0
Ends on 1.7.20X0 (delivered and ready for use on 1.7.20X0)

Plant:
The capitalisation period begins on 1.5.20X0 (the date the first expenditure was incurred)
Ends on 31.12.20X0 (as the expansion was not completed by year end).

Step 4: Calculate net expenditure
Equipment:
The only expenditure ranking for capitalisation of interest would be the first Sh. 500,000 as the other payment was made on the last day of the capitalisation period.

Plant:
Each expenditure will have to be weighted according to the time outstanding to get a total average accumulated expenditure. The computation would be as follows:

01.05.20X0	1,200 X 8/12	=	800,000
01.07.20X0	400 X 6/12	=	200,000
01.08.20X0	900 X 5/12	=	375,000
01.10.20X0	5,000 X 3/12	=	1,250,000
01.11.20X0	600 X 2/12	=	100,000
			1,275,000

Step 5: Calculate borrowing costs to be capitalised
Equipment:
The amount to be capitalised would equal 500,000 X 6/12 X 12% = Sh. 30,000

Plant:
This expenditure was financed by a specific new borrowing at 13% p.a. hence this is the interest rate to be used.

The interest to be capitalised would thus:

=	2,725,000 X 13%	=	Sh. 354,250

or

1,200 X 8/12 X 13%	=	104,000
400 X 6/12 X 13%	=	26,000
900 X 5/12 X 13%	=	48,750
5,000 X 3/12 X 13%	=	152,500
600 X 2/12 X 13%	=	13,000
		354,250

Step 6: Calculate total borrowing costs incurred.
Given as Shs. 500,000

Step 7: Limit borrowing costs capitalised to borrowing costs incurred
Interest incurred = Shs. 500,000

Shs. 384,250 will be capitalised and included in the carrying value of the asset, which will eventually be written off in the income statement in the form of depreciation.

The remaining Shs. 115,750 (500,000 – 384,250) will be charged as their interest expense in the current year's income statement.

Step 8: Add borrowing costs to asset
The composite journal entry for the interest capitalised would be:

Construction in progress:

Dr: Plant facility	354,250	
Dr: Equipment	30,000	
Cr: Interest		384,250

Note:
In 20X1, the capitalisation period for the expansion process would start on 1.1.20X1 and the opening balance of Shs. 8,100,000 expenditure would be weighted for the duration of the capitalisation period, plus the expenditures made in 20X1.

Example 2 (June 1999 Q.3)

(a) What is meant by capitalisation of borrowing costs?
(b) State the conditions to be met before capitalisation period begins.
(c) On 1 January 1998, Nyota Ltd, contracted with Ujenzi Ltd. to construct a building for Sh.20 million on land that Nyota Ltd. had purchased five years earlier. The contract will last for a year, with Nyota Ltd. making five payments in 1998. The building was completed on 31 December 1998.

Nyota Ltd. made the following payments in 1998:

	Sh million
1 January 1998	20
31 March 1998	40
30 June 1998	61
30 September 1998	44
31 December 1998	35
	200

Nyota Ltd. had the following debt outstanding at 31 December 1998:

1. A 12%, 4-year note dated 1 January 1998 with interest compounded quarterly. Both principal and interest due on 31 December 20X0 (relates specifically to building project) Sh. 85 million.
2. A 10%, 10-year note dated 31 December 1994 with simple interest and interest payable annually on 31 December Sh.60 Million.
3. A 12%, 5-year note dated 31 December 1996 with simple interest and interest payable annually on 31 December Sh.70 million.

Required

The amount of interest to be capitalised during 1998 in relation to the above contract.

Solution 2 (June 1999 Q.3)

(a) Capitalisation of borrowing costs is the inclusion of borrowing costs as part of the cost of a qualifying asset. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. The purpose of capitalisation is to obtain a more accurate original asset investment cost and to achieve a better matching of costs deferred to future periods with revenues of those future periods.

(b) Conditions to be met before capitalisation period begins:
Expenditure for the asset are being incurred
Borrowing costs are being incurred
Activities that are necessary to prepare the asset for its intended use are in progress

(c) Computing the interest to be capitalised:

(i) Obtain the average accumulated expenditure

Date	**Expenditures**	**Capitalization Period**	**Average Accumulated expenditures**
	Shs '000'		Shs '000'
1.01.98	20,000	12/12	20,000
31.03.98	40,000	9/12	30,000
30.06.98	61,000	6/12	30,500
30.09.98	44,000	3/12	11,000
31.12.98	35,000	0/12	-
	200,000		91,500

(ii) Capitalisation rate (weighted average rate) of interest to be used in respect of the general borrowing.

	Principal	Interest
10% 10-year note	60,000,000	6,000,000
12% 5-year note	70,000,000	8,400,000
	130,000,000	14,400,000

Therefore, weighted average rate of interest = $\frac{14,400,000 \text{ X } 100}{130,000,000} = 11.08\%$

(iii) Breakdown of average accumulated expenditure

Specific borrowings	85,000,000
General borrowings	6,500,000
	91,500,000

(iv) Potential interest to be capitalised

Specific borrowing: 85,000,000 $(1 + 0.03)^4$ – 85,000,000	10,668,400
General borrowing: 6,500,000 X 0.1108	720,000
	11,338,600

(v) Actual interest incurred

12% 4-year note	10,668,400
10% 10-year note	6,000,000
12% 5-year note	8,400,000
	25,068,400

Therefore, the interest to be capitalized is Shs. 11,388,600 while Shs 13,679,800 (25,068,400 – 11,388,600) is to be expensed.

3.3 GOVERNMENT GRANTS (IAS 20)

The objective of IAS 20 is to prescribe the accounting for, and disclosure of, government grants and other forms of government assistance.
The main problem with government grants is whether to report the grant as income or part of contributions by shareholders. The two common approaches are referred to as income or capital approaches. There are different arguments for each method.
IAS 20 applies to all government grants and other forms of government assistance. However, it does not cover government assistance that is provided in the form of benefits in determining taxable income.

Accounting for Grants

A government grant is recognised only when there is reasonable assurance that (a) the enterprise will comply with any conditions attached to the grant and (b) the grant will be received. The grant is recognised as income over the period necessary to match them with the related costs, for which they are intended to compensate, on a systematic basis, and should not to be credited directly to equity.

Non-monetary grants, such as land or other resources, are usually accounted for at fair value, although recording both the asset and the grant at a nominal amount is also permitted. Even if there are no conditions attached to the assistance specifically relating to the operating activities of the enterprise (other than the requirement to operate in certain regions or industry sectors), such grants should not be credited to equity.

A grant receivable as compensation for costs already incurred or for immediate financial support, with no future related costs, should be recognised as income in the period in which it is receivable.

A grant relating to assets may be presented in one of two ways:

1. as deferred income, or
2. by deducting the grant from the asset's carrying amount.

A grant relating to income may be reported separately as 'other income' or deducted from the related expense.

If a grant becomes repayable, it should be treated as a change in estimate. Where the original grant related to income, the repayment should be applied first against any related unamortised deferred credit, and any excess should be dealt with as an expense. Where the original grant related to an asset, the repayment should be treated as increasing the carrying amount of the asset or reducing the deferred income balance. The cumulative depreciation which would have been charged had the grant not been received should be charged as an expense. [

Disclosure of Government Grants

The following must be disclosed:

Accounting policy adopted for grants, including method of balance sheet presentation Nature and extent of grants recognised in the financial statements
Unfulfilled conditions and contingencies attaching to recognised grants

Government Assistance

Government grants do not include government assistance whose value cannot be reasonably measured, such as technical or marketing advice. Disclosure of the benefits is required.

Example

Kenya Fisheries Limited (KFL) erected a fish processing factory complex in early 1995 in Lodwar to process Nile perch caught in Lake Turkana. The factory complex had cost Sh.200 million and has a useful life of 20 years. The food and Agricultural Organisation (FAO) of the United Nations had provided a grant of Sh.100 millions towards the cost of the complex. When operations commenced on 1 July 1995. FAO paid a further Sh.80 million towards electricity cost for the first 10 years' operation of the factory. The only condition attached to these grants was that the factory output would be exported using empty return flights which brought relief supplies for southern Sudan into Lokichogio. If at any time during the first 10 years of operation of the factory the output was not exported, part of the grant would become repayable to FAO, in the proportion of the number of years the condition would not be fulfilled, plus two penalty years, to the period of 10 Years. The output of the processed fish was picked up at Lodwar airport, which was expanded at a cost of Sh.20 million, met by the Kenya government, to accommodate the large Hercules C130 transport aircraft. The factory became operational on 1 July 1995 and was considered by FAO as a model project. The fish was exported profitably to Europe. In early January 1999, the European Union (EU) announced that the importation of fish would be banned forthwith; KFL commenced negotiations with EU officials who allowed imports of fish to continue until 30 June 2000, pending the outcome of tests to be carried out at the factory. In the meantime, KFL carried out market research to locate alternative export markets: this proved to be fruitless, but with effect from early July 2000, KFL ceased exports and concentrated on selling to the Kenya market, which it did with a high degree of success, KFL had protracted negotiations with FAO and pleaded that "force majeure" had caused non compliance with the condition: this fell on deaf ears, and KFL refunded the amounts due on 30 April 2000. KFL's electricity costs were Sh.9 million and Sh.11 million in the years ended 30 June 2000, respectively.

Required:

(a) State the two broad approaches to the accounting treatment of government grants and the arguments in support of each of them.

(b) How should a government grant that becomes receivable as compensation for losses already incurred or for the purpose of giving immediate financial support to the enterprise with no future related costs be recognized under IAS 20? (2 marks)

(c) KFL had adopted the accounting policy of presenting all governments grants as a credit in the income statement as a single, separate item. You are required to show extracts from the balance Sheets as at 30 June 1999 and as at 30 June 2000, and from the Income Statements to these two dates, to deal with all the facts stated above, showing the figures that would appear in KFL's financial statements but also showing the figures that would have appeared if KFL had adopted the alternative accounting policy. When the 1999 financial statements were approved by the directors on 25 July 1999, they were confident that exports would be able to be resumed in the near future. The requirements of IAS 37: "provisions. . Contingent Liabilities and Contingent Assets" should be ignored in relation to the year ended 30 June 1999. (11 marks)

(Total: 20 marks)

SOLUTION

(a) **The two approaches to the accounting treatment of government grants are:**

(i). The capital approach – the grant is credited directly to shareholder's interests;
(ii). The income approach – the grant is taken to income over one or more periods

The arguments in favour of the capital approach are:

1. The government grants are a financing device and should be dealt with as such in the balance sheet rather than be passed through the income statement to offset the items of

The arguments in favour of the income approach are:

(a) Since government grants are receipts from a source other than shareholders, they should not be credited directly to shareholders' interests but should be recognized as income in appropriate periods;

(b) Government grants are rarely gratuitous; the enterprise earns them through compliance with their conditions and meeting the envisaged obligations; they should therefore be recognised as income and matched with the associated costs which the grant is intended to compensate;

(c) As income and other taxes are charges against income, it is also logical to deal with government grants, which are an extension of fiscal policies, in the income statement.

(b) A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the enterprise with no

future related costs should be recognised as income of the period in which it becomes receivable, as an extraordinary item if appropriate.

(c) **Kenya Fisheries Limited**

Balance Sheet as at 30 June **Grant deductED from assets**

Grant set up as deferred income:

Assets	**1999 Sh. m**	**2000 Sh. m**		**1999 Sh. m**	**2000 Sh. m**
Factory: Cost	200	200	Factory: Net cost	180	180
Accumulated Depreciation	(40)	(50)	Accumulated	(52)	(65)
	160	150	Depreciation	128	115

CREDIT SIDE: (No shareholders' Funds)

Deferred income: FAO grant	128	Nil	Deferred inc:/ FAO grant	48	Nil

(a) (a). FAO grant Account

	F5		1995		
1996 Jun. 30 P & K	E8	13	Jul	CB	100
1997 11		13	11	CB	80
1998 11		13			
1999 11		13			
Bal c/d		128			
		180			180
2000 CB					
April 30F 8/10 x 100		80	1999 F80		
			Jul. b/d E48		
1:8/10 x 80		64			
			2000		
			June 30 P & L A/c		
		144			144

(b) FAO Grant A/c

1995	Sh.m	1995	Sh.
July Factory	100	July 11 CB	100
1996 June 30 P & L	8	July 11 CB	
1997 11	8		80
1998 11	8		
1999 11	8		
June 30 c/d	48		
	180		180
2000		1999	
April 30 CB:		Jul. Bal c/d	48
Factory 8/10 x 100 80		April 30 Factory	80
Electricity 8/10 x 64	11	P & L	16
	144		144

Income statement for the year ended 30 June:

	1999 Sh. m		**1999 Sh. m**	**2000 Sh. m**
Income FAO grant		Depreciation	(5)	(5)
February: 100 x 1/20	5			

Electricity: 80 x 1/10	8	Electricity	(9)	(11)
	13	Deduct: FAO	(8)	(-)
Depreciation: Factory (200/20)	(10)	FAO grant		(16)
FAO grant withdrawn				

3.4 LEASES (IAS 17)
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.

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 instalment 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 instalment 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 instalment 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 form 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 include 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 form the lease.

Under the net cash investment, a lessor recognises 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 are 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)

3.5 INVESTMENT PROPERTIES (IAS 40)

IAS 40 is all about trying to identify an investment property and therefore apply the recommended accounting treatment. It is not a popular topic with the examiner although it is a very important part of the studies.

Investment property is property (land or a building or part of a building or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both. Examples of investment property: [IAS 40.8]

(i) Land held for long-term capital appreciation
(ii) Land held for undecided future use
(iii) Building leased out under an operating lease
(iv) Vacant building held to be leased out under an operating lease

The following are not investment property and, therefore, are outside the scope of IAS 40:

(i) property held for use in the production or supply of goods or services or for administrative purposes;
(ii) property held for sale in the ordinary course of business or in the process of construction of development for such sale (IAS 2 Inventories);
(iii) property being constructed or developed on behalf of third parties (IAS 11 Construction Contracts);
(iv)owner-occupied property (IAS 16 Property, Plant and Equipment), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees and owner-occupied property awaiting disposal;
(v) property that is being constructed of developed for use as an investment property (IAS 16 applies to such property until construction or development is complete). However, IAS 40 does apply to existing investment property that is being redeveloped for continuing use as investment property; and
(vi) property leased to another entity under an finance lease.

Property held under an operating lease. A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property provided that the rest of the definition of investment property is met; the operating lease is accounted for as if it were a finance lease in accordance with IAS 17 Leases; and the lessee uses the fair value model set out in this Standard for the asset recognised.

An entity may make the foregoing classification on a property-by-property basis.

Partial own use. If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. Therefore the part that is rented out is investment property. If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant.

Ancillary services. If the enterprise provides ancillary services to the occupants of a property held by the enterprise, the appropriateness of classification as investment property is determined by the significance of the services provided. If those services are a relatively insignificant component of the arrangement as a whole (for instance, the building owner supplies security and maintenance services to the lessees), then the enterprise may treat the property as investment property. Where the services provided are more significant (such as in the case of an owner-managed hotel), the property should be classified as owner-occupied.

Intracompany rentals. Property rented to a parent, subsidiary, or fellow subsidiary is not investment property in consolidated financial statements that include both the lessor and the lessee,

because the property is owner-occupied from the perspective of the group. However, such property could qualify as investment property in the separate financial statements of the lessor, if the definition of investment property is otherwise met.

Recognition

Investment property should be recognised as an asset when it is probable that the future economic benefits that are associated with the property will flow to the enterprise, and the cost of the property can be reliably measured.

Initial measurement

Investment property is initially measured at cost, including transaction costs. Such cost should not include start-up costs, abnormal waste, or initial operating losses incurred before the investment property achieves the planned level of occupancy.

Measurement subsequent to initial recognition

IAS 40 permits enterprises to choose between a fair value model and a cost model.

One method must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation. IAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model.

Fair value model
Investment property is re-measured at fair value, which is the amount for which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. Gains or losses arising from changes in the fair value of investment property must be included in net profit or loss for the period in which it arises.

Fair value should reflect the actual market state and circumstances as of the balance sheet date. [The best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts. [In the absence of such information, the entity may consider current prices for properties of a different nature or subject to different conditions, recent prices on less active markets with adjustments to reflect changes in economic conditions, and discounted cash flow projections based on reliable estimates of future cash flows.

There is a rebuttable presumption that the enterprise will be able to determine the fair value of an investment property reliably on a continuing basis. However, if, in exceptional circumstances, an entity follows the fair value model but at acquisition concludes that a property's fair value is not expected to be reliably measurable on a continuing basis, the property is accounted for in accordance with the benchmark treatment under IAS 16, Property, Plant and Equipment (cost less accumulated depreciation less accumulated impairment losses). Where a property has previously been measured at fair value, it should continue to be measured at fair value until disposal, even if comparable market transactions become less frequent or market prices become less readily available.

Cost Model

After initial recognition, investment property is accounted for in accordance with the cost model as set out in IAS 16, Property, Plant and Equipment – cost less accumulated depreciation and less accumulated impairment losses.

Transfers to or from Investment Property Classification

Transfers to, or from, investment property should only be made when there is a change in use, evidenced by:

(i) commencement of owner-occupation (transfer from investment property to owner-occupied property);
(ii) commencement of development with a view to sale (transfer from investment property to inventories);
(iii) end of owner-occupation (transfer from owner-occupied property to investment property);
(iv) commencement of an operating lease to another party (transfer from inventories to investment property); or
end of construction or development (transfer from property in the course of construction/development to investment property.

When an enterprise decides to sell an investment property without development, the property is not reclassified as investment property but is dealt with as investment property until it is disposed of.

When an entity uses the cost model for investment property, transfers between categories do not change the carrying amount of the property transferred, and they do not change the cost of the property for measurement or disclosure purposes.

Disposal

An investment property should be derecognised on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal. The gain or loss on disposal should be calculated as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the income statement. Compensation from third parties is recognised when it becomes receivable.

Disclosure

Both Fair Value Model and Cost Model

(i) whether the fair value or the cost model is used;
(ii) if the fair value model is used, whether property interests held under operating leases are classified and accounted for as investment property;
(iii) if classification is difficult, the criteria to distinguish investment property from owner-occupied property and from property held for sale.
(iv) the methods and significant assumptions applied in determining the fair value of investment property.
(v)the extent to which the fair value of investment property is based on a valuation by a qualified independent valuer; if there has been no such valuation, that fact must be disclosed.
(vi) the amounts recognised in profit or loss for:
rental income from investment property;
direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period; and

direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period.

restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.

contractual obligations to purchase, construct, or develop investment property or for repairs, maintenance or enhancements.

Additional Disclosures for the Fair Value Model

(i) a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing additions, disposals, fair value adjustments, net foreign exchange differences, transfers to and from inventories and owner-occupied property, and other changes.

(ii) significant adjustments to an outside valuation (if any)

(iii) if an entity that otherwise uses the fair value model measures an item of investment property using the cost model, certain additional disclosures are required.

Additional Disclosures for the Cost Model

(i) the depreciation methods used;

(ii) the useful lives or the depreciation rates used;

the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(iii) a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing additions, disposals, depreciation, impairment recognised or reversed, foreign exchange differences, transfers to and from inventories and owner-occupied property, and other changes;

(iv) the fair value of investment property. If the fair value of an item of investment property cannot be measured reliably, additional disclosures are required, including, if possible, the range of estimates within which fair value is highly likely to lie.

3.7 INVENTORIES (IAS 2)

Inventories are assets held for sale in the normal course of business. These include raw materials, work in progress or finished goods.

Valuation rule

Stock should be valued at lower of cost and net realisable value.

Cost

This will comprise:

- Cost of purchase
- Duties and taxes paid
- Processing cost
- Allocated overhead

NOTE:
The following costs should be excluded:

- Abnormal wastage of material, labour or other production costs e.g. overhead incurred during a strike
- Storage cost unless they relate to the raw material or work in progress.
- Administrative overheads
- Selling cost

The allocation of fixed overheads should be based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods.

Net Realizable Value
This is the estimated selling price in the ordinary course of business less the estimated costs of completion and processing costs.

NOTE:
- Estimates of NRV are based on the most reliable evidence available at the time the estimates were made
- Estimates of NRV should take into consideration fluctuation of prices
- Such estimates should take into consideration the purpose for which the inventory is held
- A new assessment is made of NRV in each subsequent period
- Where the circumstances which previously caused inventories to be written down below cost no longer exist, the amount of write down could be reversed.

Disclosure requirements on inventory
- Method adopted in determining cost e.g. FIFO, Weighted average (LIFO method no longer permitted)
- The carrying amount of inventories in suitable classification, distinguishing between unprocessed stock, work in progress and finished goods
- Investments valued at NRV
- Circumstances leading to write down of investments
- Investments pledged on security.

Example 1 (Q 5 Dec 1994)
The financial controller of Utopia chemicals Ltd. disagreed with his general manger on the accounting treatment of the items below. The financial controller approached Ozone and associates (CPAS') the auditors of the company for an opinion. You are the audit manager in charge of the technical committee of the audit firm. The financial controller itemises the following points of disagreement.

1. Stocks of 1300 Kg. Of a chemical substance called AP held in bulk was valued as follows:

Work in progress	Sh. '000'
Raw material at cost	3,400
Other direct costs	2,600
Allocated factory overheads (940,000 factory hours @ Sh. 0.5)	470
Allocated selling and distribution costs	590
	7,060

It was estimated that the work in progress would have required 50,000 factory hours to transform it into finished goods. Direct costs relates to factory labour only. The factory workers are paid Sh.100 per hour.

The company has 50,000 factory workers who work for 50 weeks in a year each of which has 5 days. A day has 7.5 working hours. During the financial year in question total factory overheads was Sh. 45,120,000. The factory production was paralysed for 2 weeks by a labour dispute arising from a demand for a 100% pay rise by the union. The company's policy is to allocate the factory overheads on the basis of factory man-hours.

A competitor of Utopia, ME chemicals Ltd. has recently introduced into the market a similar chemical, which is selling in handy packs of 100gm. at Sh.350 each. To meet the competition, Utopia chemicals Ltd. will have to pack 100 gramme containers. The cost of packaging and additional advertisements was estimated as Sh.600, 000 and Sh. 300,000 respectively. The financial controller and the general manger disagreed on valuation of work in progress.

2. AP and another chemical MP are used to manufacture a new chemical MT when AP and MP are mixed in ration of 2:3. The additional mixing cost is estimated to be Sh. 500,000. A kilogram of MP costs Shs. 510 and 1 Kg. Of MT could have been sold at Sh. 5,250.

Once again, the finance controller and the general manager are unable to agree on the valuation of work in progress.

Required

Give your considered opinion on each of the two issues of disagreement between the financial controller and general manager (Treat the two items independently).

Solution

(1)

i. The above valuation includes allocation of overheads incurred over a period of non-production. Such labour wastages should be excluded in line with IAS 2 provision

ii. Selling and distribution costs should not be capitalised in stock valuation as they are incurred after the completion of the production process

iii. No pay was made to the labourers over the strike period, as they are casuals i.e. paid on hour rate of Sh.100. Therefore all the direct cost related to labour were incurred on production.

Efficiency level achieved

$$= \frac{\text{Productive hours X 100}}{\text{Total budgeted hours}} = \frac{48 \text{ X } 5 \text{ X } 7.5 \text{ X } 100}{50 \text{ X } 5 \text{ X } 7.5}$$

$$= 96\%$$

Overheads absorbed (productive)

$$= 0.96 \text{ X } 45{,}120{,}000 = 43{,}315{,}200$$

New Overhead absorption rate

Alternative I: Efficiency level X budgeted absorption rate

0.96 X 0.5 = 0.48

Alternative II

Adjusted rate = Total productive overheads = 43,315,200 =0.48
Total productive manpower 50,000 X 48 X 7.5 X 5

Adjusted cost of AP

Raw material	Shs.3,400,000
Other direct cost	2,600,000
Factory overheads (940,000 X 0.48)	451,200
Adjusted cost	6,451,200

Net realisable value

GRV = $\frac{1300 \text{ X } 1000}{100}$ X 350 = 4,550,000

Less: additional cost	
Packing	(600,000)
Advertisement	(300,000)
Selling & distribution	(590,000)
Conversion cost (50,000 X 0.48)	(24,000)
	3,036,000

Hence the product AP should be valued at the net realisable value of Sh. 3,036,000

(2) AP cannot be sold in its current form but must be mixed with MP and sold, as a new Product MT. Provision must be made for the extra cost of MP, the mixing cost and any other specified losses during the mixing. The original MP must now be compared with the current NRV when sold as a new product MT. In the process of mixing, distinction must be made between normal losses and abnormal losses.

Mixing ratios:

AP		MP
2	:	3
1300		1950

Kg of MT = 1300 + 1950 = 3250

Gross realisable value = 3250 X 5250	=	17,062,500
Less additional costs		
Cost of purchasing MP (1950 X 510)		(994,500)
Mixing cost		(500,000)
NRV		15,568,000

Adjusted cost 6,451,200

Product AP should be valued on the basis of cost Shs. 6,451,200

Normal and abnormal losses in stock valuation

Normal losses	**Abnormal losses**
They are expected	Not expected

They are frequent	They are not frequent
They are related to the product's nature	Not related to the product nature
Their cost is absorbed by remaining good production	Their cost is deducted from total cost in determining cost of good products
e.g. spillage, evaporation, processing losses, shrinkage	e.g. theft, loss by fire, accidents

REINFORCING QUESTIONS

QUESTION ONE

Merryview conducts its activities from two properties, a head office in the city centre and a property in the countryside where staff training is conducted. Both properties were acquired on 1 April 1999 and had estimated lives of 25 years with no residual value. The company has a policy of carrying its land and buildings at current values. However, until recently property prices had not changed for some years. On 1 October 2001 a firm of surveyors revalued the properties. Details of this and the original costs are:

	land	buildings
	Ksh.	Ksh.
Head office – cost 1 April 1999	500,000	1,200,000
– revalued 1 October 2001	700,000	1,350,000
Training premises – cost 1 April 1999	300,000	900,000
– revalued 1 October 2001	350,000	600,000

The fall in the value of the training premises is due mainly to damage done by the use of heavy equipment during training. The surveyors have also reported that the expected life of the training property in its current use will only be a further 10 years from the date of valuation. The estimated life of the head office remained unaltered.

Note: Merryview treats its land and its buildings as separate assets. Depreciation is based on the straight-line method from the date of purchase or subsequent revaluation.

Required:

Prepare extracts of the financial statements of Merryview in respect of the above properties for the year to 31 March 2002. (10 marks)

QUESTION TWO

The broad principles of accounting for tangible non-current assets involve distinguishing between capital and revenue expenditure, measuring the cost of assets, determining how they should be depreciated and dealing with the problems of subsequent measurement and subsequent expenditure. IAS 16 , Property, Plant and Equipment. has the intention of improving consistency in these areas.

Required:

(a) Explain:

(i) how the initial cost of tangible non-current assets should be measured and; (4 marks)

(ii) the circumstances in which subsequent expenditure on those assets should be capitalised. (3 marks)

(b) Explain IAS 16.s requirements regarding the revaluation of non-current assets and the accounting treatment of surpluses and deficits on revaluation and gains and losses on disposal. (8 marks)

(c) (i) Broadoak has recently purchased an item of plant from Plantco, the details of this are:

	$	$
Basic list price of plant		240,000
trade discount applicable to Broadoak 12·5% on list price		
Ancillary costs:		
shipping and handling costs		2,750
estimated pre-production testing		12,500
maintenance contract for three years		24,000
site preparation costs		
electrical cable installation	14,000	

concrete reinforcement	4,500	
own labour costs	7,500	26,000

Broadoak paid for the plant (excluding the ancillary costs) within four weeks of order, thereby obtaining anearly settlement discount of 3%.
Broadoak had incorrectly specified the power loading of the original electrical cable to be installed by thecontractor. The cost of correcting this error of $6,000 is included in the above figure of $14,000.
The plant is expected to last for 10 years. At the end of this period there will be compulsory costs of $15,000 to dismantle the plant and $3,000 to restore the site to its original use condition.

Required:
Calculate the amount at which the initial cost of the plant should be measured. (Ignore discounting) (5 marks)

(ii) Broadoak acquired a 12-year lease on a property on 1 October 1999 at a cost of $240,000. The company policy is to revalue its properties to their market values at the end of each year. Accumulated amortisation is eliminated and the property is restated to the revalued amount. Annual amortisation is calculated on the carrying values at the beginning of the year. The market values of the property on 30 September 2000 and 2001 were $231,000 and $175,000 respectively. The existing balance on the revaluation reserve at 1 October 1999 was $50,000. This related to some non-depreciable land whose value had not changed significantly since 1 October 1999.

Required:
Prepare extracts of the financial statements of Broadoak (including the movement on the revaluation reserve) for the years to 30 September 2000 and 2001 in respect of the leasehold property. (5 marks)

LESSON FOUR

ACCOUNTING FOR ASSETS AND LIABILITIES (PART B)

4.1 Construction contracts (IAS 11)
4.2 Intangible assets (IAS 38)
4.3 Impairment of assets (IAS 36)
4.4 Provisions, contingent liabilities and contingent assets (IAS 37)
4.5 Financial Instruments (IAS 32, 39 and IFRS 7)
4.6 Exploration for and evaluation of Mineral Resources (IFRS 6)
4.7 Reinforcement questions
4.8 Comprehensive assigment

INSTRUCTIONS:

- Carefully study the following:
    - The relevant standards
    - The study text below

Answer the reinforcement questions at the end of the chapter and compare your answers with those given at Lesson.

4.1 CONSTRUCTION CONTRACTS (IAS 11)

Note. this topic is comprehensively covered in Financial Accounting II and therefore it is not examined within financial accounting IV. It has been included for the purpose of information only hence examples are omitted.

Under IAS 11, if a contract covers two or more assets, the construction of each asset should be accounted for separately if (a) separate proposals were submitted for each asset, (b) portions of the contract relating to each asset were negotiated separately, and (c) costs and revenues of each asset can be measured. Otherwise, the contract should be accounted for in its entirety.

Two or more contracts should be accounted for as a single contract if they were negotiated together and the work is interrelated.

If a contract gives the customer an option to order one or more additional assets, construction of each additional asset should be accounted for as a separate contract if either (a) the additional asset differs significantly from the original asset(s) or (b) the price of the additional asset is separately negotiated.

What Is Included in Contract Revenue and Costs?

Contract revenue should include the amount agreed in the initial contract, plus revenue from alternations in the original contract work, plus claims and incentive payments that (a) are expected to be collected and (b) that can be measured reliably.

Contract costs should include costs that relate directly to the specific contract, plus costs that are attributable to the contractor's general contracting activity to the extent that they can be reasonably allocated to the contract, plus such other costs that can be specifically charged to the customer under the terms of the contract.

Accounting

If the outcome of a construction contract can be estimated reliably, revenue and costs should be recognised in proportion to the stage of completion of contract activity. This is known as the percentage of completion method of accounting. To be able to estimate the outcome of a contract reliably, the enterprise must be able to make a reliable estimate of total contract revenue, the stage of completion, and the costs to complete the contract.

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 recoverable and contract costs should be expensed as incurred.

The stage of completion of a contract can be determined in a variety of ways - including the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs, surveys of work performed, or completion of a physical proportion of the contract work.

An expected loss on a construction contract should be recognised as an expense as soon as such loss is probable.

Disclosure

amount of contract revenue recognised;
method used to determine revenue;
method used to determine stage of completion; and
for contracts in progress at balance sheet date:
aggregate costs incurred and recognised profit
amount of advances received
amount of retentions

Presentation

The gross amount due from customers for contract work should be shown as an asset.

The gross amount due to customers for contract work should be shown as a liability.

4.2 INTANGIBLE ASSETS (IAS 38)

IAS 38 is a very lengthy standard as it covers the accounting treatment of many intangible assets. The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another IAS. The Standard requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures regarding intangible assets.

Scope

IAS 38 applies to all intangible assets other than financial assets , mineral rights and exploration and development costs incurred by mining and oil and gas companies, intangible assets arising from insurance contracts issued by insurance companies , intangible assets covered by another IAS, such as intangibles held for sale, deferred tax assets, lease assets, assets arising from employee benefits, and goodwill. Goodwill is covered by IFRS 3.

Key Definitions

Intangible asset: An identifiable nonmonetary asset without physical substance. An asset is a resource that is controlled by the enterprise as a result of past events (for example, purchase or self-creation) and from which future economic benefits (inflows of cash or other assets) are expected. Thus, the three critical attributes of an intangible asset are:

(i) identifiability
(iii) control (power to obtain benefits from the asset)
(iv) future economic benefits (such as revenues or reduced future costs)

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.

Examples of possible intangible assets include:

computer software
patents
copyrights
motion picture films
customer lists
mortgage servicing rights
licenses
import quotas
franchises
customer and supplier relationships
marketing rights

Intangibles can be acquired:

by separate purchase
as part of a business combination
by a government grant
by exchange of assets
by self-creation (internal generation)

Recognition

Recognition criteria. IAS 38 requires an enterprise to recognise an intangible asset, whether purchased or self-created (at cost) if, and only if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and the cost of the asset can be measured reliably.

This requirement applies whether an intangible asset is acquired externally or generated internally. IAS 38 includes additional recognition criteria for internally generated intangible assets (see below).

The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions that will exist over the life of the asset. [IAS 38.22] The probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination.

If recognition criteria not met. If an intangible item does not meet both the definition of and the criteria for recognition as an intangible asset, IAS 38 requires the expenditure on this item to be recognised as an expense when it is incurred.

Business combinations. There is a rebuttable presumption that the fair value (and therefore the cost) of an intangible asset acquired in a business combination can be measured reliably. An expenditure (included in the cost of acquisition) on an intangible item that does not meet both the definition of and recognition criteria for an intangible asset should form part of the amount attributed to the goodwill recognised at the acquisition date. IAS 38 notes, however, that non-recognition due to measurement reliability should be rare:]

The only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and either:

> (a) is not separable; or
> (b) is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.

Reinstatement. The Standard also prohibits an enterprise from subsequently reinstating as an intangible asset, at a later date, an expenditure that was originally charged to expense. This simply means that a firm cannot write back an intangible asset that had been initially written off.

Initial Recognition: Research and Development Costs

Charge all research cost to expense.

Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established. This means that the enterprise must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits.

If an enterprise cannot distinguish the research phase of an internal project to create an intangible asset from the development phase, the enterprise treats the expenditure for that project as if it were incurred in the research phase only.

Initial Recognition: In-process Research and Development Acquired in a Business Combination

A research and development project acquired in a business combination is recognised as an asset at cost, even if a component is research. Subsequent expenditure on that project is accounted for as any other research and development cost (expensed except to the extent that the expenditure satisfies the criteria in IAS 38 for recognising such expenditure as an intangible asset).

Initial Recognition: Internally Generated Brands, Mastheads, Titles, Lists

Brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated should not be recognised as assets.

Initial Recognition: Computer Software

Purchased: capitalise

Operating system for hardware: include in hardware cost

Internally developed (whether for use or sale): charge to expense until technological feasibility, probable future benefits, intent and ability to use or sell the software, resources to complete the software, and ability to measure cost.

Amortisation: over useful life, based on pattern of benefits (straight-line is the default).

Initial Recognition: Certain Other Defined Types of Costs

The following items must be charged to expense when incurred:

Internally generated goodwill
Start-up, pre-opening, and pre-operating costs
Training cost
Advertising cost
Relocation costs

Initial Measurement

Intangible assets are initially measured at cost.

Measurement Subsequent to Acquisition: Cost Model and Revaluation Models Allowed

An entity must choose either the cost model or the revaluation model for each class of intangible asset.

Cost model. After initial recognition the benchmark treatment is that intangible assets should be carried at cost less any amortisation and impairment losses.]

Revaluation model. Intangible assets may be carried at a revalued amount (based on fair value) less any subsequent amortisation and impairment losses only if fair value can be determined by reference to an active market. Such active markets are expected to be uncommon for intangible assets.]

Examples where they might exist:

Milk quotas. Stock exchange seats. Taxi medallions.

Under the revaluation model, revaluation increases are credited directly to "revaluation surplus" within equity except to the extent that it reverses a revaluation decrease previously recognised in profit and loss. If the revalued intangible has a finite life and is, therefore, being amortised (see below) the revalued amount is amortised.

Classification of Intangible Assets Based on Useful Life

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.
> **Finite life:** A limited period of benefit to the entity.

Measurement Subsequent to Acquisition: Intangible Assets with Finite Lives

The cost less residual value of an intangible asset with a finite useful life should be amortised over that life: [IAS 38.97]

The amortisation method should reflect the pattern of benefits. If the pattern cannot be determined reliably, amortise by the straight line method. The amortisation charge is recognised in profit or loss unless another IFRS requires that it be included in the cost of another asset. The amortisation period should be reviewed at least annually.

The asset should also be assessed for impairment in accordance with IAS 36.

Measurement Subsequent to Acquisition: Intangible Assets with Indefinite Lives

An intangible asset with an indefinite useful life should not be amortised.

Its useful life should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate.

The asset should also be assessed for impairment in accordance with IAS 36.

Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or completion should be recognised as an expense when it is incurred, unless it is probable that this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and the expenditure can be measured and attributed to the asset reliably. [IAS 38.60]

Disclosure

For each class of intangible asset, disclose:
useful life or amortisation rate
amortisation method
gross carrying amount
accumulated amortisation and impairment losses
line items in the income statement in which amortisation is included
reconciliation of the carrying amount at the beginning and the end of the period showing:
additions (business combinations separately)
assets held for sale
retirements and other disposals
revaluations
impairments
reversals of impairments
amortisation
foreign exchange differences
basis for determining that an intangible has an indefinite life

description and carrying amount of individually material intangible assets
certain special disclosures about intangible assets acquired by way of government grants
information about intangible assets whose title is restricted
commitments to acquire intangible assets
Additional disclosures are required about:
intangible assets carried at revalued amounts [IAS 38.124]
the amount of research and development expenditure recognised as an expense in the current period

4.3 IMPAIRMENT OF ASSETS (IAS 36)

Introduction

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

Example 2

A company has acquired another business for Kshs.4.5m: tangible assets are valued at Kshs.4.0m and goodwill at Kshs.0.5m. An asset with a carrying value of Kshs.1m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to estimate whether there has been an impairment of assets in the acquired business and what the amount of any such loss is.

Solution 2
The recoverable amount of the business (a single cash generating unit) is measured as Kshs.3.1m. There has consequently been an impairment loss of Kshs.1.4m (Kshs.4.5m - Kshs.3.1m). The impairment loss will be recognised in the income statement. The loss will be allocated between the assets as follows.

(a) A loss of Kshs.1m can be attributed to the uninsured asset that has been destroyed
(b) The remaining loss of Kshs.0.4m should be allocated to goodwill

The carrying value of the assets will now be Kshs.3m for tangible assets and Kshs.0.1m for goodwill.
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 3

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:

	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 3

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.

4.4 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS (IAS 37)

The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The key principle established by the Standard is that a provision should be recognised only when there is a liability i.e. a present obligation resulting from past events. The Standard 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.

Scope

IAS 37 excludes obligations and contingencies arising from:

(I) financial instruments carried at fair value (but IAS 37 does apply to financial instruments carried at amortised cost)
(ii) non-onerous executory contracts
insurance company policy liabilities (but IAS 37 does apply to non-policy-related liabilities of an insurance company)
(iii) items covered by another IAS. For example, IAS 11, Construction Contracts, applies to obligations arising under such contracts; IAS 12, Income Taxes, applies to obligations for current or deferred income taxes; IAS 17, Leases, applies to lease obligations; and IAS 19, Employee Benefits, applies to pension and other employee benefit obligations.

Some important definitions in IAS 37 include:

Provision: A liability of uncertain timing or amount.
Liability:
Present obligation as a result of past events
Settlement is expected to result in an outflow of resources (payment)
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
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.

Recognition of a Provision

An enterprise must recognise a provision if, and only if:
(i) a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event),
(ii) payment is probable ('more likely than not'), and
(iii) the amount can be estimated reliably.
An 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.
A 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.
A possible obligation (a contingent liability) is disclosed but not accrued. However, disclosure is not required if payment is remote.
In rare cases, for example in a lawsuit, it may not be clear whether an enterprise has a present obligation. In those cases, a past event is deemed to give rise to a present obligation if, taking account

of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date. A provision should be recognised for that present obligation if the other recognition criteria described above are met. If it is more likely than not that no present obligation exists, the enterprise should disclose a contingent liability, unless the possibility of an outflow of resources is remote.

Measurement of Provisions

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date, that is, the amount that an enterprise would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party. [his means:

Provisions for one-off events (restructuring, environmental clean-up, settlement of a lawsuit) are measured at the most likely amount.
Provisions for large populations of events (warranties, customer refunds) are measured at a probability-weighted expected value.
Both measurements are at discounted present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the liability.

In reaching its best estimate, the enterprise should take into account the risks and uncertainties that surround the underlying events. Expected cash outflows should be discounted to their present values, where the effect of the time value of money is material.

If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised as a reduction of the required provision when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The amount recognised should not exceed the amount of the provision. [IAS 37.53]

In measuring a provision consider future events as follows:

forecast reasonable changes in applying existing technology
ignore possible gains on sale of assets
consider changes in legislation only if virtually certain to be enacted

Remeasurement of Provisions

Review and adjust provisions at each balance sheet date
If outflow no longer probable, reverse the provision to income.

Some Examples of Provisions

Restructuring by sale of an operation	Accrue a provision only after a binding sale agreement
Restructuring by closure or reorganisation	Accrue a provision only after a detailed formal plan is adopted and announced publicly. A Board decision is not enough
Warranty	Accrue a provision (past event was the sale of defective goods)

Land contamination	Accrue a provision if the company's policy is to clean up even if there is no legal requirement to do so (past event is the obligation and public expectation created by the company's policy)
Customer refunds	Accrue if the established policy is to give refunds (past event is the customer's expectation, at time of purchase, that a refund would be available)
Offshore oil rig must be removed and sea bed restored	Accrue a provision when installed, and add to the cost of the asset
Abandoned leasehold, four years to run	Accrue a provision
CPA firm must staff training for recent changes in tax law	No provision (there is no obligation to provide the training)
A chain of retail stores is self-insured for fire loss	No provision until a an actual fire (no past event)
Self-insured restaurant, people were poisoned, lawsuits are expected but none have been filed yet	Accrue a provision (the past event is the injury to customers)
Major overhaul or repairs	No provision (no obligation)
Onerous (loss-making) contract	Accrue a provision

Restructurings

A restructuring is:

Sale or termination of a line of business
Closure of business locations
Changes in management structure
Fundamental reorganisation of company

Restructuring provisions should be accrued as follows:

Sale of operation: accrue provision only after a binding sale agreement .If the binding sale agreement is after balance sheet date, disclose but do not accrue

Closure or reorganisation: accrue only after a detailed formal plan is adopted and announced publicly. A board decision is not enough.

Future operating losses: Provisions should not be recognised for future operating losses, even in a restructuring

Restructuring provision on acquisition (merger): Accrue provision for terminating employees, closing facilities, and eliminating product lines only if announced at acquisition and, then only if a detailed formal plan is adopted 3 months after acquisition.

Restructuring provisions should include only direct expenditures caused by the restructuring, not costs that associated with the ongoing activities of the enterprise.

What Is the Debit Entry?

When a provision (liability) is recognised, the debit entry for a provision is not always an expense. Sometimes the provision may form part of the cost of the asset. Examples: obligation for environmental cleanup when a new mine is opened or an offshore oil rig is installed.

Use of Provisions

Provisions should only be used for the purpose for which they were originally recognised. They should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources will be required to settle the obligation, the provision should be reversed.

Contingent Liabilities

Since there is common ground as regards liabilities that are uncertain, IAS 37 also deals with contingencies. It requires that enterprises should not recognise contingent liabilities - but should disclose them, unless the possibility of an outflow of economic resources is remote.

Contingent Assets

Contingent assets should not be recognised - but should be disclosed where an inflow of economic benefits is probable. When the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Disclosures

Reconciliation for each class of provision:

- Opening balance
- Additions
- Used (amounts charged against the provision)
- Released (reversed)
- Unwinding of the discount
- Closing balance

A prior year reconciliation is not required.

For each class of provision, a brief description of:

- Nature
- Timing
- Uncertainties
- Assumptions
- Reimbursement

4.5 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 of 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:

(i) 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.
(ii) Employers' rights and obligations under employee benefit plans [see IAS 19].
(iii) 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.
(iv) Contracts for contingent consideration in a business combination [see IFRS 3].
(v) Contracts that require a payment based on climatic, geological or other physical variables (weather derivatives) [see IAS 39].

IAS 32 applies to those contracts to buy or sell 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.

Important definitions

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 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 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.

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: 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 instruments is a financial liability is 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 financially liability exists in 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:

a) The occurrence or non-occurrence of uncertain future events, or
b) 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 $\frac{1}{(1.09)^3}$)*	1,544,367
Present value of the interest: KSh.120,000 payable annually in arrears for three years.	
(KSh.120,000 x $\frac{1-(1.09)^{-3}}{0.09}$)*	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.

a) 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.
b) Distributions to holders of a financial instrument classified as an **equity instrument** should be **debited directly to equity** by the issuer.
c) **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 circumstance. In all other cases, financial assets and financial liabilities are presented separately.

Section summary

- Financial instruments must be classified as **liabilities** or **equity**
- The **substance** of the financial instrument is more important than its **legal form**
- The **critical feature of a financial liability** is the contractual obligation to deliver cash or another financial instrument.
- **Compound instruments** are split into equity and liability parts and presented accordingly
- **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.

- **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.

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 judgement. 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 abut 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 this 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 judgement 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** eg 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 derecognition

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

a) An entity has transferred substantially all the risks and rewards of ownership?

b) 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 part 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

- **All financial assets and liabilities** should be **recognised on the balance sheet**, including derivatives.
- 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.
- Financial liabilities should be derecognised when they are **extinguished.**

IAS 39 MEASUREMENT 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:
   (i) Acquired or incurred principally for the purpose of selling or repurchasing it in the near term.
   (ii) 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.
   (iii) 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:

a) Loans and receivables originated by the entity
b) Held-to-maturity investments
c) 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:

a) **Loans and receivables**
b) **Held to maturity investments**
c) 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 are 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:

Amortised cost at	income statement interest income for	interest received during year	amortised cost

Year	Beginning of year	year (@10%)	(cash flow)	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:

1) 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.
2) Purchased 6% debentures in FG Co on 1January 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%.
3) 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

1. 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

2. 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

3. 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:

a) Significant financial difficulty of the issuer
b) A breach of contract, such as a default in interest or principal payments
c) The lender granting a concession to the borrowers that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty
d) It becomes probable that the borrower will enter bankruptcy
e) 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

a) 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

b) 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

c) 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

- Initial recognition, financial instruments are measured at cost.
- Subsequent measurement depends on how a financial asset is classified.
- Financial assets at **fair value through profit or loss** are measured at **fair value;** gains and losses are recognised in **profit or loss.**
- **Available for sale** assets are measured at **fair value;** gains and losses are taken to **equity**.
- **Loans and receivables** and **held to maturity** investments are measured at **amortised cost;** gains and losses are recognised in **profit or loss.**
- 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.

6.1 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).

6.2 Conditions for hedge accounting

Before a hedging relationship qualifies for hedge accounting, **all** of the following **conditions** must be met.

a) 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).
b) 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).
c) For **cash flow hedges,** a **forecast transaction** that is the subject of the hedge must be **highly probable** and must present an exposure t variations in cash flows that could ultimately affect profit and loss.
d) The effectiveness of the hedge can be **measured reliably**.
e) 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 form **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:

a) Are adjusted against the carrying of the asset or liability, or

b) 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

a) The effective portion of the gain or loss on the hedging instrument is recognised directly in equity through the statement of changes in equity.

b) 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

DBIT 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	

Realisation of gain on hedging instrument

The cumulative gain of $18,387,097 recognised in equity:

- Is transferred to the income statements as the asset is used, i.e. over the asset's useful life: or
- 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.
- Hedge accounting is permitted in certain circumstances, provided the hedging 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 insturments

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 sensitity 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

4.9 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.

REINFORCEMENT QUESTIONS

QUESTION ONE (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:

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)

QUESTION TWO (ACCA)

(a) During the last decade it has not been unusual for the premium paid to acquire control of a business to be greater than the fair value of its tangible net assets. This increase in the relative balance sheet proportions of intangible assets has made the accounting practices for them all the more important. During the same period many companies have spent a great deal of money internally developing new intangible assets such as software and brands. IAS 38 'Intangible Assets' was issued in September 1998 and prescribes the accounting treatment for intangible assets.
Required:
In accordance with IAS 38, discuss whether intangible assets should be recognised, and if so how they should be initially recorded and subsequently amortised in the following circumstances:
– when they are purchased separately from other assets;
– when they are obtained as part of acquiring the whole of a business; and
– when they are developed internally. (10 marks)

Note: your answer should consider goodwill separately from other intangibles.

(b) Dexterity is a public listed company. It has been considering the accounting treatment of its intangible assets and has asked for your opinion on how the matters below should be treated in its financial statements for the year to 31 March 2004.
(i) On 1 October 2003 Dexterity acquired Temerity, a small company that specialises in pharmaceutical drug research and development. The purchase consideration was by way of a share exchange and valued at Ksh.35 million. The fair value of Temerity's net assets was Ksh.15 million (excluding any items referred to below).

Temerity owns a patent for an established successful drug that has a remaining life of 8 years. A firm of specialist advisors, Leadbrand, has estimated the current value of this patent to be Ksh.10 million, however the company is awaiting the outcome of clinical trials where the drug has been tested to treat a different illness.

If the trials are successful, the value of the drug is then estimated to be Ksh.15 million. Also included in thecompany's balance sheet is Ksh.2 million for medical research that has been conducted on behalf of a client.

(4 marks)

(ii) Dexterity has developed and patented a new drug which has been approved for clinical use. The costs of developing the drug were Ksh.12 million. Based on early assessments of its sales success, Leadbrand have estimated its market value at Ksh.20 million. (3 marks)

(iii) Dexterity's manufacturing facilities have recently received a favourable inspection by government medical scientists. As a result of this the company has been granted an exclusive five-year licence to manufacture and distribute a new vaccine. Although the licence had no direct cost to Dexterity, its directors feel its granting is a reflection of the company's standing and have asked Leadbrand to value the licence. Accordingly they have placed a value of Ksh.10 million on it. (3 marks)

(iv) In the current accounting period, Dexterity has spent Ksh.3 million sending its staff on specialist training courses. Whilst these courses have been expensive, they have led to a marked improvement in production quality and staff now needs less supervision. This in turn has led to an increase in revenue and cost reductions. The directors of Dexterity believe these benefits will continue for at least three years and wish to treat the training costs as an asset. (2 marks)

(v) In December 2003, Dexterity paid Ksh.5 million for a television advertising campaign for its products that will run for 6 months from 1 January 2004 to 30 June 2004. The directors believe that increased sales as a result of the publicity will continue for two years from the start of the advertisements. (3 marks)

Required:

Explain how the directors of Dexterity should treat the above items in the financial statements for the year to 31 March 2004. (15 marks as indicated)

Note: The values given by Leadbrand can be taken as being reliable measurements. You are not required to consider depreciation aspects.

QUESTION THREE (ACCA)

IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' was issued in 1998. The Standard sets out the principles of accounting for these items and clarifies when provisions should and should not be made. Prior to its issue, the inappropriate use of provisions had been an area where companies had been accused of manipulating the financial statements and of creative accounting.

Required:

(a) Describe the nature of provisions and the accounting requirements for them contained in IAS 37. (6 marks)

(b) Explain why there is a need for an accounting standard in this area. Illustrate your answer with three practical examples of how the standard addresses controversial issues. (6 marks)

(c) Bodyline sells sports goods and clothing through a chain of retail outlets. It offers customers a full refund facility for any goods returned within 28 days of their purchase provided they are unused and in their original packaging. In addition, all goods carry a warranty against manufacturing defects for 12 months from their date of purchase. For most goods the manufacturer underwrites this warranty such that Bodyline is credited with the cost of the goods that are returned as faulty. Goods purchased from one manufacturer, Header, are sold to Bodyline at a negotiated discount which is designed to compensate Bodyline for manufacturing defects. No refunds are given by Header, thus Bodyline has to bear the cost of any manufacturing faults of these goods.

Bodyline makes a uniform mark up on cost of 25% on all goods it sells, except for those supplied from Header on which it makes a mark up on cost of 40%. Sales of goods manufactured by Header consistently account for 20% of all Bodyline's sales.

Sales in the last 28 days of the trading year to 30 September 2003 were $1,750,000. Past trends reliably indicate that 10% of all goods are returned under the 28-day return facility. These are not faulty goods. Of these 70% are later resold at the normal selling price and the remaining 30% are sold as 'sale' items at half the normal retail price.

In addition to the above expected returns, an estimated $160,000 (at selling price) of the goods sold during the year will have manufacturing defects and have yet to be returned by customers. Goods returned as faulty have no resale value.

Required:

Describe the nature of the above warranty/return facilities and calculate the provision Bodyline is required to make at 30 September 2003:

(i) for goods subject to the 28 day returns policy; and

(ii) for goods that are likely to be faulty. (8 marks)

(d) Rockbuster has recently purchased an item of earth moving plant at a total cost of $24 million. The plant has an estimated life of 10 years with no residual value, however its engine will need replacing after every 5,000 hours of use at an estimated cost of $7·5 million. The directors of Rockbuster intend to depreciate the plant at $2·4 million ($24 million/10 years) per annum and make a provision of $1,500 ($7·5 million/5,000 hours) per hour of use for the replacement of the engine.

Required:

Explain how the plant should be treated in accordance with International Accounting Standards and comment on the Directors' proposed treatment. (5 marks)

COMPREHENSIVE ASSIGNMENT NO.2

TO BE SUBMITTED AFTER LESSON 4
To be carried out under examiation conditions and sent to the Distance Learning Administrator for marking by Strathmore University.

TIME ALLOWED: 3 HOURS. ATTEMPT ANY FIVE QUESTIONS

QUESTION ONE

M & I Bank Limited has its head office situated on "the hill" to the South West downtown Nairobi. The piece of land of which the building is situated is freehold. The land cost Sh.10 million on 1 July 1989. The building on this piece of land was erected at a cost of Sh.100 million and was completed in June 1991. M & I Bank Limited moved its head office into the building during June 1991, and occupied the whole building. The board of directors estimated that the useful life of the building was 50 years with effect from 1 July 1991. They estimated that the residual value of the building was nil. They decided to have depreciation charged on the straight –line method.

On 1 July 2000 M & I Bank Limited purchased the leasehold of a plot of land in downtown Nairobi. The lease cost of Sh.102 million was for a period of 51 years. Between 1 July 2000 and 30 June 2001, a building was erected on this land at a cost of Sh.300 million. Initially it was planned that a branch of the bank would be situated in the building but this was thought inappropriate. As result, it was decided that the whole building was to be rented out. The estimated useful life of this building was also 50 years and the residual value nil. M & I Bank Limited have found it difficult to find tenants to occupy the building. Income and expenses in relation to this building are as follows (these figures are in the ledger but are not yet reflected in the financial statements):

Year ended 30 June	**2002 sh million**	**2003 sh million**
Rental income receivable	24	54
Direct operating expenses including repairs and Maintenance for floors rented out	(6)	(12)
Direct operating expensed including repairs and maintenance for empty floors	(6)	(5)
Total direct operating expenses	(12)	(17)
Net income from investment property	(12)	37

M & I Bank limited has always used the benchmark treatment for owner occupied under IAS 16 (property, plant and equipment) and the cost model for investment properties under IAS 40 (investment properties) however the directors were concerned about the fair values of the head office building and land the buildings in downtown Nairobi, in case any impertinent losses needed to be provided for under IAS 36 (impairment assets) in the year ended 30 June 2002. As at 30 June 2002, the fair value of the head office land was Sh.50 million and the fair value of the head office building was Sh.468 million – there was no change in the estimated useful life. The fair value of the building in downtown Nairobi at 30 June 2002 was Sh.310 million. Kysons, registered valuers and estate agents carried out this valuation. The directors had Kysons repeat the valuation of the building in downtown Nairobi in June 2003. The fair value at 30 June 2003 will be Sh.318 million.

The directors decide to change the accounting policies in relation to owner-occupied property and investment property, from the benchmark treatment and the cost model to the allowed alternative treatment and the fair value model, respectively. They decide that an adjustment should be made to

the opening balance of the retained earnings for the earliest period presented in the accounts to 30 June 2003. The depreciation charge of the year ended 30 June 2002 will not change for the head office building. The directors think that the new accounting policies will result in a more appropriate presentation of events in the financial statements. The statement of changes in equity should reflect the fact that some of the revaluation surplus is realized as the asset is used by the enterprise.

Required:

(a). Show the necessary journal entries required to finalize the accounts for the year ending 30 June 2003, taking into account the changes in the accounting policies. Show the prior period adjustments separately. (7 marks)

(b). Show extracts from the balance sheet giving the figures as at 30 June 2002 and 30 June 2003 for land, buildings, revaluation reserve and deferred taxation. The rate of tax on income is 30% and on capital gains is nil. (8 marks)

(c). Show extracts from the income statement that must be disclosed to ensure that the disclosure requirements of the International Financial Reporting Standards are complied with. (5 marks)

(Total: 20 marks)

QUESTION TWO

ZDC Ltd. acquired 40% of the ordinary shares of BSL Ltd. on 1 January 1999 for Sh.210 million when the credit balance on the profit and loss account of BSL Ltd. was Sh.100 million.

On 1 July 2002, the directors of ZDC Ltd. acquired 90% of the ordinary shares of ADL Ltd. The purchase consideration was settled by the issue of 24 million ordinary shares of ZDC Ltd. which have a par value of Sh.20 but had a market value of Sh.32.50 as at 1 July 2002.

The financial statements of the three companies for the financial year ended 31 December 2002 are provided below:

	Profit and loss account for the year ended 31 December 2002		
	ZDC Ltd. Sh.'million'	**ADL Ltd. Sh.'million'**	**BSL Ltd. Sh.'million'**
Sales	4,500	3,000	2,000
Cost of sales	(3,325)	(2,400)	(1,600)
Gross profit	1,175	600	400
Dividend received	12	-	-
	1,187	600	400
Operating expenses	(595)	(330)	(250)
Operating profit	592	270	150
Finance cost	(50)	-	-
Profit before tax	542	270	150
Corporation tax	(205)	(100)	(58)
Profit after tax	337	s170	92
Dividend paid	(100)	(50)	(30)
Dividend proposed	(100)	(50)	(30)
	(200)	(100)	(60)

Retained profit	137	29	32

	Balance Sheet as at 31 December 2002		
	ZDC Ltd. Sh.'million'	ADL Ltd. Sh.'million'	BSL Ltd. Sh.'million'
Assets:			
Fixed assets	1,450	700	450
Investment in BSL Ltd. at cost	210		
Current assets	700	360	245
	2,360	1,060	695
Equity and liabilities:			
Share capital	1,000	500	300
Profit and loss account balance	545	310	212
	1,545	810	512
Loans	500		
Current liabilities	315	250	183
	2,360	1,060	695

Additional information:

1. On 1 January 2002, ZDC Ltd., held stock of goods purchased from ADL Ltd. during the year ended 31 December 2001 at a cost of Sh.25 million ADL Ltd. had made a profit of 20% on the selling price of the goods. None of the goods were included in the closing stock of ZDC Ltd. as at 31 December 2002.
2. During the year ended 31 December 2002, ADL Ltd. made total sales of Sh.600 million to ZDC Ltd. The sales were made at a profit of 25% on cost of and one-fifth of the goods were included in the closing stock of ZDC Ltd. as at 31 December 2002. The sales were made evenly during the year.
3. The fair values of the fixed assets of ADL Ltd. as at 1 July 2002 were the same as the net book values.
4. As at 31 December 2002, ZDC Ltd. had in its closing stock, goods worth Sh.50 million which were purchased from BSL Ltd. BSL Ltd. had made a profit of Sh.10 million on this transaction.
   Goodwill or premium on acquisition is amortized on a straight line basis over a five year period.
5. ZDC Ltd. does not accrue its share of proposed dividends from group companies.
6. The trading results of ADL Ltd. accrued evenly during the year
7. ZDC Ltd. has not accounted for its cost of investment in ADL Ltd.

Required:

(a). The consolidated profit and loss account of ZDC Ltd. and its subsidiary ADL for the year ended 31 December 2002 using the:

(i). Acquisition method (10 marks)

(b). The consolidated balance sheet of ZDC Ltd. and its subsidiary ADL Ltd. as at 31 December 2002 using the:

(i). Acquisition method (10 marks)

(Total: 20 marks)

QUESTION THREE

ABC Ltd is an enterprise that regularly purchases new subsidiaries.On 30th June 2004, the enterprise acquired all the equity shares of XYZ Ltd for a cash payment of Shs 260 million.The net assets of XYZ Ltd on 30th June 2004 were Shs 180 Million and no fair value adjustments were necessary upon consolidation of XYZ Ltd for the first time.

On 31st December 2004, ABC Ltd carried out a review of the goodwill on consolidation of XYZ Ltd for evidence of impairment.The review was carried ot despite the fact that there were no obvious indications of adverse trading conditions for XYZ Ltd.The review involved allocating the net assets of XYZ Ltd into three cash generating units and computing the value in use of each unit.The carrying values of the individual units before any impairment adjustments are given below.

	Unit A Shs M	Unit B Shs M	Unit C Shs M
Patents	5	-	-
Property,plant and equipment	60	30	40
Net Current Assets	20	25	20
	85	55	60
Value in use of unit	72	60	65

It was not possible to meaningfully allocate the goodwill on consolidation to the individual cash-generating units, but all other net assets of XYZ Ltd are allocated in the table shown above.The patents of XYZ Ltd have no ascertainable market value but all the current assets have a market value that is above carrying value.The value in use of XYZ Ltd as a single cash-generating unit at 31st December 2004 is Shs 205 million.

Required:

a) Explain what is meant by a cash generating unit (2 Marks)

b) Explain why it is necessary to review the goodwill on consolidation of XYZ Ltd for impairment at 31st December 2004 (3 Marks)

c) Demonstrate how the impairment loss in unit A will affect the carrying value of the net assets of unit A in the consolidated financial statement of ABC Ltd (5 Marks)

d) Explain and calculate the effect of the impairment review on the carrying value of the goodwill on consolidation of ABC Ltd at 31st December 2004. (5 Marks)

(Total: 15 Marks)

QUESTION FOUR

Chuma Structures Limited (CSL) commenced business on 1 November 1993 and makes up its accounts to 31 October each year. In its accounting policy note, CSL,. states that it depreciates its property, plant and equipment on the straight line method, that it revalues all of its property, plant and equipment every three years and that any revaluation surplus realized (either as the asset is being used or on disposal) is transferred to distributable reserves as a movement on reserves.

The directors of CSL had Myad Lasika, Registered Valuers; revalue the property, plant and equipment of the company as at 31 October 1999. A summary of the position at that date is as follows:

Asset	Date of purchase	Original Cost Sh. million	Original Residual value Sh. million	Useful Life at Purchase: Years	Revaluation Amount 31 Oct. 1996 Sh. million	Residual Value 31 Oct. 1996 Sh. million	Revaluation Amount 31 Oct. 1999 Sh. million	Residual Value 31 Oct. 1999 Sh. million	Tax Base 31 Oct.1999 Sh. million
Freehold Land	1 Nov. 92	60	N/A	N/A	120	N/A	180	N/A	NIL
Factory Building	1 Nov. 93	200	40	40	400	67	538	79	68
Machinery:									
Items A	1 Nov. 93	180	NIL	20	340	NIL	212	NIL	32
Items B	2 Nov. 98	120	20	10	N/A	N/A	132	24	42
Items C	2 Nov. 98	160	NIL	10	N/A	N/A	146	NIL	56
Vehicles	2 Nov. 98	40	NIL	5	N/A	N/A	35	NIL	25
		760					1,243		

Additional information:

1. CSL had a new factory in the course of construction as at 31 October 1999. This new factory was contiguous to the present factory. From the time building commenced (1 January 1999) to 31 October 1999, direct material and direct labour costs capitalised were Sh.240 million. Production overheads to be capitalised were Sh.60 million, which included depreciation of Sh.2 million and Sh.3 million from the factory and Machinery Items A respectively. CSL was committed to spending a further Sh.100 million on this factory in the year to 31 October 2000 – the expected date of completion of the factory was 1 June 2000.
2. On 2 November 1998, CSL had sold vehicles for Sh.5 million which had cost Sh.20 million on 1 November 1993, and which had been revalued at market value of Sh.12 million on 31 October 1996. These vehicles had a useful life of 5 years and a residual value of nil. The entire class of vehicles had been replaced on 2 November 1998.
3. CSL has four separate classes for property, plant and equipment. Land, factory building, machinery and vehicles.
4. CSL's directors want depreciation to be charged for the year prior to any revaluation being effected.
5. The rate of corporation tax for year of income 1999 is $32^{1/20}\%$. For the foreseeable future it will be 30%
6. CSL has not accounted for deferred tax in the past but wishes to do so in the financial statements for the year ended 31 October 1999. No prior period adjustment should be made in relation to deferred tax.

7. The review of the useful lives of all items of property, plant and equipment as at 31 October 1999 showed that expectations were not different from previous estimates. No impairment losses are foreseen.

Required:

(a) Prepare the Land, Buildings (a separate account should be prepared for the new factory building), Machinery, Vehicles, Vehicles Disposal, Depreciation, Revaluation Reserve and Deferred Tax Accounts for the year to 31 October 1999. (14 marks)

(b) Prepare the property, plant and equipment movement schedule to be included in the financial statements for the year ended 31 October 1999, giving disclosure of all the items required by IAS 16 and Kenya Companies Act. (6 marks)

(Total: 20 marks)

QUESTION FIVE

You have been asked to assist the financial accountant of Myriad in preparing the company.s financial statements for the year to 30 September 2001. The financial accountant has asked for your advice in the following matters:

(a) Myriad has recently adopted the use of International Accounting Standards and a review of its existing policy of prudently writing off of all development expenditure is no longer considered appropriate under IAS 38 .Intangible Assets.. The new policy, to be first applied for the financial statements to 30 September 2001, is to recognize development costs as an intangible asset where they comply with the requirements of IAS 38. Amortisation of all .qualifying development expenditure is on a straight-line basis over a four-year period (assuming a nil residual value). Recognised evelopment expenditure .qualifies. for amortisation when the project starts commercial production of the related product. The amount of recognised development expenditure, and the amount qualifying for amortisation each year is as follows:

	$000	**$000**
amount recognised amount qualifying		
as an asset for amortisation		
in the year to 30 September 1999	420	300
in the year to 30 September 2000	250	360
in the year to 30 September 2001	560	400
	1,230	1,060

No development costs were incurred by Myriad prior to 1999.
Changes in accounting policies should be accounted for under the benchmark treatment in IAS 8 .Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies..

Required:
(i) Explain the circumstances when a company should change its accounting policies; and (4 marks)
(ii) Prepare extracts of Myriad.s financial statements for the year to 30 September 2001 including the comparatives figure to reflect the change in accounting policy. (6 marks)
Note: ignore taxation.

(b) Myriad owns several properties which are revalued each year. Three of its properties are rented out under annual contracts. Details of these properties and their valuations are:

Property type/life	cost	value 30 September 2000	value 30 September 2001
	$000	$000	$000
A freehold 50 years	150	240	200
B freehold 50 years	120	180	145
C freehold 15 years	120	140	150

All three properties were acquired on 1 October 1999.The valuations of the properties are based on their age at the date of the valuation. Myriad.s policy is to carry all non-investment properties at cost. Annual amortisation, where appropriate, is based on the carrying value of assets at the beginning of the relevant period.

Property A is let to a subsidiary of Myriad on normal commercial terms. The other properties are let on normal commercial terms to companies not related to Myriad.

Myriad adopts the fair value model of accounting for investment properties in IAS 40 .Investment Properties., and the benchmark treatment for owner-occupied properties in IAS 16 .Property, Plant and Equipment..

Required:

(i) Describe the possible accounting treatments for investment properties under IAS 40 and explain why they may require a different accounting treatment to owner-occupied properties and (5 marks)

(ii) Prepare extracts of the consolidated financial statements of Myriad for the year to 30 September 2001 in respect of the above properties assuming the company adopts the fair value method in IAS 40. (5 marks)

(Total 20 marks)

LESSON FIVE

ACCOUNTING FOR TAX

CONTENTS

CONTENTS

5.1 Introduction
5.2 Corporation Tax
5.3 Deferred Tax

INSTRUCTIONS

- The required reading for this topic is as follows:
    - The International Accounting Standard No.12
    - Read the Study Text below
- Attempt reinforcing questions at the end of the lesson

5.1 INTRODUCTION

IAS 12 on Income Taxes deals with two main types of taxes;

(i) Corporation Tax
(ii) 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.

5.2 CORPORATION TAX

Corporation tax is the tax payable by a company as a result of generating profits from trading. 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. However 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 ass 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:

(i) Sh 1,100,000
(ii) Sh.900,000

(i) 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.
(ii) There is 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.

5.3 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

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 recognized 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 amounof equity in the same or different period, should be charged or credited to equity andnot 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 realized 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 recognize a deferred tax asset for all deductible temporary differences to the extent that it s probable that taxable profit will be available againstwhich 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 bass, or to realize 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 every one 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 (revised1996) '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 theses 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.

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.

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, 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
		Balance (1.1.83)	-
Bal (31.12.83) c/f	10,500	P & L A/c (31.9.83) (35% x 30,000)	10,500
	10,500		10,500
P & L A/c (1984)	10,500	Bal (1.1.84) b/f	10,500
Bal (31.12.84)	-		
	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

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

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 viz

  i. Full deferral
  ii. 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

- Under this method, originating timing differences are recorded at the rate of corporation tax ruling in the period in which the timing difference occured.
- 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
Cummulative 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 (50%)	(2,625)	(2,625)	1,313	1,313	1,313
20X2 – origin – 20X1	(4,594)			2,297	2,297
(45%) origin – 20X2 Tax rate adj. (negative – 5% x 2,625)	(3,500)	(8,094)	3,642	1,575	1,575
			(131)		
Deferred tax bal. (31.12.X2)		(10,719)	3,511	3,872	3,872
			4,824	5,185	5,185
20X3 (40%)					
- Reversal – 20X1					
- origin - 20X2	7,219			(3,465)	(3,610)
- origin - 20X3	(6,125)			2,756	2,756
Tax rate adj. (negative – 5% x 10,719)	(1,312)	(218)	87	525	525
			(536)		
Deferred Tax bal. (31.12.X3)		10,937	(449)	(184)	(329)
			4,375	5,001	4,856
20X4 (35%)					

- Reversal - 1992					
- origin - 20X3	9,625			(4,428)	(4,331)
Tax rate adj.	(2,297)	7,338	(2,568)	919	919
(negative – 5% x 10,937)					
			(547)		
		3,599	(3,115)	(3,509)	(3,412)
Deferred Tax bal. (31.12.X4)					1,444
			1,260	1,492	

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	20X1	Profit and Loss A/c	1,313
			1.1.X2	Balance b/f	1,313
31.12.X1	Bal c/d	4,824	20X2	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

2.5 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 carryforward 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 differnce 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)

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)

Taxable profit	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 (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

2.7 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.

REINFORCING QUESTIONS

QUESTION ONE

a) The original IAS 12 did not refer explicitly to fair value adjustments made on a business combination and did not require an enterprise to recognise a deferred tax liability in respect of asset revaluations. The revised IAS 12 " income taxes " now requires deferred tax adjustments for these items and classifies them as temporary differences.

Required:

Explain the reasons why IAS 12 (revised) requires companies to provide for deferred taxation on revaluations of assets and fair value adjustments on a business combination irrespective of the tax effect in the current accounting period. (6 marks)

b) Baobab Ltd was incorporated on 1 April 20X0. In the year ended 31 March 2001, the company made a profit before taxation of Sh. 10,000,000 (depreciation charged being Sh. 1,000,000). The company had made the following capital additions:

Plant	-	Sh. 4,800,000
Motor vehicles	-	Sh. 1,200,000

Corporation tax is chargeable at the rate of 30%. Capital deductions are computed at the rate of 25% per annum on written-down value.

The company has prepared capital expenditure budgets as at 31 March 2001 which reveal the following patterns:

	Capital allowance Sh. '000'	**Depreciation Sh. '000'**
Year to 31 March 2002	1,700	1,600
Year to 31 March 2003	2,300	1,900
Year to 31 march 2004	2,100	1,900
Year to 31 March 2005	1,500	2,100
Year to 31 March 2006	2,400	2,900
Year to 31 March 2007	2,500	2,000

From 1 April 2007, capital allowances are expected to exceed depreciation charges each year.

Required:

i) Compute the corporation tax payable for the year ended 31 March 2001. (2 marks)
ii) Compute the deferred tax charge for the year ended 31 March 2001 on:

Full-provision basis (5 marks)
Partial-provision basis (7 marks)

(Show the profit and loss account and balance sheet extracts with respect to the provisions under each method.) **(Total: 20 marks)**

QUESTION TWO

Kazuki Ltd wishes to ensure that its accounts are produced in accordance with tax effect accounting using the liability method and accounting for all timing differences; up to now, the company's accounts have not been prepared on this basis.

The published accounts for 20X4 and the draft accounts for 20X5 are shown below:

Profit and Loss Account for the year ended 30 November	20X4	20X5
	Sh'm'	Sh'm'
Profit/(loss)	(40)	160
Taxation:		
Provision for tax payable	**Nil**	**56**
	(40)	104
Dividends proposed	10	60
	(50)	44
Statement of retained profit:		
Brought forward for the year	340	290
	(50)	44
Carried forward	290	334

Balance Sheet as at 30 November	20X4	
	Sh'm'	Sh'm'
PPE (NBV)	300	260
Current assets	270	320
Current liabilities	180	146
	90	174
	390	434
Ordinary share capital	100	100
Profit and Loss account	290	334
	390	434

You have established the following:

1) Kazuki Ltd had purchased an item of fixed assets on 1 December 20X2 for Sh. 100 million which was entirely deductible for tax purposes; Kazuki carries the item in fixed assets and is depreciating it at 20% per annum on cost on the straight line basis.
2) Kazuki had made a general provision for bad debts of Sh. 10 million in the year ended 30 November 20X4 because the financial position of a number of its customers was uncertain at that time. Subsequently, with the strengthening of the Kenya Shilling and a quickening of economic activity the provision was not required and was written back in the year ended 30 November 20X5. At 30 November 20X4 it was thought that provision would be needed for at least 3 years into the future.
3) Kazuki provides for tax payable on the current year basis. It should be assumed that for all years after 30 November 20X3, 50% of the tax is payable after 6 months of the accounting year, a further 25% after a further 3 months and the last 25% after the final 3 months.
4) The rate of corporation tax was 40% for the year of income 20X4 and 35% for the year of income 20X5; the rate is predicted to be 35% for the foreseeable future. At 30 November 20X4 it had bee expected that the rate for 20X5 would be 40%.
5) Kazuki has no permanent differences; the only timing differences are those in the accounts or notes.

Required:

a) Prepare the Profit and Loss Account for the year ended 30 November 20X5 and the Balance Sheet as at that date, together with corresponding figures for the preceding year, for Kazuki in accordance with IAS 10: Accounting for Income Tax and IAS 12: Extraordinary and Prior Period Items, using the full provision method. The current portion of the Deferred Tax Balance should be show appropriately. (16 marks)

b) Write up the Corporations Tax Account and the Deferred Tax Account for the two years ended 30 November 20X4 and 20X5. (4 marks)

(Total: 20 marks)

(Dec 1995)

QUESTION THREE

a) In relation to IAS 12 (Revised) on Income Taxes:

i) Discuss the arguments in favour of and against providing for deferred tax on revaluation of PPE. (3 marks)

ii) Identify the merits and demerits of the full provision method of deferred taxation (4 marks)

b) Mauzo Ltd is a plastic toy manufacturer. Its toy sales have been adversely affected by imports and it has been changing towards the supply of plastic office equipment. Profits are expected to continue to fall for the next four years when they are expected to stabilize at the year 20X0 level. You are also informed that there will be a regular programme of plant renewal.

The following information is available:

Year ended 30 April	Profit before depreciation and tax	Capital Allowances	Depreciation
	Sh. '000'	Sh. '000'	Sh. '000'
19X7	6,250	2,000	400
19X8	6,000	400	800
19X9	5,500	400	1,200
20X0	5,000	2,800	800

Assume a corporation tax rat of 33%. On 1 March 19X6 there was a nil balance on the deferred tax account.

Required:

Profit and Loss Account and balance sheet extracts for corporation tax and deferred taxation for the four years 19X7 – 20X0 using the following methods:

i) Flow-through
ii) Full-provision
iii) Partial provision (13 marks)

(Total: 20 marks)

LESSON SIX

ACCOUNTING FOR EMPLOYEE BENEFITS

CONTENTS

INTRODUCTION
EMPLOYEE BENEFITS
REINFORCING QUESTIONS

INSTRUCTIONS:

- Carefully study the following:
    - IAS 19 Employee benefits
    - The study text below
- Answer the reinforcement questions at the end of the chapter and compare your answers with those given at Lesson 9

6.1 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.

6.2 The 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.

6.3 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.

a) When the cost of employee benefits should be recognised as a liability or an expense.
b) The amount of the liability or expense that should be recognised.

As a basic rule, the standard states the following:

a) 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.

b) 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.

6.4 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.

1. **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.

2. **Post-employment benefits,**

   E.g. Pensions and post employment medical care

3. **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.

4. **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.

6.5 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 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).

6.6 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.

a) 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.

b) 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.

- It may be necessary to rely on actuarial assumptions about what the future amount of benefits payable will be.

- 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.

SHORT TERM EMPLOYEE BENEFITS

Accounting for short-term employee benefits is fairly straightforward, because there **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 20x9.

Question sick leave

Puma Co has 100 employees. Each is entitled to five working days of paid sick leave for each year, and unused sick leave can be carried forward for one year. Sick leave is taken on a LIFO basis (i.e. firstly out of the current year's entitlement and then out of any balance brought forward).

As at 31 December 20 x 8, the average unused entitlement is two days per employee. Puma Co. expects (based on past experience which is expected to continue) that 92 employees will take five days or less sick leave in 20 x 9, the remaining eight employees will take an average of 61/2 days each.

Required

State the required accounting for sick leave.

Answer

Puma Co expects to pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20 x 8, i.e. 11/2 days x 8 employees. Puma Co should recognise a liability equal to 12days of sick pay.

2.4 **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.

2.5 **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 employees if none have during the year. Sema co estimates that this will be reduced staff turnover to 2.5% in 2009.

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.

POST EMPLOYMENT BENEFITS

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. 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.

There are two types or categories of post –employment benefit plan, as given in the definition in section 1 above.

a) **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.

b) **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.

a) **Funding** a defined benefit plan, i.e. paying contributions into the plan.

b) **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

These were defined above. 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 infact 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.

- 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.

- Employer b 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.

- There are two categories of **post-retirements benefits:**
  - Defined contribution schemes
  - Defined benefit scheme.

- **Defined contribution schemes** provide benefits commensurate with the fund available to produce them.
- **Defined benefit schemes** provide promised benefits and so contributions are based on estimates of how the fund will perform.
- **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.

1. **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.

a) **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.

b) Any liability for **unpaid contributions** that are due as at the end of the period should be recognised as a **liability** (accrued expense).
c) 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.

2. **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 the 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.** The present value

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 upto 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:
   (i) Any unrecognised actuarial losses and past service costs
   (ii) Any refunds expected from the plan
   (iii) 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.

a) The **current service cost**
b) **Interest**
c) The **expected return on any plan assets**
d) The actuarial gains or losses, to the extent that they are recognised
e) **Past service cost** to the extent that is recognised
f) 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.

a) **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.
b) **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.

- **Actual events** (e.g. Employee turnover, salary increases) differ from the actuarial assumptions that were made to estimate the defined benefit obligations.

- **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).

- **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:

- For all its defined benefits plans.
- 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:

a) The **expected return** on the plan assets, which is an actuarial assumption, and
b) 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 were 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	
For 6months at 5% (i.e. 10.25% annually compounded every 6months)	15,000
	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:

a) 10% x Sh.1,500,000 and
b) 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.

a) 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.

b) 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.

Exam focus Point

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.

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.

Question (comprehensive)

For the sake of simplicity and clarity, all transactions are assumed to occur at the year end.

The following data applies to the post employment defined benefits compensation scheme of an entity.

Expected return on plan assets: 12% (each year)
Discount rate: 10% (each year)
Present value of obligation at start of 20 x 2: Sh.1m
Market value of plan assets at start of 20x21: Sh.1m

The following figures are relevant.

	20x2 Sh.'000	20x3 Sh.'000	20x4 Sh.'000
Current service cost	140	150	150
Benefits paid out	120	140	150
Contributions paid by entity	110	120	120
Present value obligation at year end	1,200	1,600	1,700
Market value of plan assets at year end	1,250	1,450	1,610

Required

Show how the reporting entity should account for this defined benefit plan in each of years 20x2, 20x3 and 20x4.

Answer

The actuarial gain or loss is established as a balancing figure in the calculations, as follows.
Present value of obligation

		20x2 Sh.'000	20x3 Sh.'000	20x4 Sh.'000
PV of obligation at start of year	1,000	1,200	1,600	
Interest cost (10%)		100	120	160
Current service cost		140	150	150
Benefits paid		(120)	(140)	(150)
Actuarial (gain)/loss on obligation: balancing fig		80	270	(60)
		1,200	1,600	1,700

Market value of plan assets

	20x2 Sh.'000	20x3 Sh.'000	20x4 Sh.'000
Market value of plan assets at start of year	1,000	1,250	1,450
Expected return on plan assets (12%)	120	150	174
Contributions	110	120	120
Benefits paid	(120)	(140)	(150)
Actuarial gain/ (loss) on plan assets: balancing fig	40	70	16
	1,250	1,450	1,610

10% corridor

The next step is to determine whether the actuarial gains or losses exceed the tolerance limit of the 10% corridor. The 10% limit is 10% of the higher amount of the PV of the obligation (before deducting the plan assets) and the plan assets.

		20x2 Sh.'000		20x3 Sh.'000		20x4 Sh.'000
Limit of corridor		125		160		170
Unrecognised actuarial gains/(losses)				(40)		(160)
Actuarial gain/(loss) for year: Obligation	(80)		(270)		60	
Sub-total		40		70		16
Actuarial gain/(loss) realised		(40)		(240)		(84)
Unrecognised actuarial gains/(losses)		-		(80)		-
		(40)		(160)		(84)

In the balance sheet, the liability that is recognised is calculated as follows

	20x2 Sh.'000	20x3 Sh.'000	20x4 Sh.'000
Present value of obligation	1,200	1,600	1,700
Market value of plan assets	1,250	1,450	1,610
	(50)	150	90
Unrecognised actuarial gains/(losses)	(40)	(160)	(84)
Liability/ (asset) in balance sheet	(90)	(10)	6

The income statement will recognise the following.

	20x2 Sh.'000	20x3 Sh.'000	20x4 Sh.'000
Current service cost	40	150	150
Interest cost	100	120	160
Expected return on plan assets	(120)	(150)	(174)
Net actuarial (gain)/loss recognised in the year	-	80	
Expense recognised in the income statement	120	200	136

REINFORCEMENT QUESTION

Savage, a public limited company, operates a funded defined benefit plan for its employees. The plan provides a pension of 1% of the final salary for each year of service. The cost for the year is determined using the projected unit credit method. This reflects service rendered to the dates of valuation of the plan and incorporates actuarial assumptions primarily regarding discount rates, which are based on the market yields of high quality corporate bonds.

The expected average remaining working lives of employees is twelve years.

The directors have provided the following information about the defined benefit plan for the current year (year ended 31 October 2005):

(i) the actuarial cost of providing benefits in respect of employees' service for the year to 31 October 2005 was $40 million. This is the present value of the pension benefits earned by the employees in the year.

(ii) The pension benefits paid to former employees in the year were $42 million.

(iii) Savage should have paid contributions to the fund of $28 million. Because of cash flow problems $8 million of this amount had not been paid at the financial year end of 31 October 2005.

(iv) The present value of the obligation to provide benefits to current and former employees was $3,000 million at 31 October 2004 and $3,375 million at 31 October 2005.

(v) The fair value of the plan assets was $2,900 million at 31 October 2004 and $3,170 million (including the contributions owed by Savage) at 31 October 2005. The actuarial gains recognised at 31 October 2004 were $336 million.

With effect from 1 November 2004, the company had amended the plan so that the employees were now provided with an increased pension entitlement. The benefits became vested immediately and the actuaries computed that the present value of the cost of these benefits at 1 November 2004 was $125 million. The discount rates and expected rates of return on the plan assets were as follows:

	31 October 2004 31	October 2005
Discount rate	6%	7%
Expected rate of return on plan assets	8%	9%

The company has recognised actuarial gains and losses in profit or loss up to 31 October 2004 but now wishes to recognise such gains and losses outside profit or loss in a 'statement of recognised income and expense'.

Required:

(a) Show the amounts which will be recognised in the Balance Sheet, Income Statement and the Statement of Recognised Income and Expense of Savage for the year ended 31 October 2005 under IAS19 'Employee Benefits', and the movement in the net liability in the balance sheet. (Your calculations should show the changes in the present value of the obligation and the fair value of the plan assets during the year. Ignore any deferred taxation effects and assume that pension benefits and the contributions paid were settled at 31 October 2005.) (21 marks)

(b) Explain how the non-payment of contributions and the change in the pension benefits should be treated in the financial statements of Savage for the year ended 31 October 2005. (4 marks)

COMPREHENSIVE ASSIGNMENT NO.3

TO BE SUBMITTED AFTER LESSON 6

To be carried out under examiation conditions and sent to the Distance Learning Administrator for marking by Strathmore University.

TIME ALLOWED: 3 HOURS ATTEMPT ALL FIVE QUESTIONS

QUESTION ONE

The following draft balance sheets relate to Rod, a public limited company, Reel, a public limited company, and Line, a public limited company, as at 30 November 2002:

	Rod	Reel	Line
	$m	$m	$m
Non-current Assets			
Tangible non-current assets – cost/valuation	1,230	505	256
Investment in Reel	640		
Investment in Line	160	100	
	2,030	605	256
Current Assets			
Inventory	300	135	65
Trade receivables	240	105	49
Cash at bank and in hand	90	50	80
	630	290	194
Total assets	2,660	895	450
Capital and reserves			
Called up share capital	1,500	500	200
Share premium account	300	100	50
Revaluation Reserve			70
Accumulated Reserves	625	200	60
	2,425	800	380
Non-current liabilities	135	25	20
Current liabilities	100	70	50
Total equity and liabilities	2,660	895	450

The following information is relevant to the preparation of the group financial statements:

(i) Rod had acquired eighty per cent of the ordinary share capital of Reel on 1 December 1999 when the accumulated reserves were $100 million. The fair value of the net assets of Reel was $710 million at 1 December 1999. Any fair value adjustment related to net current assets and these net current assets had been realised by 30 November 2002. There had been no new issues of shares in the group since the current group structure was created.

(ii) Rod and Reel had acquired their holdings in Line on the same date as part of an attempt to mask the trueownership of Line. Rod acquired forty per cent and Reel acquired twenty-five per cent of the ordinary share capital of Line on 1 December 2000. The accumulated reserves of Line on that date were $50 million and those of Reel were $150 million. There was no revaluation reserve in the books of Line on 1 December 2000. The fair values of the net assets of Line at 1 December 2000 were not materially different from their carrying values.

(iii) The group operates in the pharmaceutical industry and incurs a significant amount of expenditure on the development of products. These costs were formerly written off to the income statement as incurred but thenreinstated when the related products were brought into commercial

use. The reinstated costs are shown as 'Development Inventory'. The costs do not meet the criteria in IAS38 'Intangible Assets' for classification as intangibles and it is unlikely that the net cash inflows from these products will be in excess of the development costs. In the current year, Reel has included $20 million of these costs in inventory. Of these costs $5 million relates to expenditure on a product written off in periods prior to 1 December 1999. Commercial sales of this product had commenced during the current period. The accountant now wishes to ensure that the financial statements comply strictly with IAS/IFRS as regards this matter.

(iv) Reel had purchased a significant amount of new production equipment during the year. The cost before trade discount of this equipment was $50 million. The trade discount of $6 million was taken to the income statement. Depreciation is charged on the straight line basis over a six year period.

2

(v) The policy of the group is now to state tangible non-current assets at depreciated historical cost. The group changed from the allowed alternative treatment to the benchmark treatment under IAS16 'Property, Plant and Equipment' in the year ended 30 November 2002 and restated all of its tangible non-current assets to historical cost in that year except for the tangible non-current assets of Line which had been revalued by the directors of Line on 1 December 2001. The values were incorporated in the financial records creating a revaluation reserve of $70 million. The tangible non-current assets of Line were originally purchased on 1 December 2000 at a cost of $300 million. The assets are depreciated over six years on the straight line basis. The group does not make an annual transfer from revaluation reserves to the accumulated reserve in respect of the excess depreciation charged on revalued tangible non-current assets. There were no additions or disposals of the tangible non-current assets of Line for the two years ended 30 November 2002.

(vi) During the year the directors of Rod decided to form a defined benefit pension scheme for the employees of the holding company and contributed cash to it of $100 million. The following details relate to the scheme at 30 November 2002:

	$m
Present value of obligation	130
Fair value of plan assets	125
Current service cost	110
Interest cost – scheme liabilities	20
Expected return on pension scheme assets	10

The only entry in the financial statements made to date is in respect of the cash contribution which has been included in Rod's trade receivables. The directors have been uncertain as how to deal with the above pension scheme in the consolidated financial statements because of the significance of the potential increase in the charge to the income statement relating to the pension scheme. They wish to immediately recognise any actuarial gain.

(vii) Goodwill is written off over four years on the straight line basis.

Required:

(a) Show how the defined benefit pension scheme should be dealt with in the consolidated financial statements. (4 marks)

(b) Prepare a consolidated balance sheet of the Rod Group for the year ended 30 November 2002 in accordance with the standards of the International Accounting Standards Board. (21 marks)

(25 marks)

QUESTION TWO

(a) IAS 12 (revised) "Income Taxes" requires an enterprise to provide for deferred tax in full for all deferred tax liabilities with only limited expectations. The original IAS 12, and the equivalent Kenyan Accounting Standard, allowed an enterprise not to recognize deferred tax

assets and liabilities where there was reasonable evidence that timing differences would not reverse for some considerable period ahead; this was known as the partial provision method.

The original IAS 12 did not refer explicitly to fair value adjustments made on a business combination and did not require an enterprise to recognize a deferred tax liability in respect of asset revaluations. The revised IAS 12 now requires deferred tax adjustments for these items and classifies them as temporary differences.

Required:

(i) Explain why the IASC decided to require recognition of the deferred tax liability for all temporary differences (with certain exceptions) rather than allowing the partial provision method. (5 marks)

(ii) Discuss the reasons why IAS 12 (revised) requires enterprises to provide for deferred taxation on revaluations of assets and fair value adjustments on business combination. (5 marks)

(b) K Limited has the following balance sheet and tax bases at 30 June 2000, before providing for any deferred tax in the year to 30 June 2000.

	Carrying values		**Tax bases**	
	Sh. '000'	**Sh. '000'**	**Sh. '000'**	**Sh. '000'**
Non-current assets				
Buildings (Factory)		100,500		22,500
Plant and equipment		156,000		39,000
Investment in M Ltd.: cost		1,977		1,977
Long-term quoted investments		198,000		198,000
		456,477		
Current Assets	45,000		45,000	
Current liabilities.				
Trade payables	(40,500)		(40,500)	
Provision for repairs	(900)		(Nil)	
	(41,400)	3,600		
		460,077		
Capital and reserves.				
Equity capital		30,000		30,000
Revaluation reserve		73,500		-
Retained profit		298,047		-
Shareholders' funds		401,547		
Non-current liabilities				
Long-term loan	30,000		33,000	
Deferred tax (bal. b/l)	27,030		27,030	
		57,030		
Deferred income:				
Grant from World Bank		1,500		
		460,077		

1. K Limited acquired 100% of the ordinary share capital of M limited on 30 June 2000. The net assets of M limited as on this day were as follows:

	Fair value Sh. '000'	Carrying value Sh. '000'	Tax value Sh. '000'
Buildings (Factory)	1,500	900	300
Plant and equipment	120	90	45
Inventory	372	342	342
Trade receivables	330	330	330
Current liabilities	(495)	(495)	(315)
	1,827	1,167	702

M limited does not carry a deferred tax liability in its accounts.

2. K Limited's director decided to revalue K Limited's buildings at Sh.150 million and the plant and equipment to Sh.180 million, investments were not to be revalued. K Limited's buildings had cost Sh.135 million and the plant and machinery Sh.210 million.
3. The tax rate had changed from 35% to 30% in the current year.
4. During the year, the directors agreed to provide Sh.900,000 for future repairs to the buildings. The expense is allowable for tax when it is paid.
5. The grant from the World Bank is included as deferred income in the balance sheet and is not taxable.
6. Goodwill arising on acquisition is not an allowable expense for tax purposes. Since the subsidiary was acquired on 30 June 2000, no amortisation has been charged in the financial statements.
7. K Limited raised a long-term loan of Sh.33,000,000 during the year and recorded it net of transaction costs. The transaction costs of Sh.3,000,000 are allowable for tax in the year ended 30 June 2000.

Required:
Calculate the deferred tax expense for K Limited which would appear in the group financial statements under IAS 12 (revised) "Income Taxes" for the year ended 30 June 2000. (10 marks)

(Total: 20 marks)

QUESTION THREE

(a) Explain the meaning of the following terms as used in pension accounts
   (i) Funded schemes. (2 marks)
   (ii) Experience adjustments. (2 marks)

(b) Afya pensioners is a funded, non-contributory defined benefit scheme that was established by the management of Afya Food processors Limited in 1950. The directors have always expensed the company's contribution to the scheme in the period of contribution and also credited to the income statement of any period, any refunds made from the scheme during the period in question.

As a result of the above policy, material variations in costs and incomes of Afya Food Processors Limited have arisen in the past years. These worsened by any contribution holidays or redundancies of employees. In this year's audit, the auditors. Ujuzi and Associates, described the company's pension accounting policy as "inadequate" as the resulting accounts do not give a true and fair view of pension costs to the employer. The auditors have also pointed out that current policy can be used to manipulate the company's profit levels.

The auditors have suggested that either of two approaches (the accrued benefits or prospective benefits) be adopted the management in accounting for pension costs.

Required:

(i) Do you agree with the auditors positions? Why? (4 marks)
(ii) State and explain three reasons why there may be variations in the regular pension costs to the employer. (6 marks)
(iii) Briefly explain the two accounting approaches suggested by the auditor. What is their effect on the pension fund?(4 marks)
(iv) What would be the main objective of adopting an accounting standard, with respect to pension costs, for organisation like Afya Food Processors Limited? (2 marks)

(Total: 20 marks)

QUESTION FOUR

(a) (i) IAS 12 'Income Tax' was issued in 1996 and revised in 2000. It details the requirements relating to the accounting treatment of deferred tax.

Required:
Explain why it is considered necessary to provide for deferred tax and briefly outline the principles of accounting for deferred tax contained in IAS 12 'Income Tax'. (5 marks)

(ii) Bowtock purchased an item of plant for $2,000,000 on 1 October 2000. It had an estimated life of eightyears and an estimated residual value of $400,000. The plant is depreciated on a straight-line basis. The tax authorities do not allow depreciation as a deductible expense. Instead a tax expense of 40% of the cost of this type of asset can be claimed against income tax in the year of purchase and 20% per annum (on a reducing balance basis) of its tax base thereafter. The rate of income tax can be taken as 25%.

Required:
In respect of the above item of plant, calculate the deferred tax charge/credit in Bowtock's income statement for the year to 30 September 2003 and the deferred tax balance in the balance sheet at that date. (6 marks)

Note: work to the nearest $000.

(b) Bowtock has leased an item of plant under the following terms:
Commencement of the lease was 1 January 2002
Term of lease 5 years
Annual payments in advance $12,000
Cash price and fair value of the asset – $52,000 at 1 January 2002
Implicit interest rate within the lease (as supplied by the lessor) is 8% per annum (to be apportioned on a time basis where relevant).
The company's depreciation policy for this type of plant is 20% per annum on cost (apportioned on a time basis where relevant).
Required:
Prepare extracts of the income statement and balance sheet for Bowtock for the year to 30 September 2003 for the above lease.

QUESTION FIVE

Sumias Sugar Company Limited is in the process of finalizing its financial statements for the year ended 31 March 2003.
Its loss before taxation for the year is Sh.110 million. Included in this figure is a capital gain on the sale of some land: the capital gain was Sh.20 million. In arrival at loss figure, non-allowable expenses (for taxation purposes) of Sh.10 million had been incurred and a non-allowable depreciation charge of Sh.120 million had also been made. The equivalent tax-allowable capital allowances (wear and tear deductions and farm works deductions) figure was Sh.50 million.

The performance of the company depends very much on how much cheap sugar is imported tax free from COMESA region. However, the directors have an assurance from the Treasury that suitable action will be taken. Based on this assurance you have projected that profit in the year to 31 March 2004 will be Sh.150 million; there will be a non-allowable expenses of Sh.20 million in the year to 31 March 2004 , and it is envisaged that a non-taxable capital gain will be made of Sh.10 million (you have included these in the projected profit of Sh.150 million). The capital allowances figure will be Sh.80 million and the depreciation charge will be Sh.130 million.

At 31 March 2002, there was a deferred tax liability due to accelerated capital allowances of Sh.500 million and a deferred tax asset on a tax loss brought forward of Sh.20 million. The rate of corporation tax throughout the period should be taken to be 30%. Tax losses can be carried backwards in Kenya, but can be carried forward indefinitely.

Required:

(a). Compare the tax liability for the year ended 31 March 2003 and the estimated liability for the year ending 31 March 2004. (1 mark)

(b). Show the part of the income statement from "profit(loss) before tax" to "profit(loss) after tax" and showing the tax charge or credit in its separate components and as a sub-total, for both years. (4 marks)

(c). Prepare the reconciliation of expected tax based on accounting profit/ (loss) to the tax charge /(credit), for both years. (4 marks)

(d). Show the deferred tax figures in the Balance Sheets, offsetting if appropriate, and the movement on the deferred tax account for both years. (6 marks)

(Total: 15 marks)

LESSON SEVEN

PREPARATION FOR FINANCIAL REPORTS AND OTHER INFORMATION

CONTENTS

7.1 CASHFLOW STATEMENTS (IAS 7)
7.2 EARNINGS PER SHARE (IAS 33)
7.3 RELATED PARTIES (IAS 24)
7.4 SEGMENTAL REPORTS (IAS 14)
7.5 SHARE BASED PAYMENTS.(IFRS 2)
7.6 INSURANCE CONTRACTS (IFRS 4)
7.7 FIRST TIME ADOPTION OF IFRS (IFRS 1)
7.8 VALUATION OF SHARES
7.9 CAPITAL REDUCTIONS AND REORGANIZATIONS (RECONSTRUCTIONS)
7.10 VALUE ADDED STATEMENTS.
7.11ACCOUNTANTS REPORT IN A PROSPECTUS

7.12 REINFORCEMENT QUESTIONS

7.1 CASH FLOW STATEMENTS (IAS 7)

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. These adjustments have a number of disadvantages:

- They are often estimates, and the profit is consequently an estimate;
- The underlying cash flow become 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. It simply records monies passing into and out of the bank, and is not blurred by estimates of accruals, etc.

Note that the cash flow statements 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.

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.

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:
  - Increases (decreases) in the balances of operating asset accounts are subtracted (added).
  - 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 (eg – 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.

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

Net income	Kshs. 30,000
Add non cash items: depreciation	5,000
	35,000
Add change in operating accounts – decrease in inventory	15,000
= CFO	Kshs.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 addbacks is 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 adjustment 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 to replace 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 eg:-

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 on 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.

NB - 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 summarised 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'
		Bal b/d	1,370,000
Bank	1,471,000	Deferred tax	649,000
		P&L	1,442,000
Deferred tax	680,000		
Bal c/d	1,310,000		
	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 (pur-			
chases)	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

Working 3

Investment in Associated Coy

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

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 Sh. million'	2000 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 ordinary shares of Sh.10 at a price of Sh.20 upon the exercise of directors' option during the year.
9. There was an exchange loss on re-translation of foreign equity investment of Sh.205 million and again 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.

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 non current 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	
Interest received (15 + 34 – 170	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 (480 + 205.5)	(635)	
Net cash used in investing activities		(655)
Cash flows from financing activities		124
Proceeds of issuance of share capital (directors options)	20	
Proceeds from long term borrowing (1,262 – 930-100+10)	242	
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

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

3.	Investments and non-current liabilities:	Sh 'million'	Sh 'million'	Cash flow
	(a) Trade investments – balance 31 May 2000	50		
	Foreign equity investment	605		605
	Exchange difference	(205)	400	
	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

(4) 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.

Example 3 (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. 'million'
Sales		
Cost of sales		596
Gross profit		(417)
Other operating income		179
Distribution costs		12
Administrative expenses		(48)
Other operating expenses		(154)
Operating loss		(19)
Finance cost: Interest		(30)
expense		(35)
Profit on disposal of		19
subsidiary		(46)
Loss before tax	(2)	
Tax:	13	
Current		
Deferred tax		
		11
Net Loss		(35)
Minority interest		4
Net loss attributable to		(31)
shareholders.		

	2003 Sh. million'	2003 Sh million'
Capital employed		
Share capital	400	300
Share premium	112	84
Retained earnings	64	95
Shareholder's funds	576	479
Minority interest	13	21
Non-current liabilities	589	500
Bank loans	29	52
Deferred tax liabilities	18	17
Provisions for liabilities and	18	19
charges	-	2
Finance lease liabilities	65	90
	654	590
Represented by:		
Non-current asset:		
Property, plant and equipment		
cost:	705	769
Depreciation	(161)	(135)
	544	634
Intangible assets: Goodwill	40	50
cost	(24)	(50)
Amortization	16	25
	16	2
Deferred tax assets	576	661
Current assets:	158	225
Inventories	103	134
Trade and other receivables	11	9
Tax recoverable	3	5
Cash and cash equivalents	275	373
Current liabilities	112	188
Trade and other payables	-	2
Current tax	2	8
Finance lease liabilities	83	246
Bank overdrafts	197	444
	78	(71
Net current assets/(liabilities)	654	590

Additional information:

1. 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.

2. The other companies in the group sold property, plant and equipment which had cost Sh.11 million for Sh.9 million.
3. The figures for provisions for liabilities and charges are made up entirely of amounts due in respect of staff retirement gratuities.
4. There was an issue of ordinary shares at a premium of 30%, issue costs were charged against the share premium.
5. 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

6. 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.
7. Share issue costs are shown as cashflows from financing activities.
8. 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)

Solution

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)

7.2 EARNINGS PER SHARE (IAS 33)

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.

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.
Earnings per share to be calculated are:

- Basic earnings per share
- Diluted earnings per share

Basic Earning Per Share

$$\text{Basic} = \frac{\text{Net profit/loss attributable to ordinary shares}}{\text{Weighted average no. of ordinary shares outstanding (WANOS) (issued during the period)}}$$

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 through out the accounting period.

Required

Calculate the Earnings Per Share

Solution 2

Earnings per share = $\frac{381,500}{750,000}$ = Sh. 0.509 or 50.9 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.

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.	Net profit attributable to ordinary shares	Shs
	Post tax net profit for the period	197,600
	Less: preference dividend	(28,000)
		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:	3,600,000 X 4/12	1,200,000
		3,200,000

Earnings per share = 169,600 X = Sh. 0.053 or 5.3 cents
3,200,000

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

Solution 4

1. Net profit attributable to ordinary shares

Net profit for the period	Sh. 1,200
Less: preference dividend (7% X 1,500)	105
	1,095

2. Weighted average number of shares

As at 1.1.2001	500,000
Add: Bonus 1/5 X 500,000	100,000
	600,000

Earnings per share = 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 = 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	
Post tax net profit for the group for the period		273,200	
Less: minority interest		(7,400)	265,800
Less: preference dividend 100,000 X 0.07		(7,000)	258,800
Equity shares in issue			
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	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.

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

= 4,000,000 / 4	=	1,000,000
Less: Shares to be issued at full market price		
1,000,000 x 2.8 / 3.5		(800,000)
Bonus shares		200,000

Therefore Bonus = 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 Actual cum-rights price / 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:

Earnings per share X Theoretical ex-rights price / 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:

(No. of ord. Shares outstanding prior to the rights issue X fair value of shares)
+ (No. of shares issued through rights issue X rights price)
No. of ord. Shares outstanding prior to the rights issue + 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

$$= \frac{1{,}085{,}400}{4{,}522{,}727} = 0.24 \text{ or } 24 \text{ cents}$$

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

$$\text{Bonus} = \frac{416{,}667}{4{,}000{,}000 + 583{,}333} = \frac{1}{11}$$

(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

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 20X0,000 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

Basic EPS = 2,480,000 = Sh. 3.1
.....
..... **800,000**

Diluted EPS = 2,480,000 = Sh. 2.48
.....
..... **1,000,000**

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			**Shs**
Basic earnings			
Post net profit			372,000
Less: preference dividends (7% X 400,000)			(28,000)
			344,000
Equity shares in issue →	4,000,000		
Basic earnings per share =	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 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 = 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 year end 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				
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

$$\text{Basic EPS} = \frac{344,000}{4,120,000} = 0.083 \text{ or } 8.3 \text{ cents}$$

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

$$\text{Diluted EPS} = \frac{386,900}{5,400,000} = 7.2 \text{ cents}$$

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 = 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

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 = 367,400 / 5,400,000 = 6.8 cents

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	=	100,000
Total number of shares to be issued		
Less: Number of shares issued at full market price		
100,000 X 15/20		(75,000)
		25,000

Diluted EPS = $\frac{1,200,000}{50,000 + 25,000}$ = 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.

Example 13

Net profit attributable to ordinary shareholders	Sh 10m
Ordinary shares outstanding	Sh. 2m
Average fair value of 1 ordinary share during the year	Sh 75

Potential ordinary shares

Options: 100,000 with exercise price of sh. 60
Convertible preference shares 800,000 shares entitled to cumulative dividend of Sh 8 per share. Each preference share is convertible to 2 ordinary shares and 5% convertible loan stock, nominal amount sh.100m. Each sh 1000 bond is convertible to 20 ordinary shares.

Required

Compute the basic EPS and diluted EPS.

Solution 13

Determining whether potential ordinary shares are dilutive or anti dilutive

	Increase in Earnings	Increase in ordinary shares	Incremental earnings per share
Options			
Incremental earnings	Nil		
Incremental shares issued for			
No consideration (100,000 X 15/75)		20,000	nil
Convertible preference shares			
Incremental earnings (8 X 800,000)	6,400,000		
Incremental shares (2 X 800,000)		1,600,000	4
5% convertible bonds			
Incremental earnings (5% X 100,000,000 X 0.65)	3,250,000		
Incremental shares 100,000 X 20 / 1,000		2,000,000	1.625

	Net Profit	Ordinary shares	EPS
Basic	10,000,000	2,000,000	5.00
Options	---	20,000	
	10,000,000	2,020,000	4.95
5% convertible loan stock	3,250,000	2,000,000	
	13,250,000	4,020,000	3.30
Convertible preference shares	6,400,000	1,600,000	
	19,650,000	5,620,000	3.50

Therefore diluted EPS = Sh. 3.30

Please refer to the appendix to IAS 33 for more illustrative examples.

7.3 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 disclosure 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 licence 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
Tourists Paradise Limited, TPL is a company quoted on the Nairobi Stock exchange. Its managing directors, Mr. Tamiba, owns 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

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

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 interests in the roting power is owned, directly or indirectly by any person described in © 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

7.4 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 ncludes 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: Those 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)

7.5 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:

(i) 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.

(ii) 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.

(ii) 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.

(iv) 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.

(v) 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.

(vi) 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.

(vii) 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.

(viii) 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.

7.6 INSURANCE CONTRACTS (IFRS 4)

IFRS 4 on Insurance contracts is also a new standard that tries to improve disclosure requirements by insurance companies. The project is still on going and further improvements are expected either on the standard or a new standard on this part. The standard has not been examined before.

Provisions of IFRS 4

Scope. IFRS 4 applies to virtually all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 Financial Instruments: Recognition and Measurement. Furthermore, it does not address accounting by policyholders.

Definition of insurance contract: An insurance contract is a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

Accounting policies: The IFRS exempts an insurer temporarily (until completion of Phase II of the Insurance Project) from some requirements of other IFRSs, including the requirement to consider the IASB's Framework in selecting accounting policies for insurance contracts. However, the IFRS:

Prohibits provisions for possible claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions).
Requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets.
Requires an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and prohibits offsetting insurance liabilities against related reinsurance assets.

Changes in accounting policies: IFRS 4 permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant. In particular, an insurer cannot introduce any of the following practices, although it may continue using accounting policies that involve them:

(i) Measuring insurance liabilities on an undiscounted basis.

(ii) Measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current market-based fees for similar services.
(iii) Using non-uniform accounting policies for the insurance liabilities of subsidiaries.

Re-measuring insurance liabilities: The IFRS permits the introduction of an accounting policy that involves re-measuring designated insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities.

Prudence: An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence.

Future investment margins: 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.

Asset classifications: 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'.

Other issues. The IFRS:

Clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.

Requires an insurer to unbundle (that is, to account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet.
Clarifies the applicability of the practice sometimes known as 'shadow accounting'.
Permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer.
Addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments.

Disclosures. The IFRS requires disclosure of:

Information that helps users understand the amounts in the insurer's financial statements that arise from insurance contracts:
— Accounting policies for insurance contracts and related assets, liabilities, income, and expense.
— The recognised assets, liabilities, income, expense, and cash flows arising from insurance contracts.
— If the insurer is a cedant, certain additional disclosures are required.
— Information about the assumptions that have the greatest effect on the measurement of assets, liabilities, income, and expense including, if practicable, quantified disclosure of those assumptions.
— The effect of changes in assumptions.

— Reconciliations of changes in insurance liabilities, reinsurance assets, and, if any, related deferred acquisition costs.
Information that helps users understand the amount, timing and uncertainty of future cash flows from insurance contracts:
— Risk management objectives and policies.
— Those terms and conditions of insurance contracts that have a material effect on the amount, timing, and uncertainty of the insurer's future cash flows.
— Information about insurance risk (both before and after risk mitigation by reinsurance), including information about:

The sensitivity of profit or loss and equity to changes in variables that have a material effect on them.
Concentrations of insurance risk.
Actual claims compared with previous estimates.

— The information about interest rate risk and credit risk that IAS 32 would require if the insurance contracts were within the scope of IAS 32.
— Information about exposures to interest rate risk or market risk under embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

See the appendix to the standard for illustrative examples but lay emphasis on the disclosure requirements.

7.7 FIRST TIME ADOPTION OF IFRS (IFRS 1)

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. 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. 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. **Accounting policies.** 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. **IFRS reporting periods.** 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. **Derecognition of some old assets and liabilities.** 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:

previous mergers or goodwill written-off from reserves;
the carrying amounts of assets and liabilities recognised at the date of acquisition or merger;
how goodwill was initially determined (do not adjust the purchase price allocation on acquisition).

b. 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):

- the standard itself
- a basis for conclusions which summarises the IASB's considerations in arriving at the requirements of the standard
- 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 beaddressed 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:

	$000	$000
Property, plant and equipment		1,000
Goodwill		450
Development costs		400
		1,850
Current assets		
Inventory	150	
Trade receivables	250	
Bank	20	
	420	
Current liabilities	(320)	
Net current assets		100
		1,950
Non-current liabilities		
Restructuring provision	(250)	
Deferred tax	(300)	(550)
		1,400
Issued share capital		500
Retained earnings		900
		1,400

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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.

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'sreporting 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 nondiscounted 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 detailsof 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, plantand equipment, employee benefits, translation differences for net investments in foreign operations and derivativeinstruments. 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 (toretrospective 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		
		1,550
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))		820
		1,320
Current liabilities		
Trade and other payables	320	
Non-current liabilities		
Restructuring provision (w (iii))	nil	
Deferred tax (w (iv))	360	680
Total equity and liabilities		2,000

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.
(iv) 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

7.8 VALUATION OF SHARES

Introduction

The investment market in Kenya is developing. Various securities are now being transacted both fixed income (bonds, commercial papers, treasury bonds, debenture stock) and fluctuating income securities (ordinary shares, preference shares etc).

Valuation is the process of determining the intrinsic value of an investment.

Objectives of valuation

- Determine consideration on take-overs and amalgamations
- Determine listing price for unquoted companies
- For loan securities
- Assisting individual investors to determine true value on sales
- Other objectives e.g. tax purposes

Methods of valuation

1. Book value / asset based method

(a) Book value of assets

V = Asset book value – Liabilities

$$\text{Value per share} = \frac{\text{Total valuation}}{\text{Number of shares}}$$

(b) Net Realisable Value of assets

V = NRV of assets – Liabilities

(c) Replacement value approach

V = Assets at their replacement values – liabilities

(d) Nominal value approach

V = par value of share capital

Limitations

- Book values are not equivalent to true values
- Difficult in estimating NRVs
- No going concern assumption
- Determining the value of intangible assets

2. Earnings based method

(a) The earnings yield approach (EY)

Industrial EY:

EY = EPS/MPS X 100

Company's average earning per year

$$V = \frac{\text{Average EPS}}{\text{Industrial EY}}$$

Annual growth rate in earning (g)

$$V = \frac{\text{EPS}}{\text{EY - g}}$$

(b) Dividend yield approach

$$V = \frac{\text{Average DPS}}{\text{Industrial DY}}$$

Annual growth rate in dividends (g)

$$V = \frac{\text{Average DPS}}{\text{DY - g}}$$

Example 1 (July 200 Q.4)

Mr. Eama wishes to sell his minority shareholding of 3,000 Sh.10 shares in Zebra Crafts Limited. Zebra Crafts Limited is a private company with an issued share capital of Shs. 1,500,000. The current shareholders and their shareholdings are as follows:

Shareholder	Shareholding (shares)
Mr. Athmany	73,500
Ms. Boiyon	36,000
Mr. Chewe	24,000
Ms. Duale	13,500
Mr. Eama	3,000

The income statements for the five years to 30 June 2000 are as follows:

Year ended 30 September	1996 Shs '000'	1997 Shs '000'	1998 Shs '000'	1999 Shs '000'	2000 '000'
Sales	47,880	50,400	67,200	101,640	140,400
Cost of sales	(20,805)	(21,900)	(35,040)	(62,460)	(93,720)
Gross profit	27,075	28,500	32,160	39,180	46,680
Admin. Expenses	(10,260)	(10,800)	(12,000)	(14,400)	(16,800)
Distribution costs	(15,330)	(16,140)	(18,000)	(21,600)	(25,200)
Operating profit	1,485	1,560	2,160	3,180	4,680
Taxation	(456)	(480)	(720)	(1,080)	(1,630)
Profit after tax	1,029	1,080	1,440	2,100	3,050
Ordinary dividend	(250)	(270)	(288)	(300)	(315)
Retained profit	779	810	1,152	1,800	2,735

The gross dividend yield on quoted companies operating in the same business sector is 12%. You are advised that this yield should be increased to 18% to allow for lack of marketability. The rate of corporation tax should be taken to be 30% through the period being considered.

Required

(a) Discuss the relevance of dividends in the valuation of Mr. Eama's shareholding. Illustrate your answer from the data given.
(b) Explain the factors you would take into account when estimating the future dividends and when estimating the investor's required yield.
(c) Explain how your approach when valuing a minority interest could be influenced by the size of the shareholding, or the fact that the owner is a party related to other significant shareholders.

Solution 1

(a) The relevance of dividend in the valuation of Mr. Eama shareholding:
- Dividend represent the income flow of an investment
- It is relevant to the investors who value actual cash flow from an investment and not growth. Earnings generated by the company are only significant to those investors if translated into dividends.

Average dividend per share

	1996 '000'	1997 '000'	1998 '000'	1999 '000'	2000 '000'
DPS = Total Dividend	250	270	288	300	315
No. of shares	150	150	150	150	150
	1.67	1.8	1.92	2	2.1

Average DPS = $\frac{1.67 + 1.8 + 1.92 + 2 + 2.1}{5}$ = Shs. 1.898

Recommended value per share

$$= \frac{DPS}{r + p}$$

Where p = risk premium (no marketability)
r = Normal required return

$$V = \frac{1.896}{} = \text{Sh. } 10.5$$

.....

.....**0.12 + 0.06**

Total value of Mr. Eama's holding: 3000 X Sh. 105 = Shs. 315,000

(b) Factors to take into account when determining the future dividends and when estimating the investor's required yield

a. Level of profitability – expected increase in profits should be translated into increased dividend if the Dividend payout is maintained
b. The dividend policy used by the related companies in estimating required yield you consider:-
    i. Yield on alternative investment
c. Market price – the yield generated should be in tandem with the prevailing market price
d. Marketability – lack of marketability should be compensated by higher yields
e. Other factors e.g. tax level on investment income

(c)

a. Where shares required, would generate controlling interest, the investor (Eama) is able to charge a premium over a market price of Sh. 10.5
b. Acquisition by Athmany would guarantee controlling interest i.e. above 50%

$$= \frac{73,500 + 3,000}{150,000} \text{ X } 100 = 51\%$$

c. Joint control by significant shareholders i.e. B, C & D would also guarantee controlling interest especially where a common voting system is adopted.

(c)Price earnings approach.....

Industrial P/E ratio

$$P/E = \frac{\text{MPS (No. of times)}}{\text{EPS}}$$

This represents the number of years it would take to recover back the security.

Companies average EPS

$$V = P/E \text{ ratio } X \text{ Average EPS}$$

(d) The average maintainable profit approach

$$V = \frac{\text{Maintainable profits (average)}}{R - g}$$

Exclude:

- Supernormal profit
- Extra-ordinary gains and losses
- Prior period errors

Therefore: Value per share $= \frac{\text{Total value}}{\text{No. of shares}}$

(e) Supernormal profit approach

Normal profit: Industrial ROA X Valuation of company assets

ROA = Return of asset

Supernormal profit
= actual company profit – normal industrial profit

$$V = \frac{\text{Normal profit}}{r} + \frac{\text{supernormal profit}}{r + p}$$

Where p is the risk premium on supernormal profits.

Example 2

The industrial return on asset in the tea sector is 10%. A company in this industry has total assets valued at Shs. 20,000,000. The normal return is 5% with a risk premium of 2.5%. Average profits of over 5 years have been Shs. 1,750,000.
NB: these earnings are expected to double in the future.

Solution 2

Normal profit = ROA X Asset valuation

= 10% X 20,000,000 = 2,000,000

Actual profit 5 years: 1,750,000
Expected change X 2
Expected profit 3,500,000

Supernormal profits:3.5m – 2m
..... =
..... 1.5 m

Normal profit = 2m

Value = $\frac{2,000,000}{0.05}$ + $\frac{1,500,000}{0.05 + 0.025}$ = Shs. 60,000,000

Limitations of earning based methods

- They are based on forecasts which could be error prone
- No consideration is given to the balance sheet and hence the assets
- It assumes the company will always be a going concern
- Difficulties in determining appropriate required rate of returns on risk premium.

Factors to consider valuation

- Average profitability
- Dividend payment policy (the higher the dividend the higher the value)
- Management quality
- Existence of an available market e.g. NSE
- Tax level on the investment income
- Level of demand and supply
- Expected return on alternative investment
- Government policy in the sector concerned
- The economic factors affecting the industry in which the company operates i.e. the interest rates, inflation rates, legislation controls etc.

7.9 CAPITAL REDUCTIONS AND REORGANIZATIONS (RECONSTRUCTIONS)

Definition of Terms — Capital Reduction and Reconstruction

(a) **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.

(b) **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.

INTRODUCTION

Reasons for reduction of capital

These may be summarized as follows:-

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.

A scheme may take the form of:-

a. Capital reduction (C.A. 1948 s.66) or
b. External reconstruction (C.A. 1948 s. 287)

Definitions

a) Capital reduction – utilizes the credit released in a reduction of the share capital to write down asset values and write of accumulated losses
b) 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.

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

i. Two cases where capital reduction occurs without consent of the court:-

   a. Where shares are forfeited.
   b. Where shares are surrendered to avoid forfeiture

ii. Two cases of apparent capital reduction when in fact no actual reduction occurs:-

   a. Redemption of redeemable preference shares under 1948 s. 58
   b. Unmissed shares cancelled under 1948 s.61.

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.

EXTERNAL RECONSTRUCTION

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 mebers' 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:

1. 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.
2. value of trade marks has been re-assessed at Kshs.24,000.
3. Goodwill no longer possesses an attributable value and is to be written off.
4. Tangible assets have been revalued as follows

Land and buildings	Kshs. 33,000
Plant and machinery	Kshs. 138,600

5. 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.
6. 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

7. Provision for bad debts deducted in arriving at trade debtors (Kshs.33,180) is to be increased by a further Kshs.2,600.
8. Recoverable Tax has been carried forward since 20X6 and should be written off.
9. No dividends have been declared on the 7% preference shares in the financial years 20X7 and 20X8
10. 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.

11. 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.

12. 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).
13. 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.
14. 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.
15. 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

a. These costs have been incurred in the development of a new high security communications system.
b. This is the purchase of the "Hermus" trade mark when Seito acquired all the assets of Hermes and Company for cash in 20X3.

c. Goodwill arose on the occasion of the acquisition referred to in Note 2 (above), the unamortised portion of which is Kshs. 62,700.
d. 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

e. The share capital of Seito consisted of:

	Authorised Kshs.	**Issued 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

	Kshs.
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:

(b) CAPITAL REDUCTIONS A/C

Ref	Particulars	Kshs.	Ref	Particulars	Kshs.
1.	Development costs	191,800	9.	Preference share capital	10,000
2.	Trademarks	30,000	11.	Share premium A/c	15,000
3.	Goodwill	62,700	12.	Ordinary Share reduction	516,800
4.	Land and Buildings	70,000		Revaluation Reserve	76,400
4.	Plant and Machinery	56,000			
5.	Loss on investments	6,250			
6.	Raw material & Consumables	13,240			
6.	Work-in-progress	22,480			
6.	Finished goods	11,100			
7.	Trade debtors	2,600			
8.	Tax recoverable	17,630			
9.	Preference Share Capital	3,000			
11.	Profit & Loss A/c	130,200			
9.	Share premium (2 x 7% x 30,000 - 1/10 x 30,000)	1,200			
		618,200			618,200

(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	254,180
		278,180
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)	
Payables (amounts due in less than one year)		
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.

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(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.

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(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.

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(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)

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(5)	Loans from directors	16,000	
	Ordinary shares of 25p each – 10,00		2,500
	Share premium		7,500
	Reconstruction account (amount of loans cancelled)		6,000

Capitalisation and writing off of directors' loans

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(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	50,000	
Receivables	63,623	
Cash	45,387	
		159,010
Payables: amounts falling due within one year		
Trade	50,247	
Net current assets	108,763	
Total assets less current liabilities	288,763	
9.5% Debenture 20X12	89,000	
		199,763
Called up share capital		
Issued ordinary shares of 25p each		142,500
Issued 8% cumulative preference shares of Kshs.1 each		35,000
		17,500
		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)	9,516		
	12,316		
Directors (W4)		680	
Ordinary shareholders			
Balance (W4)	40,100		27,189
	Kshs. 50,000		Kshs. 50,000

(d) Comments on the capital structure

$$\text{Gearing is } \frac{\text{Kshs.35,000 + Kshs.89,000}}{\text{Kshs.288,763}} = 43\%$$

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.	Cr.
	Kshs	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 Kshs.1		35,000
9.5% Debenture 20X12		89,000
Trade creditors		50,247
Share premium account		17,500
Reconstruction account		4,763
	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				
Interest	(6,400)		(8,455)	
Preference div.	(3,500)	(9,900)	(2800)	11,255

Available for ordinary		
Shareholders	40,100	38,745

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

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

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.

i. The Sundry Members A/c - takes all shareholders claim (share capital plus various reserves).

ii. 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.

iii. 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		
10% debentures		(60,000)
		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

(b) REALISATION ACCOUNT

	Kshs.		**Kshs.**
31.12.X1 Cash	2,000	31.12X1 Purchaser	108,000
PPE	76,000	Consideration	
Inventory	22,000		Kshs.
Tradereceivables	15,000	- Cash	2,000
Premium on debentures	6,000	- Fixed Assets	70,000
- Stock	21,000		
- Trade debtors	15,000		108,000
		Sundry members	
		(deficit on realisation)	13,000
	121,000		121,000

(c) SUNDRY MEMBERS ACCOUNT

	Kshs.		*Kshs.*
31.12.X1Profit loss	40,000	31.12.X1Ordinary shares	80,000
Realisation	13,000	Share premium	15,000
Purchaser	42,000		
	95,000		95,000

(d) PURCHASER (ERIOKI (20X2)) ACCOUNT

	Kshs.		**Kshs.**
31.12.X1 Realisation	108,000	31.12.X1 10% debentures	66,000
		Ordinary Kshs.1 shares	42,000
	108,000		108,000

(e) 10% DEBENTURES ACCOUNT

	Kshs.		**Kshs.**
31.12.X1 Purchaser 12% debentures in ERIOKI (1992) Ltd	66,000	31.12.X1 Balance c/d	60,000
		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)

	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

12% Debentures

	Kshs.		Kshs.
	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		

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		
Ordinary shares of Kshs. 1 each, fully paid		42,000

2.5 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

AMALGAMATIONS AND TAKEOVERS

3.1 Amalgamations

Amalgamations occur where two or more companies wish to combine their businesses and a new identity for the combined business is sought. This probably represents a minority of combinations. Amalgamations arise in circumstances where the companies concerned are looking for a new start and a new identity.

Normally, the new company will issue shares to the liquidating companies as consideration for the assets acquired. The new company may, as part of the consideration, take over creditors (e.g trade creditors, debentures) of the liquidating companies. As indicated in Section 5.2 above, it is only with the agreement of the creditors that their claim can be transferred from one company to another so there could be cases where settlement of such claims must be made on the liquidation of the companies concerned.

In fact we have met transactions involved with the liquidation of one business and the transfer of its assets to another before. In Section 5.2, we considered capital reconstructions which involved the liquidation of one company and the transfer of its assets to a new company formed for that purpose.

The major difference with an amalgamation is that amalgamations involve more than one company going into liquidation. This difference can even cause disagreements over the value of assets of the liquidated businesses (the assets of the new business). With capital reconstructions and conversions of unincorporated businesses into companies, the owners are the same before and after. Any under or over-valuation of the assets is not too important. This is not the case with amalgamations. For instance the new companies shares will be apportioned to the shareholders of the liquidating companies in proportion to the value of the assets of the liquidating company concerned. Thus the relative value of the assets of each of the liquidated companies becomes important.

Let's have a look at an example that can highlight the accounting treatment for an amalgamation.

Example:

Andrew Ltd was incorporated with an authorised share capital of Shs 200,000 divided into 600,000 ordinary shares of 25 cents each and 50,000 Shs 1 10% cumulative preference shares to take over the existing business including cash of Alpha Ltd and Beta Ltd at 31 December 20X2.

The draft Balance Sheets of Alpha Ltd and Beta Ltd as at 31 December 20X2 were as follows:

Balance Sheet as at 31 December 20X2

	Alpha Shs	**Beta Shs**		**Alpha Shs**	**Beta Shs**
Capital – ordinary	30,000	20,000	Freehold property – cost	28,000	12,000
Shares of Shs 1 each	18,000	6,500	Plant at cost	32,000	25,000
Reserves	3,000	26,000	Less: Depreciation	(10,000)	(8,000)
Trade creditors 1	14,000	-	Development	-	10,000
Bank			Expenditure	15,000	7,500
			Stock	10,000	2,000
			Debtors	-	4,000
	65,000	52,500	Bank	75,000	52,500

You are given the following information:

1. The purchase consideration for the assets of the business acquired is to be:

(a) The amount which Andrew Ltd would have to invest at 15% per annum to yield the weighted average profit of the past three years. These weights are to be 1, 2, 3, respectively and

(b) assumption by Andrew Ltd of the liabilities of each company.

Profits, which take account of the adjustments required in Note 4 following; were

	Alpha Ltd	*Beta Ltd*
	KShs	***KShs***
20X1	8,000	17,000
20X1	14,000	13,000
20X2	16,500	6,500

2. The fixed assets have a fair value at 31 December 20X2 as follows:

	Alpha Ltd	*Beta Ltd*
	KShs	***KShs***
Freehold property	35,000	18,000
Plant	17,500	22,000

3. The development expenditure of Sh 10,000 has been reviewed. The project it relates to is technically viable but unless the new company is formed to acquire Beta Ltd and provide additional funds, there is doubt as to whether Beta Ltde is a going concern. However, subject to the amalgamation, it is felt that the carrying value should remain of Shs 10,000.

4. Provision is to be made as follows:

	Alpha Ltd	**Beta Ltd**
(a) For obsolete stock	5% of Balance sheet value	—
(b) For doubtful debts	3% of debtors	2.5% of debtors

5. The purchase consideration is to be satisfied as follows:

   (a) The assumption of the trade creditors and the Bank Overdraft.
   (b) Preference shares will be issued to the value of the freehold property.
   (c) 75% of the remaining purchase considerations will be satisfied by the issue of 250 ordinary shares in Andrew Ltd at a premium of 5 cents per share.
   (d) The remainder of the purchase consideration will be satisfied by cash.

6. The trade creditors and the bank concerned have agreed to the transfer of their claim against the acquired businesses to Andrew LTd.
7. Andrew Ltd will issue sufficient ordinary shares at a premium of 5 cents per share to establish a liquidity ratio of 1:1. (The liquidity ratio is current assets excluding stock to current liabilities).
8. The shares received by Alpha and Beta are to be divided to the nearest whole number. If not exactly divisible the balance is to be sold for cash and the cash proceeds distributed.

Using the information and draft balance sheets above, show

(a) The journal entries in the books of both Alpha and Beta Ltd to deal with the disposal of the assets and the liquidation of the companies
(b) Show the balance sheet of Andrew Ltd immediately following the amalgamation.

Solution

(a) The journal entries in the books of Alpha Ltd are as follows:

Dr. Ordinary Shares	Shs 30,000	
Dr. Reserves	Shs 18,000	
Cr. Sundry members A/c	Shs 48,000	

(Being the share capital and reserves transferrred to the Sundry members account).

Dr. Provision for depreciation	Shs 10,000	
Dr. Realisation A/c	Shs 75,000	
Cr. Freehold property		Shs 28,000
Cr. Plant		Shs 32,000
Cr. Stock		Shs 15,000
Cr. Debtors		Shs 10,000

(Being the transfer of the assets to be acquired to the Realisation A/c).

Dr. Andrew Ltd	Shs 122,000	
Cr. Realisation A/c		Shs 122,000

(Being the consideration for the assets to be acquired See Working 1).

Dr. Realisation A/c	Shs 47,000	
Cr. Sundry members		Shs 47,000

(With the surplus in realisation of the assets (122,000 - 75,000)

Dr. Trade creditors	Shs 13,000	
Dr. Bank overdraft	Shs 14,000	
Dr. Sundry members		
Preference shares of Andrew Ltd		Shs 35,000
Ordinary shares of Andrew Ltd (60,000 x 75%)	Shs 45,000	
Cash	Shs 15,000	
Cr. Andrew Ltd accounts		Shs 122,000

(Being the settlement by Andrew Ltd of the consideration (including preference shares to the value of Alpha Ltd freehold property))

The journal entries in the books of Beta Ltd should be as follows:

Dr. Ordinary shares	Shs 20,000	
Dr. Reserves	Shs 6,500	
Cr. Sundry memberd a/c		Shs 26,500

(Being the share capitaland reserves transferred to the sundry members account).

Dr. Provision for deprciation	Shs 8,000	
Dr. Realisation a/c	Shs 52,500	
Cr. Freehold property		Shs 12,000
Cr. Plant		Shs 25,000
Cr. Development expenditure		Shs 10,000
Cr. Stock		Shs 7,500

	Cr. Debtors	Shs 2,000
	Cr. Bank	Shs 4,000

(Being the transfer of the assets to be acquired to the realisation account).

Dr. Andrew Ltd	Shs 95,447	
Cr. Realisation A/c		Shs 95,447

(Being the consideration for the assets to be acquired by Andrews Ltd).

Dr. Realisation A/c	Shs 42,947	
Cr. Sundry members a/c		Sh 42,947

(Being the surplus on the realisation of the assets (95,447 - 52,500)

Dr. Trade creditors		Shs 26,000
Dr. Sundry members		
Preference shares of Andrew Ltd		Shs 18,000
Ordinary shares of Andrew LTd (51,447 x 75%)		Shs 38,585
Cash		Shs 12,862
Cr. Andrew Ltd account		Shs 95,447

(Being the settlement by Andrew Ltd of the consideration including preference shares to the value of Beta Ltd's freehold property).

Working 1: Calculation of the purchase consideration

	Alpha Ltd		**Beta Ltd**
8,000 x 1 =	8,000	17,000 x 1 =	17,000
14,000 x 2 =	28,000	13,000 x 2 =	26,000
16,500 x 3	49,500	6,500 x 3 =	19,500
	85,500		62,500
Average (85,500/6)	14,250	Average (62,500/6)	10,417
Thus 14,250 x 100/15	95,000	Thus 10,417 x 100/15	69,447
Add liability	27,000	Add liability	26,000
Consideration	122,000		95,447

(b) Inorder to prepare the Balance Sheets for Andrew Ltd as at 31.12.X2, the following workings are in order.

W2. Value of goodwill

Total purchase consideration (122,000 + 95,447)			Sh 217,447
less:	Freeholds (35,000 + 18,000)	Sh 53,000	
	Plant (17,500 + 22,000)	Sh 39,500	
	Development Expenditure	Sh 10,000	

Stock (14,250 + 7,500)	Sh 21,750	
Debtors (9,700 + 1,950)	Sh 11,650	
Cash	Sh 4,000	Sh (139,900)
		77,547

Goodwill is what is paid for a business in excess of the sum of the value of the tangible assets.

W3. The Share Value

Before the share issue the cash would be:

		Sh	***Sh***
Alpha's balance			4,000
less:	Beta's overdraft		(14,000)
			(10,000)
less:	Amount paid to shareholder		
	Alpha	15,000	
	Beta	12,862	(27,862)
Overdraft			(37,862)

Cash required for 1:1 liquidity i.e.
Cash + Debentures = Creditors
Debtors = 39,000 - 11,650 = Shs 27,350

Therefore cash required to be raised

= Shs 37,862 + Shs 27,350 = Shs 65,212

This implies that $\frac{65,212}{Sh\ 0.3}$ = Shs 217,373 shares

Nominal value 217,373 x Sh 0.25 =		Sh	54,343
Share premium (217,373 x Shs 0.05)	=	Sh	10,869
		Sh	65,212

Shares issued as part of consideration

Value of shares issued:	Alpha	Sh.		45,000
	Beta		Sh	38,585
				83,585

This implies $\frac{Shs\ 83,585}{(0.25 + 0.05)}$ = 278,617 shares

Made up of	-	Nominal value	=	278,617 x Sh 0.25	=	69,654
	-	Share premium	=	278,617 x Sh 0.05	=	13,931
					Sh	83,585

Thus the total issued ordinary share capital

= Sh 54,343 + Sh 69.654 = Shs 123,997

and total share premium

= Shs 10,869 + 13,931 = Shs 24,800

Andrew Ltd

Balance Sheet as at 20x2

	Shs	Shs
Non Current assets		
Goodwill (W2)		77,547
Freehold property		53,000
Plant		39,500
Development expenditure		10,000
		180,047
Current Assets		
Inventory	21,750	
Receivables	11,650	
Cash (W3)	27,350	
	60,750	
Less creditors: amounts falling due within 12 months	(39,000)	21,750
		201,797
Capital and Reserves		
10% preference shares of Shs 1		53,000
Ordinary shares of Sh. 0.25 each (W3)		123,997
Share premium account		24,800
		201,797

Summary

The new company formed out of an amalgamation will issue shares to the liquidating companies as consideration for the assets acquired.
The accounting entries are similar to liquidations and takeovers and involve

- The transfer to the new company in the books of the companies to be liquidated
- The transfer and issue of shares in the books of the new company.

As accountants, we can calculate what a particular shareholder in one of the old companies will receive for his shares under the terms of amalgamations.

Takeovers or Absorptions

Business combinations can take different forms or approaches depending on the nature, and the circumstances surrounding the whole business deal: When a business which is already trading as a company, is to combine with another company basically three approaches can be taken. These are:

(a) Company A sells the assets to company B typically with the consideration being met all or partly in shares in Company B. Company A is then put into liquidation, it ceases to exist and the combined business trades as Company B. This is often known as ABSORPTION. Also, this is what many authors refer to as TAKE OVER.
(b) A new Company C can be formed. Companies A and B both go into liquidation, selling their net asset to Company C typically in exchange for shares in Company C. Companies A and B

cease to exist and the combined business trades as Company C. This is often known as an AMALGAMATION.

(c) Company B buys the shares of Company A's shareholders. Payment is made typically in Company B shares, Company B loan stock, cash or a combination of two or three of these. This is probably the most popular way to effect the combination. After the combination both companies continue to trade but Company A is under the control of Company B if Company B owns shares holding more than 50% of the voting rights of Company A. The two companies are then usually referred to as a group. This approach can be accounted either as an acquisition or a MERGER.

The accounting necessary to deal with amalgamations and acquisitions have already been dealt with in Section 5.3 and 5.1 respectively.

Infact we have already looked at the accounting requirements to deal with an absorption. A capital reconstruction—Section 2.4 above—is in effect an absorption. The only difference is that with a capital reconstruction the absorbing company is a new one which typically has no assets before it takes over those of the absorbed one this, of course, does not affect the transaction.

Note that Takeovers is not only applied to mean amalgamation and absorption situations, but also in the acquisition of a controlling interest where an offer is made direct to the shareholders (Jennings Page 392).

The example on Jennings Pages 394-400 can demonstrate a situation where a company is formed to takeover unincorporated business.

Otherwise, reasons for takeovers and mergers is of relevance to this subject but is well covered in the Financial Management Study Manual.

7.10 VALUE ADDED STATEMENTS

Companies do not prepare value added statements mainly because there are no legal or professional requirements to do so. It is presumed that in the future this topic may not be examined and has been included here as it is part of the syllabus.

INTRODUCTION

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). Value added therefore represents the increase in value attached to purchased inputs and application of knowledge and human skills to create a finished product or service of greater value.

The value added statement is normally in two parts; the first shows the value added by the team whilst the second shows how that value added has been divided between the team members (i.e. those contributing to its creation). These are:

- Employees
- Providers of capital, and
- The government

The government contribution is presumably the provision of a stable environment in which the company's activities can take place.

Illustrative statement

The following are the main elements of a value added statement:

A Company Statement of Value Added
For the year to 31 December 200X

.....		
.....		
.....		
.....		**Shs '000**
.....		**Shs '000**
Turnover		xx
Less: brought in material and services		(xx)
Value added		xx
Applied in the following way:		
To pay employees		
Wages, pensions and fringe benefits		
.....		
.....		**xx**
.....		
To pay providers of capital		
Interest on loans		
.....		
xx		
Dividends to shareholders	xx	xx
To pay government		
Corporation tax payable.....		
.....		
.....		**xx**
Local rates	xx	xx
Total distributed		
.....		
.....		
.....		**xx**
To provide for maintenance and expansion of assets:		
Depreciation	xx	

Retained profits	xx	xx
Value added		xx

As may be seen, the value added statement is largely a rearrangement of information disclosed in the company's published accounts. However, the value added statement differs from profit and loss statement in that payments for wages, interest are generally regarded as costs in the profit and loss account but as a share in the value added statement.

Advantages of value added statement

- The statement is a means of showing how the wealth created by the organisation is distributed
- The emphasis in the statement is on all members of the team whilst profit and loss account emphasizes the wealth accrued to shareholders
- The term 'profit' is an unpopular word. It is associated with exploitation. It is hoped that the term 'value added' will be more popular.
- The statement reflects the employee participation in added value
- The amount of the government interest is more clearly shown
- The amount by which the resources of the company increase which includes the depreciation charge is shown
- The statement can provide a new insight into a company's performance and can be the basis for calculating a number of useful ratios, hence it can be used as a tool for decision making
- It usefully elaborates on productivity and helps towards a productivity scheme

Productivity is increased when the same or better outputs are produced with a reduction in the resources consumed. Such a change will always be reflected in the level of value added and this provides better means of measuring productivity.

Disadvantages

- The meaning attached to the term 'value added' is not the same as the economists 'value added' or that used for value added taxation. This may cause confusion.
- The team in a wider sense also includes suppliers of goods and services but they do not participate in added value.
- Value added, as generally disclosed, will be increased if fixed assets are bought rather than rented, employees engaged rather than using subcontracting.

Most of the items in the illustrative statement can be presented in more than one way. The following are the alternative treatment.

Turnover

The statement can show sales net of VAT/sales tax on the grounds that the company is in this case a collecting agent for the government. An alternative is the presentation of gross sales (inclusive of VAT/sales tax) with the amount of VAT/sales tax also shown as part of the government's share of the value added. This alternative is adopted on the grounds that the generation of VAT/sales tax is part of the value added by the operations of the company.

Bought in materials and services

Some authorities advocate for the inclusion of depreciation as a deduction in arriving at value added on the grounds that the purchase of a fixed asset from a non-team member is a bought in item and it is only the fact that it has a long life that necessitates the charging of depreciation. Others are of the opinion that depreciation is a non cash expense and the funds representing it are available for investment in new capital assets thus it should be regarded as part of the provision for maintenance of capital.

Payment to employees

This is that gross pay of employees, which is regarded as their remuneration. It is possible to include pay net of PAYE under this heading, showing the PAYE deduction as part of the government share.

Payment to government

This is where there is a lot of variety in practice. Some companies merely show ' Corporation tax payable'. Others show all taxes paid to the government. In this case the heading 'To pay government' might include:

- Corporation tax
- Employees PAYE
- Taxation deducted from interest payable
- VAT
- Local rates
- Motor vehicle licence fees
- Customs and exercise duties

There seems to be arguments in favour of both treatments. To include just the figures for corporation tax avoids the need for arbitrary distinctions and time consuming analysis of the accounts to ascertain the totals of the various taxes. It also has the advantage of agreement with profit and loss account figure.

On the other hand, inclusion of all taxes shows more clearly the total 'take' by the government and possibly facilitates international comparison.

Non trading items

Where a company has a non-trading item, an example of which is investment income it is preferably included in the first part of the statement. I.e.

Turnover	xx
Less: bought in materials and services	(xx)
value added by the company	
	xx
add: investment income	
	xx
Value added available	xx

The argument put forward for this treatment is that although it may be argued that investment income is a share of the value added distributable by another company rather than a part of the value added by the company itself, that investment income is certainly a part of the value added available to the team member. It is impossible to eliminate it from the individual income of the team members. It must therefore be included as part of the value added.

Group of companies – minority interest

The value added statement will be based upon the consolidated profit and loss account rather than the profit and loss account of the parent company. It will therefore show value added by the group.

The minority interests in subsidiary companies must therefore be treated as members of the team and their share of the value added included in the lower part of the statement. Two methods are commonly used in practice:

Some companies show, under the heading, 'To pay providers of capital', the full share of minority interests in the current profits, whether or not these are distributable as dividends". Other companies split the share of profits applicable to minority interests, showing dividends paid and payable under the heading 'To pay providers of capital' and the retained profits applicable to the minority interest as a separate item under the heading 'retained profits available for investment'.

Associated companies

The treatment of the associated company profit and dividends might present some difficulty. one possible approach is to include the dividend received from the associate. however, it is preferable to treat the associate as it is treated in the profit and loss account and include the group's share of associate company profit in the value added statement.

i.e. 1st part: share of profits of associated companies
2nd part: to pay the government
corporation tax payable by associate companies
retained to provide for investment

Why different treatment of items in VAS

It can be observed from the above that there are alternative treatments of items in the value added statement and each treatment is acceptable. This is because there is no accounting standard covering value added statements, hence a variety of treatment exists.

Example

(a) IAS 21 recommends two methods for the translation of financial statements of foreign operations from the functional currency to the currency used by the enterprise that establish the foreign operations.

Required:

State the two methods and explain how they are applied on the translation of the financial statements (6 marks)

(b) The following balances were extracted from the books lootex Ltd. for the year ended 30 September 2000.

	Sh. '000'
Purchase of equipment	7,500
Purchase of raw materials	19,655
Depreciation expense	675
Interest expense	350
Investment income	310
Closing stock of raw materials	3,400
Minority interest in the profits of the subsidiary	200
Ordinary dividends	340
Value added tax – included in the turnover	8,000
Wages, salaries and pension	5,000
Current tax (corporation tax)	770
Turnover	32,135

Required:
Value added statement. (9 marks)
(Total: 15 marks)

Solution

(a) The two methods for translation of financial statement as recommended by IAS 21 are

(i) Functional Method (Formerly temporal method) – This is applied where the foreign operation is an extension of the reporting enterprise's operation. In these case the foreign operation acts as a selling agency or to produces raw materials and manufacturers parts or subassemblies or it is located overseas tax, or exchange control or similar reasons. IAS 21 argues that the functional method is appropriate since the affairs of such a foreign operation are so closely inter-linked with those of investing enterprise that the business of the foreign operation is regarded as a direct extension of the business of the investing enterprise rather than an independent business.

Under this approach:

- All monetary assets and liabilities are translated at the closing rate.

- Non-monetary items that are carried in terms of historical costs are translated at the exchange rate existing as at the date of the translation (spot rate)

- Non monetary items that are carried at fair value should be translated using the exchange rates that existed when the values were determined.

- Income statement items are translated at the rate running at the time the transactions occurred. If transactions are numerous over the year the average rate does not fluctuate widely over the year the average rate can be used.

- Depreciation is translated at the rate applied to translate the property, plant and equipment in the balance sheet.

- Any gain or loss on exchange is dealt with in the income statement as income or expense in the period in which they arise.

(ii) The Presentation method (Formerly net investment method)

It is adopted when the foreign operation is a foreign entity under this approach, the assets and liabilities both monetary and non-monetary of the foreign entity should be translated at the closing rate.

Income and expense items of the foreign entity should be translated at exchange rates at the date of the transactions except where the foreign entity reports in the currency of a hyper inflationary economy, in which case income and expense items should be translated at the closing rate. For practical reasons an average rate is used to translate income and expense items of a foreign operation.

All resulting exchange differences should be classified as equity until the disposal of the net investment.

(b) Lootex Ltd. Value added statement for the year ended 30 September 2000

	Sh. '000'	**Sh. '000'**
Turnover (gross)		32,135
Cost of bought in materials and services		16,255
Value added to the company		15,880
Investment income		310
Value added available to the company		16,190
Applied as: -		
To employees		
Wages, salaries and pension		5,000
To providers of capital		
Interest expenses	350	
Ordinary dividends	340	
Minority interest profits	200	890
To the government		
Corporation tax	770	
VAT	8,000	8,770
Retained for expansion and maintenance		
Depreciation	675	
Retained profit	855	1,530
		16,190

Workings

P and L Account

	Sh. '000'	Sh. '000'
Turnover (32135 – 8000) VAT		24,135
Cost of sales		
Purchase of raw materials	19,655	
Closing stock of raw materials	(3,400)	16,255
Gross profit		7880
Investment income		310
		8190

7.11ACCOUNTANTS REPORT IN A PROSPECTUS

These are reports prepared by independent reporting accountants as required by the appointing authority or by legislation. The objective is to express an opinion of the truth and fairness of the accounting information included in any statement or schedule.

This report may be required:

- when a prospectus is issued to the public
- during merger and acquisition in estimating the fairness of consideration
- on profit forecasts reported by directors
- on company's credit worthiness during loan acquisition

Review of profit forecasts

Analysis will be made on:

- whether the forecasts are prepared on consistent accounting policies
- achievements of previous forecasts made
- expected economic and political changes likely to affect forecast achievement
- extra ordinary and other contingent occurrences expected to affect company's performance e.g. expected acquisitions, climate changes etc.

Credit worthiness

Issue of consideration include:

- the current and expected liquidity position
- past performance in terms of loan repayment
- external changes likely to impact on loan repayment
- expected future management policy on operation
- ability to renegotiate loan repayment schedule

Prospectus

A prospectus is a statement issued to prospective shares and debenture holders inviting them to subscribe for securities in the company. It should ideally disclose a statement on the profit and loss for the preceding five years and the latest published balance sheet before the prospectus issue. It will also indicate the current directors, nature of company operations, reasons for the share or debenture issue and the company future policy.

Reporting accountant's role

- ensure that the previous profit and losses have been prepared or the basis of consistent accounting policies.
- Adjusting for extra-ordinary and exceptional items: losses are added back and gains deducted
- Prior period errors: they are adjusted on the profits in the years concerned
- Expected loan repayment after balance sheet date. Any interest paid in prior years is added back in adjusting respective profit and earnings per share
- Subsequent disposal of assets and investments. Any investment income not expected to recur should be deducted
- Asset revaluation: the fixed assets should reflect any subsequent revaluation undertaken after the published balance sheet date indicating the valuer, qualifications and valuation date
- To make sufficient disclosures not available in the prospectus e.g. expected changes in director's remuneration.
- Analyse the accuracy in computation of earning per share
- Confirm their substantive disclosure on material issues have been made
- Make other adjustments considered appropriate

Contents of the report

- The relevant period of examination
- Where known, the identity of company's auditors
- Accounting policies adopted and consistently applied
- The adjusted profit and loss statement
- Other material disclosure

The report will be attached to the prospectus before issue.

Example 1 (June 1995 Q.3)

Utopia Co. ltd, a company incorporated in Kenya intends to issue shares to the public for cash. The directors of Utopia Ltd., approached GOOSE, a firm of Certified Public Accountants of Kenya to carry out the necessary investigations and submit the accountants report for inclusion in the prospectus.

An examination of the published accounts of the past five years; and available information discloses the following:

1. Extracts of the audited accounts:

	1990 '000'	1991 '000'	1992 '000'	1993 '000'	1994 '000'
Turnover	44,200	57,200	80,600	85,800	98,800
Profit before depr. And tax	4,160	6,994	10,322	9,906	11,440
Depreciation	728	962	1,092	1,144	1,430
Issued share capital	20,800	20,800	20,800	20,800	20,800
Div. rate %	8%	10%	14%	14%	16%

The summarised balance sheet as on 31 December 1994 showed:

Non Current assets:	**'000'**	**'000'**
Freehold land & buildings (cost)	5,200	

Plant & machinery	7,800	
Less: acc. Depreciation	3,380	4,420
		9,620
Current assets		
Inventory (at lower of cost and NRV)	9,880	
Receivables	14,040	
Quoted investments (cost)		
Market value sh. 3.12 m	2,080	
Balance at at bank	1,040	
	27,040	
less: current liabilities	(2,860)	24,180
		33,800
Financed by:		
Share capital (800,000 @ Sh 26)		20,800
Reserves		10,400
		31,200
15% debentures (redeemable on 1 Feb 2000)		2,600
		33,800

2. By the close of 1994, the freehold land and buildings were valued by a professional firm of valuers at Sh. 8,450,000
3. On 1 February 1995, the 15% debentures, which were issued in 1990 were redeemed at par. Due to cash flow problems, the directors sold one of its investments to finance the redeeming of debentures. Based on its sale price, this investment had given a dividend yield of 20% in 1994 and 16% in each of the earlier years.
4. The directors emoluments were calculated on the basis of 10% of the profits before tax as shown by the audited accounts, after deducting these from emoluments. A resolution was passed as from 1 January 1995, that each of the four directors would receive an additional fee of Sh. 26,000.
5. At the end of 1992 the company closed down its retail department, which had previously only broken even. The company suffered a loss of Sh. 390,000. The total sales of this department amounted to:
   1990 - 2,080,000
   1991 - 2,340,000
   1992 - 1,040,000
   This department is operated without fixed costs.
6. Included in the depreciation charge in 1991 is an exceptional write off of Sh. 130,000 in an anticipated obsolescence of a fixed asset in the same year at the same value. The write off did not take place. Depreciation on machinery was consistently provided at 10% which is considered adequate in the light of available data.
7. Due to an electrical problem, fire broke out and destroyed the stock records of 1990 and 1992. However it was accepted that the stock was valued properly. Due to errors in the company's records, stocks in 1994 were valued at 5% less than their true value, while in 1993 stocks were valued at 5% more than their true value.
8. The turnover is the net of aggregate amount receivable for goods supplied and services rendered.

Required

The accountants report to be included in the prospectus.

Solution 1

Profit adjustments

	1990 '000'	1991 '000'	1992 '000'	1993 '000'	1994 '000'
Turnover (gross)	44,200	57,200	80,600	85,800	95,800
- Retail turnover	(2,080)	(2,340)	(1,040)	-	-
Net turnover	42,120	54,860	79,560	85,800	95,800
Profit before depr:	4,160	6,994	10,322	9,906	11,440
Depreciation	(728)	(962)	(1,092)	(1,144)	(1,430)
	3,432	6,032	9,230	8,762	10,010
Director emolument					
10/110 X 3,432	312	548	839	796.5	910
	3,120	5,484	8,391	7,965.4	9,100
Adjustment					
Add: debenture int. (15% X 2,600)	390	390	390	390	390
Div.(inv. Income)	(416)	(416)	(416)	(416)	(520) (20% X 2,600)
Loss on retail dept.			390		
Obsolescence		130			
depr. On with write back stock adj.	(13)	(13)	(13)	(13)	
(10% X 9,850)					520
	3,094	5,575	8,742	7,926	9,477
taxation 30%	928	1,672	2,622	2,378	2,843
profit to s/holders	2,166	3,902	6,119	5,548	6,634

The directors
Utopia Co. Ltd

Date:

Ladies and gentleman

RE: ACCOUNTANT'S REPORT ON PROSPECTUS

We have examined the audited accountant of Utopia Co. Ltd for the five year ended 31.12.94. Our report is prepared in compliance with the companies act requirement and ICPAK guidelines on accountant's report.

The following accounting policies have been consistently adopted:

- Historical costs subject to assets revaluation
- Stock valuation at lower of cost and net realisable value

- Investment valued at cost

The adjusted profit is presented below:

	1990	1991	1992	1993	1994
Adjusted turnover	42,120	54,860	79,560	85,800	98,800
Adjusted profit	2,166	3,902	6,119	5,548	6,634
Dividend declared (8% X 20,800)	1,664	2,080	2,912	2,912	3,328
DPS	2.08	206	3.64	3.64	4.16
EPS	2.7	4.88	7.65	6.9	8.29

The latest published balance sheet adjusted as we considered appropriate is presented below:

Balance sheet adjusted
As at 31.12.94

	Sh '000'	Sh '000'	
Non Current assets			
Freehold land & building		8,450	
Plant & Machinery at cost	7,800		
Less: depreciation (3,380 – 130 + 13 X 4)	3,302	4,498	
			12,948
Current assets			
Inventory	10,400		
Receivables	14,040		
Investment	2,080		
Bank	1,040		
	27,560		
Current liabilities	(2,860)		24,700
			37,648
Financed by			
Share capital			20,800
Reserves			14,248
15% debentures		2,600	
			37,648

Reserves A/C

Depr. On write back (13 X 4)	52	Balance b/d	10,400
		Revaluation gain (8,450 – 5,200)	3,250
		Write back	130
Bal c/d	14,248	Stock adjustment	520
	14,300		14,300

Disclosure Note:

- Debenture were redeemed on 1st Feb 1995 from proceed on sales of investment
- Commencing 1st Jan 1995 each director will receive an additional Sh.26,000 p.a.
- The company's retail department was closed at the end of 1992.

Yours Sincerely,
(signed)

REINFORCEMENT QUESTIONS

QUESTION ONE (ACCA)

The following draft financial statements relate to Squire, a public limited company:

Draft Group Balance Sheet at 31 May 2002

	2002 sh.m	2001 sh.m
Non-current assets:		
Intangible assets	80	65
Tangible non-current assets	2,630	2,010
Investment in associate	535	550
	3,245	2,625
Retirement benefit asset	22	16
Current Assets		
Inventories	1,300	1,160
Trade receivables	1,220	1,060
Cash at bank and in hand	90	280
	2,610	2,500
Total assets	5,877	5,141
Capital and reserves:		
Called up share capital	200	170
Share premium account	60	30
Revaluation reserve	92	286
Accumulated profits	508	505
	860	991
Minority interest	522	345
Non-current liabilities	1,675	1,320
Provisions for deferred tax	200	175
Current liabilities	2,620	2,310
Total equity and liabilities	5,877	5,141

Draft Group Income Statement for the year ended 31 May 2002

	sh.m	sh.m
Revenue		8,774
Cost of sales		(7,310)
		1,464
Distribution and administrative expenses		(1,030)
Share of operating profit in associate		65
Profit from operations		499
Exchange difference on purchase of non-current assets		(9)
Interest payable		(75)
Profit before tax		415
Income tax expense (including tax on income from associate sh.20 million)		(225)
Profit after tax		190
Minority interests		(92)
Profit for period		98

Draft Group Statement of Recognised Gains and Losses for the year ended 31 May 2002

	sh.m
Profit for period	98
Foreign exchange difference of associate	(10)
Impairment losses on non-current assets offset against revaluation surplus	(194)
Total recognised gains and losses	(106)

Draft Statement of changes in equity for the year ended 31 May 2002

	sh.m
Total recognised gains and losses	(106)
Dividends paid	(85)
New shares issued	60
Total movements during the year	(131)
Shareholders. funds at 1 June 2001	991
Shareholders. funds at 31 May 2002	860

The following information relates to Squire:
(i) Squire acquired a seventy per cent holding in Hunsten Holdings, a public limited company, on 1 June 2001. The fair values of the net assets acquired were as follows:

	sh.m
Tangible non-current assets	150
Inventories and work in progress	180
Provisions for onerous contracts	(30)
	300

The purchase consideration was sh.200 million in cash and sh.50 million (discounted value) deferred consideration which is payable on 1 June 2003. The provision for the onerous contracts was no longer required at 31 May 2002 as Squire had paid compensation of sh.30 million in order to terminate the contract on 1 December 2001. The group amortises goodwill over five years. The intangible asset in the group balance sheet comprises goodwill only. The difference between the discounted value of the deferred consideration (sh.50m) and the amount payable (sh.54 million) is included in .interest payable..
(ii) There had been no disposals of tangible non-current assets during the year. Depreciation for the period charged incost of sales was sh.129 million.

(iii) Current liabilities comprised the following items:

	2002	2001
	sh.m	sh.m
Trade payables	2,355	2,105
Interest payable	65	45
Taxation	200	160
	2,620	2,310

(iv) Non-current liabilities comprised the following:

	2002	2001
	sh.m	sh.m
Deferred consideration . purchase of Hunsten	54 .	
Liability for the purchase of non-current assets	351 .	
Loans repayable	1,270	1,320
	1,675	1,320

4
(v) The retirement benefit asset comprised the following:

Movement in year:	sh.m
Surplus at 1 June 2001	16
Current and past service costs charged to income statement	(20)
Contributions paid to retirement benefit scheme	26
Surplus at 31 May 2002	22

Required:
Prepare a group cash flow statement using the indirect method for Squire group for the year ended 31 May 2002 in accordance with IAS7 .Cash Flow Statements.
The note regarding the acquisition of the subsidiary is not required.
(25 marks)

QUESTION TWO (ACCA)

(a) Accounting regulators believe that undue emphasis is placed on Earnings per share (EPS) and that this leads tosimplistic interpretation of financial performance. Many chief executives believe that their share price does notreflect the value of their company and yet are pre-occupied with earnings based ratios. It appears that if chiefexecutives shared the views of the regulators then they may disclose more meaningful information than EPS to themarket, which may then reduce the reporting gap. and lead to higher share valuations. The reporting gap can besaid to be the difference between the information required by the stock market in order to evaluate the performance of a company and the actual information disclosed.

Required:
(i) Discuss the potential problems of placing undue emphasis on the Earnings per share figure. (5 marks)
(ii) Discuss the nature of the .reporting gap. and how the gap might be eliminated. (5 marks)
(b) Company X has a complex capital structure. The following information relates to the company for the year ending 31 May 2001:
(i) The net profit of the company for the period attributable to the preference and ordinary shareholders of theparent company was $14·6 million. Of this amount the net profit attributable to discontinued operations was$3·3 million.
The following details relate to the capital of the company:

	m
(ii) Ordinary shares of $1 in issue at 1 June 2000	6
Ordinary shares of $1 issued 1 September 2000 at full market price	1·2

The average market price of the shares for the year ending 31 May 2001 was $10 and the closing market price of the shares on 31 May 2001 was $11. On 1 January 2001, 300,000 partly paid ordinary shares of $1 were issued. They were issued at $8 per share with $4 payable on 1 January 2001 and $4 payable on 1 January 2002. Dividend participation was 50 per cent until fully paid.

(iii) Convertible loan stock of $20 million at an interest rate of 5% per annum was issued at par on 1 April 2000. Half a year.s interest is payable on 30 September and 31 March each year. Each $1,000 of loan stock is convertible at the holder.s option into 30 ordinary shares at any time. $5 million of loan stock was converted on 1 April 2001 when the market price of the shares was $34 per share.

(iv) $1 million of convertible preference shares of $1 were issued in the year to 31 May 1998. Dividends are paid half yearly on 30 November and 31 May at a rate of 6% per annum. The preference shares are convertible into ordinary shares at the option of the preference shareholder on the basis of two preference shares for each ordinary share issued. Holders of 600,000 preference shares converted them into ordinary shares on 1 December 2000.

(v) Warrants to buy 600,000 ordinary shares at $6·60 per share were issued on 1 January 2001. The warrants expire in five years time. All the warrants were exercised on 30 June 2001. The financial statements were approved on 1 August 2001.

(vi) The rate of taxation is to be taken as 30%.

Required:
Calculate the basic and diluted Earnings per share for X for the year ended 31 May 2001 in accordance with IAS33 Earnings per share (15 marks)

QUESTION THREE
The following financial statements relate to Sema International plc for the year ended 31 December 20X1

Group profit and loss account for the year ended 31 December 20X1

	Sh. '000'	Sh. '000'
Turnover		
Continuing operations		
Ongoing	214,277	
Acquisitions	7,573	
	221,850	
Discontinued operations	54,853	
		276,793
Cost of sales		(220,398)
Gross profit		56,305
Distribution costs	21,886	
Administrative expenses	21,421	(43,307)
		12,998
Other operating expenses		894
Income from interests in associated undertakings		3,575
		17,467
Operating Profit		
Continuing operations		
Ongoing	16,590	

Acquisitions	1,585	
	18,175	
Discontinued operations	(708)	17,467
Profit on disposal of PPE	1,170	
Discontinued operations:		
Loss on sale of operations	(3,168)	(1,998)
		15,469
Income from investments	1,648	
Interest payable	(1,432)	216
Profit on ordinary activities before taxation		15,685
Tax on profit on ordinary activities		(4,747)
Profit on ordinary activities after taxation		10,938
Minority interests		(404)
Profit attributable to members of the parent company		10,534
Dividends		(2,815)
Retained Profit for the year		7,719

Group balance sheet at 31 December 20X1

	Kshs
Non Current Assets	
Intangible assets	2,680
Tangible assets	43,940
Investments in associated undertakings	26,670
	73,290
Current Assets	
Inventory	33,962
Receivables	26,470
Cash at bank and in hand	11,468
	71,900
Current Liabilities: Creditors	(35,530)
Net Current Assets	39,370

Total assets less current liabilities	112,660
Non current liabilities	(16,338)
Accruals and deferred income	
Deferred government grants	(3,530)
Minority interest	(812)
	91,980
Capital and Reserves	
Called up share capital	39,600
Share premium account	645
Revaluation reserve	12,725
Profit and loss account	39,010
	91,980

The following information is relevant to the financial statements of Sema International plc.

a) The group manufacturers and sells printing machinery locally and within East Africa.

i) Sales to Uganda customers account for 32% of total group turnover.
ii) Sales origination for Uganda subsidiaries account for 34% of the total group turnover including inter-company sales.
iii) Discontinued activities totally relate to Kenyan business and operations.
iv) Items (i) and (ii) above relate solely to continuing activities.

a) Total inter-company sales from continuing activities were Sh. 6.5 million during the year. Ugandan subsidiary companies originated 20% of these sales.
b) Ugandan subsidiaries contributed 24% of the continuing operating profit before taking into account common costs and the profit before tax of associated undertakings. Any apportionment of the common costs of Sh. 2.4 million was deemed to be misleading by the directors and therefore no apportionment was to take place. The associated undertakings are all operating from Kenya.
c) The group has 25% of its tangible and intangible fixed assets located in Uganda and 30% of its current assets. No government grants have been received in Uganda. The creditors falling due after more than one year relate to a loan obtained by the parent company. Additionally, the directors felt that it was not possible to allocate Current Liabilities of Sh. 7.8 million between the segments. After adjusting for this amount 30% of the balance related to activities in Uganda.
d) The directors have decided that for the purpose of the disclosure IAS35, the acquisitions in the year do not have a material impact on a business segment as they relate to Kenya operations. However they consider that the discontinued operations have a material impact on the operations in Kenya

Required:

a) Prepare a segmental report by geographical area for Sema International plc in accordance with IAS14 'Segmental reporting' IAS35, the Companies Act and other standards
(All calculations should be to the nearest Sh.000) **(20 marks)**

QUESTION FOUR

Beta Ltd has been suffering from the adverse trading conditions largely due to the effect of obsolescence on its products. This has resulted in losses in each of the last five years. The company is unable to secure an extension of its present overdraft and creditors are pressing for payment. The directors feel that a new product just developed by the company will make it profitable in the future but they are worried that a winding up order may be made before this can be achieved. The following is the balance sheet as at 31 October 20X0.

		Book values		Present Values
Non Current	Sh.	Sh	Sh.	Sh
Goodwill			600,000	-
Patents, trademarks etc			220,000	40,000
			820,000	
Freehold land & buildings		2,400,000		
Plant and vehicles		1,000,000	3,400,000	720,000
			4,220,000	
Current assets				
Stock and debtors		1,280,00		1,160,000
Listed shares at cost		300,000		280,000
		1,580,000		
Creditors falling due within one year				
Trade	(2,360,000			
Overdraft	(620,000)	(2,980,000		
Net current liabilities			(1,400,000)	
			2,820,000	
Share capital & reserves				
Called up share capital				
Sh.20% cum preference shares fully paid dividends are 3 years in arrears			1,000,000	1,000,000
Ordinary shares of Sh. 20 each fully paid			4,000,000	4,000,000
Share premium account			1,200,000	1,200,000
12% mortgage loan secured on freehold land			1,200,000	1,200,000
Profit and loss account			(4,580,000)	(4,580,000)
			2,820,000	

The following additional information is available:

1. Scheme costs are estimated at Sh. 96,000
2. Preference shares rank in priority to ordinary shares in the event of a winding up
3. The bank had indicated that they would advance a loan of up to Sh.1,000,000 provided that the overdraft is cleared and a second mortgage on the freehold land is given.
4. To ensure speedy production of the new product, it would be necessary to expend Sh. 400,000 on new plant and Sh.300,000 on increasing stocks.
5. The creditors figure of Sh.2,360,000 includes Sh.380,000 that would be preferential in a liquidation

Required:

a) Suggest a scheme of capital reduction and write up the capital reduction account (12 marks)

b) Outline suggestions as to the action that should be taken by the directors to improve the liquidity of the company (8 marks)

(Total: 20 marks)

QUESTION FIVE

a) What is meant by the term 'disaggregation report'? (2 marks)

b) With reference to financial reporting by companies explain in point form the
(i) benefits and
(ii) objections and problems that may arise from implementation from this type of reporting. (10 marks)

c) You are a group financial accountant of a diverse group of companies. The board of directors has instructed you to exclude from the consolidated financial statements the results of some loss making subsidiaries as the board believes that the inclusion of the loss making subsidiaries will distort the performance of other more profitable subsidiaries.

Required:

Write a memorandum to the board of directors explaining the circumstances when a subsidiary can be excluded and the accounting treatment of such excluded subsidiaries.
(Improvise suitable details as necessary). (12 marks)

(Total: 24 marks)

LESSON EIGHT

CURRENT ISSUES AND THEORETICAL FRAMEWORK OF ACCOUNTING

CONTENTS:

8.1 Introduction
8.2 Measurement of income, capital and valuation of assets
8.3 Concepts of capital and capital maintenance
8.4 Accounting principles and conventions
8.5 Users of financial accounting reports and their needs
8.6 Desirable characteristics of good accounting information
8.7 Accounting regulation and standard setting
8.8 Employment reports
8.9 Social responsibility accounting
8.10Environmental reports
8.11 Applications of accounting research

INSTRUCTIONS:

- Carefully study the following:
    - Framework for the preparation and presentation of financial statements and IAS 1
    - Part 1 of advanced Financial Accounting by Richard Lewis & David
    - The study text below
- Answer the reinforcement questions at the end of the chapter and compare your answers with those given at Lesson 9

8.1 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?

8.2 Measurement of income, capital and the valuation of assets

Financial statements

Financial statements form part of the process of financial reporting. 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 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.
- *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.

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.

8.3 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.

8.4 Accounting principles and conventions

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 statements are prepared in conformity with these principles in order to place more reliance on them.
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 supply 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, so 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 judgement 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 judgement. A conceptual framework may be useful in distinguishing between areas of judgement 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.

8.5 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.

8.6 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 decisions of users by helping them evaluate past, present or future events nor confirming, or correcting their past evaluations.
    - 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 judgements 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.

8.7 Accounting regulation and standard setting

The accounting profession is regulated worldwide. In many countries it is regulated by a private body, which is usually supported by the government.

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 judgement 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 forces them to report to interested parties without necessarily making them to do so through regulation. This necessitates the need to unregulate 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 lack 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. This include:

(1) **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:

(i) 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,
(ii) To promote the use and rigorous application of those standards,
(iii) And to work actively with national standard setters to bring about convergence of national accounting standards and IFRSs to high quality solutions.

(2) 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.

(3) 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.

(4) 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.

(5) 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.

(6) 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.

(7) 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.

8.8 EMPLOYMENT REPORTS

Introduction

Corporations have always been accountable to their shareholders and accountants and Auditors have traditionally been engaged in the provision of information to satisfy this relationship. Recently, however corporate management have realized that other individuals also have a stake in an organisation and its activities. Although shareholders are important, organisations are also accountable to a wide range of stakeholders.

At times, the interests of employees can even dominate the interest of shareholders.

The purpose of employee reports is to inform employees in the context of a general communicative and consultative philosophy of the corporate environment in which they work. For example, there is a need to inform employees and correct any misunderstanding about the necessity for company profits and for explanations of the manner in which they are applied. Many companies have embarked upon the practice of informing employees about matters of which management believes they should be aware of.

The emphasis in employee reports is on making information visually attractive and comprehensible. A general problem is the low level of interests of employees in company affairs, and to overcome apathy, colours, diagrams and cartoons are used. Financial information is shown in the form of bar charts, pie charts or other diagrams which are easily understood. In view of employees interest in the performance of his own unit, there is a strong need for segment reporting.

Advantages of employee reports

The main aim of reporting directly to employees is to promote goal congruency by explaining how the interests and efforts of employees relate to those of the firm. The intention is to improve communications and employees understanding of the manner in which the firm is being managed in the interests of all participants. For example, employees are more likely to accept technological change if direct reporting can create a climate of opinion in which the interests of employees are identified with those of management.

Another aim of reporting directly to employees is to improve public relations. Management realizes that employee reports have effects which extend beyond the firm. Employee reports are read by persons outside the firm, members of the employee's family, and friends. They not only have public relations implications, but also may be helpful in the recruitment of personnel.

Disadvantages of employee reports

Two major disadvantages affect employee reports. First, as they are prepared by management for employees, they may be perceived by employees as being slanted towards giving employees only what the management wishes them to know. For this reason, employees may not see employee reports as providing them with information directly relevant to their needs. Second, the desire to simplify employee reports so as to make them readily understandable may lead to misleading generalizations.

Financial reporting to employees

The accountant has been involved in the process of reporting to employees in two distinct ways;
- direct reporting to employees in the form of employee accounts
- reporting as part of the process of collective bargaining

Reports to employees

Employees about to undertake negotiations with employers may use accountants to provide the necessary figures and options for them in a report, in preparation for their meeting with the employers. The main situations where this might arise are pay negotiations, profit sharing schemes and threatened redundancies. Obviously, the accountants will obtain a great deal more information if the employer company is cooperative.

Pay negotiations

The accountants will probably include the following matters in their report

(a)An analysis of current pay levels by grade; pay structures and review, benefits and bonuses

(b) .....Information on the current level of pay in this particular industry

(c)A brief analysis of the company's past history (3 to 5 years), particularly in terms of productivity of the work force. An analysis of turnover and profit per worker could be calculated using the information in the accounts.

(d)The current cash flow situation should be analysed, based on the most recent accounts and any other recent information. Ability to pay for a pay rise is obviously of fundamental importance.

(e)..... Analysis of the claims the employees wish to make

Recommendations should be made as to whether the employees have any chance of getting the pay rise they are claiming. Compromise levels could be suggested, or alternative benefits, such as improved facilities, leave and notice terms.

Profit sharing scheme

Such schemes offer employees (or selected groups of them) bonuses, perhaps in the form of shares in the company, related directly to profits. The accountants may be called upon to write a report on a proposed profit sharing scheme and they will be asked whether the employee in question should accept the scheme.

The contents of the report will include the following:

a) An analysis of the proposed scheme, including the method of calculating the 'bonuses'
b) An application of the scheme (if possible) to the last few years' audited accounts. This should produce an analysis of how employees would have fared in the past under the scheme. The accountants should highlight factors, which might produce different results in the future.
c) Any tax implication should be noted
d) Examples of the impact on a selection of fictitious employees should be given, including the range of amounts received, the timing of the receipts, the tax effects and so on.

The recommendations should list the reasons for accepting or rejecting a scheme and suggestions for any improvements.

Redundancies

accountants' reports in a situation where redundancies are being made would not be usual. however, the accountants could report on the value of voluntary redundancy packages compared to the value of future wages. the accountants could also investigate and suggest levels of compensation for workers made compulsorily redundant.

Summary

Traditionally, the interests of investors have been recognised as paramount both in terms of company law and in terms of accounting theory. Changes in the social environment and in political attitudes have begun to emphasize the importance of the employees. This process may be seen in the context of the movement towards participation in the decision making

which has featured largely in the literature of management science, and in the discussion of the concept of industrial democracy, which has excited the imagination of progressive elements in western european countries.

8.9 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.
This include:
recruiting practices

- training programmes
- experience building (job rotation)
- job enrichment
- wage and salary levels
- fringe benefit plans
- congruence of employees and organisations goals
- mutual trust and confidence
- job security
- stability of work force
- lay offs and recall practices
- transfer and promotion policies
- 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 labelling 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 judgement 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 judgements 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 judgements, 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. The se 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

8.10ENVIRONMENTAL 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 clean up 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.

8.11 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 = 0.012X1 + 0.014X2 + 0.033X3 + 0.006X4 + 0.999X5

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 redeption 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	
Instalment 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.

(b) (i) Net working capital

	Sh '000'
Current assets	
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: $0.014 \times \frac{110,080}{379,780} \times 100 = 0.41$

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: $0.999 \times \frac{400,000}{379,780} \times 100 = 1.05$

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.

REINFORCING QUESTIONS

QUESTION ONE

a) Differentiate between regulated and unregulated accounting information market
b) Using suitable examples briefly explain the doctrine of 'market failures'.
c) State briefly the arguments in favour of unregulated accounting information market.

QUESTION TWO

(a) Explain the main steps undertaken by IASB in the process of setting accounting standards.
(b) Discuss particular issues that may arise in developing an accounting standard for agricultural produce and specify how they could be dealt with in order to achieve the desired results.

QUESTION THREE

You have been asked to prepare a brief and concise and brief paper on conceptual framework for financial reporting purposes. The paper is intended to orient financial reporting practices towards the needs of users.

a) Explain the main steps, which you should undertake in developing a conceptual framework for financial reporting.
b) Write concise notes on the objectives of income measurement, which you may recommend to the standards setting committee in improving the existing financial reporting practices.

QUESTION FOUR

a) Accounting standards improve the quality and uniformity of reporting and introduce a definitive approach to the concept of what is true and fair. List the main advantages and disadvantages of accounting standards.
b) A decision was recently made by the council of the Institute of Certified Public Accountants of Kenya (ICPAK) to shift to the International Accounting Standards and to phase out Kenyan Accounting Standards. What reasons have persuaded the council to make this change and what benefits are likely to accrue to the accounting profession?

QUESTION FIVE

a) 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.
b) The 'concept of capital maintenance' is primarily concerned with how an enterprise defines the capital that it seeks to maintain.
c) Explain clearly the concepts of financial capital maintenance and physical capital maintenance.
d) How is profit earned under each of the two concepts above?

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

COMPREHENSIVE ASSIGNMENT NO.4

TO BE SUBMITTED AFTER LESSON 8

To be carried out under examiation conditions and sent to the Distance Learning Administrator for marking by Strathmore University.

TIME ALLOWED: 3 HOURS ATTEMPT ALL FIVE QUESTIONS

QUESTION ONE

Hisa Company Ltd. was incorporated in 1988 with an issued share capital of 2,500,000 ordinary shares of Sh.10 each and 1,000,000 8% cumulative participating preference shares of Sh.10 each. All the shares were paid for in full.

In 1992, the company issued 2,500 10% debentures of Sh.1000 each. The terms of issue stipulate that each debenture is convertible into 75 ordinary shares of Sh.10 each on 31 December 2003 and those not converted will be redeemed at par on 31 December 2008.

On 1 March 1998, the company granted its directors options to take up 500,000 ordinary shares at a price of Sh.12 per share.

On 1 April 1999, the ordinary shares were split into shares of Sh.2.50 each and on 1 December 1999 a further 3,000,000 ordinary shares were issued at fair value to satisfy the purchase of certain business rights acquired.

On 2 December 1999, 200,000 of the above options were taken up when the fair value of the shares was Sh.6 each. The average fair value of the shares during the year was, Sh.5 each. The following information has been extracted from the consolidated income statements for the years ended 31 March 1999 and 31 March 2000.

	2000 Sh. '000'	1999 Sh. '000'
Net operating income	19,800	18,410
Income from investments	420	360
Net income before taxation and extraordinary items	20,220	18,770
Taxation	(7,630)	(6,920)
Net income after taxation	12,590	11,850
Less: Minority interest	(1,270)	(1,440)
Profit attributable to members of the group	11,320	10,410
Extraordinary items	(2,000)	(1,500)
Profit after tax and extraordinary items	9,320	8,910
Dividends (Note 1)	(4,000)	(3,200)
Retained profits for the year	5,320	5,710
Retained profit brought forward	18,530	12,820
Retained profit carried forward	23,850	18,530

Note

Dividends paid 31 March:		
On ordinary shares	3,200	2,400
On preference shares	800	800
	4,000	3,200

Required:

(a) Calculate the basic earnings per share figure to be disclosed in the published accounts of Hisa Company Ltd. for the years ended 31 March 1999 and 31 March 2000. 12 marks)

(b) Calculate the diluted earnings per share figure to be disclosed in the published accounts of Hisa company Ltd. for the year ended 31 March 2000. Assume a tax rate of 32.5% (10 marks)

(c) Discuss the usefulness of the earnings per share figure. (3 marks)

(Total: 25 marks)

QUESTION TWO

The following is the summarized balance sheet of Tabu Ltd. at 30 June 2002

	Sh.'000'	Sh.'000'	Sh.'000'
Non-current assets:			
Tangible: Freehold property			85,000
Plant			10,000
			95,000
Intangible: Patents		10,500	
Goodwill		28,000	38,500
			133,500
Current assets:			
Inventory		85,000	
Receivables		97,000	
Investments (market value Sh.25 million)		11,000	
Deferred advertising		20,000	
		213,000	
Current liabilities:			

Bank overdraft	39,000		
Payables	50,000		
Debenture interest payable	4,500		
Accruals	10,000		
Directors loans	20,000	(123,500)	89,500
			223,000
Financed by:			
Share capital:			
6% 8 million cumulative preference shares of Sh.10 each.			
15 million ordinary shares of Sh.10 each.			80,000
			150,000
			230,000
Revenue reserves:			
Profit and loss account			(82,000)
Shareholders account			148,000
Non-current liabilities:			
6% Debentures			75,000
			223,600

The court approved a scheme of re-organization submitted by the debenture holders and agreed upon by other interested parties to take effect on 1 July 2002 as follows:

1. The preference shares to be written down to Sh.7.50 each and the ordinary shares to Sh.2.00 each; each class of shares then to be consolidated into shares of Sh.10 each. The rate of dividend on preference shares to be increased to 10%.
2. The preference dividends are four years in arrears of which three-quarters are to be waived and ordinary shares are to be allocated at par for the balance.
3. The debenture holders to have their interest paid in cash, to take over freehold property (book value Sh.20 million) at a valuation of Sh.24 million in part repayment of their holding and to provide additional cash capital of Sh.26 million secured by a floating charge on the company's assets at an interest rate of Sh.12% per annum.
4. Patents, goodwill and deferred advertising to be written off, Sh.15 million to be written off stock, Sh.11.7 million to be provided for bad debts and the remaining freehold properties to be revalued at Sh.77.5 million.
5. Investments to be realized.
6. The directors to accept settlement of their loans as to 90% thereof by allotment of ordinary shares at par and as to 5% in cash, the balance of 5% being waived.
7. The trade creditors to be paid Sh.0.10 in every shilling to maintain and obtain an extension of the credit period.
8. The bank has sanctioned an overdraft limit of Sh.10 million to provide working capital.
9. There are capital commitments amounting to Sh.75 million which are to be canceled on payment of $3^1/_3$ % of the contract price as a penalty.
10. The authorized capital was restored to its original amount.

Required:

(a). The capital reduction account to record the scheme of capital re-organization.(8 marks)

(b). The balance sheet of Tabu Limited as at 1 July 2002 immediately after affecting the scheme.
(12 marks)

(Total: 20 marks)

QUESTION THREE

In January 2003, Gwano Ltd. a private limited company, decided to float its shares to the public. You have been approached to prepare the accountants report for inclusion in the prospectus.

The following information has been provided:

1. Extracts from the accountants of Gwano Ltd. for the last five financial years ended 31 March 2003 are given below:

	2003 Sh. '000'	2002 Sh. '000'	2001 Sh. '000'	2000 Sh. '000'	1999 Sh. '000'
Turnover	37,600	31,000	29,000	24,500	20,000
Cost of sales	26,000	24,900	19,800	18,600	14,300
Administration expenses	2,300	1,600	1,300	1,200	1,100
Selling and distribution expenses	1,700	1,300	1,200	1,100	950
Finance costs	480	480	480	480	480
Profit on disposal of wholesale branch	-	-	360	-	-
Taxation	1,800	1,520	1,450	1,000	900
Issued ordinary share capital	16,000	16,000	16,000	10,000	10,000
Dividend rate	10%	8%	6%	6%	5%

2. **Balance sheet as at 31 March 2003:**

	Sh. '000'	Sh. '000'
Assets:		
Non-current assets:		
Freehold property (cost)	8.500	
Plant and machinery (Net book value)	6,200	
Furniture and fixtures (Net book value)	3,600	
		18,300
Current assets:		
Stock (at lower of cost or net realizable value)	5,600	
Debtors (net of specific provision for doubtful debts)	4,200	
Quoted investments (Cost)	3,600	
Prepayments	1,200	
Balance at bank	850	
		15,450
		33,750
Equity and liabilities:		
Capital and reserves		
Ordinary share capital (Sh. 20 per value)	16,000	
Share premium	2,000	
Profit and loss account	4,000	
		22,000

Non-current liabilities:		
6% Debentures	4,000	
8% Debentures	3,000	
Deferred tax	1,050	
		8,050
Current liabilities:		
Trade creditors	3,200	
Accruals	500	
		3,700
		33,750

3. The 8% debentures were redeemed at per in May 2003 using proceeds from the sale of one-half of the quoted investments. The investments sold had generated the following incomes in the five years ended 31 March:

	2003	**2002**	**2001**	**2000**	**1999**
	Sh. '000'	**Sh. '000'**	**Sh. '000'**	**Sh. '000'**	**Sh. '000'**
Investment income	152	140	125	110	80

4. In the financial year ended 31 March 2001, the company sold its wholesale branch and made a profit of Sh.600,000 before tax. The applicable tax rate was 40%.
The turnover of this branch had been as follows for the three financial years ended 31 March:

2001	Sh.1,350,000
2000	Sh. 1,800,000
1999	Sh. 2,100,000

5. On 1 April 1999, the company purchased furniture worth Sh.1,000,000 which was incorrectly recorded as a purchase of goods for resale. To date, the error has not been corrected. The closing stock as at 31 March 2000 comprised only goods for resale.
Furniture is depreciated on the straight-line basis at 10% per annum based on cost. The same rate applies to plant and machinery. Depreciation expense on furniture and fixtures included in the administration expenses.

6. Investigations revealed that closing stocks on 31 March 2002 were understated by Sh.600,000 whereas closing stocks on 31 March 2003 were overstated by Sh.400,000.
The stocks as at the end of other financial years were correctly stated.

7. As at 31 March 2001, the company had received a sales order of Sh.2 million for foods to be supplied in the financial year ending 31 March 2002. The company treated the order as sales for the financial year ended 31 March 2001 but included the cost of sales in the closing stocks for the year.
The cost of this sales was Sh.1,500,000.

8. On 31 March 2003, freehold property was valued at Sh.12 million and quoted investments had a market value of Sh.6 million.

9. In the year ended 31 March 2001, the company issued bonus shares financed by a capitalization of its retained earnings.

10. As at 31 March 2003, the company had capital commitments amounting to Sh.120 million of which Sh.80 million had been contracted for.
11. The turnover is the net aggregate amount receivable for goods supplied and services rendered .

Required:
Accountants report for inclusion in the prospectus. **(20 marks)**

QUESTION FOUR

The following information relates to the Tsavo Group of companies:

1. **Group profit and loss account for year ended 31 March 2004**

	Sh. "000"
Net profit before taxation	52,334
Share of associated company's profits	25,071
	77,405
Interest expense	(6,850)
	70,555
Taxation (of which Sh.6,713,000 is attributable to associated company)	(18,769)
	51,786
Proposed dividend	(7,946)
Retained profit for the year	43,840
Profits retained:	
In parent and subsidiaries	41,922
In associated company	1,918
	43,840

2. **Group balance sheet as at 31 March**

	2004		**2003**	
Non-current assets:	**Sh. "000"**	**Sh. "000"**	**Sh. "000"**	**Sh. "000"**
Tangible fixed assets		456,758		353,323
Investment – associated company		210,432		208,514
		667,190		561,837
Current assets:				
Stock	166,318		133,164	
Debtors	254,957		233,585	
Cash in hand	4,110		7,398	
	425,385		374,147	
Creditors: amounts falling due within one year				
Creditors	183,580		148,234	
Bank overdraft	88,639		32,880	
Taxation	22,605		19,180	
Proposed dividend	7,946		6,028	
	302,770		206,322	
Net current assets		122,615		167,825
		789,805		729,662
Creditors: amounts falling due after more than one year				
Loan		(57,403)		(62,609)
Deferred taxation		(10,549)		(17,262)
		721,853		649,791
Capital and reserves:				
Called up share capital		490,186		457,991
Reserves		231,667		191,800
		721,853		649,791

3. During the year ended 31 march 2004, in relation to its operating activities, the Tsavo group received Sh.208,240,000 from its customers and made the following cash payments:

	Sh. "000"
To suppliers	58,910
To and on behalf of employees	44,662
Other	31,099

4. During the year ended 31 March 2004, Tsavo Ltd. acquired 100% of the ordinary share capital of Mara Ltd. This purchase was financed by Sh.71,925,000 in cash and this issue of 235,000 ordinary shares at Sh.137 each.
The following information relates to Mara Ltd. as at the date of acquisition:

	Sh. "000"
Tangible non-current assets	66,582
Stock	29,318
Debtors	17,810
Bank and cash balances	685
Creditors	(14,248)
	100,147
Share capital	38,360
Reserves	61,787
	100,147

5. During the year ended 31 March 2004, additions to the tangible non-current assets, excluding those acquired from Mara Ltd., amounted to Sh.44,388,000 and there were no disposals. Depreciation for the non-current assets amounted to Sh.7,535,000 for the year ended 31 March 2004.
6. Dividends of Sh.15,070,000 were received from the associated company during the year 31 March 2004.
7. Interest of Sh.5,480,000 was paid during the year ended 31 March 2004.

Required:
Cash flow statement for the year ended 31 March 2004 in accordance with the requirement of IAS 7 (Cash Flow Statements). **(15 marks)**

QUESTION FIVE

Many cooperate boards are now agreed on the need to take responsibility for any potential or actual social impact caused by their companies' activities. This is done through a social responsibility report.

Required:
(a). Write short notes on five issues/stakeholders that may be addressed by a company's social responsibility report. (5 marks)
(b). Explain five benefits that would accrue to a company from the reporting of the company's social responsibility activities. (5 marks)
(c). Comparing conventional financial accounting reporting with social responsibility reporting, list and explain five challenges peculiar to social responsibility accounting. (5 marks)

LESSON NINE

REVISION AID

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PAST CPA EXAMINATION PAPERS

- DECEMBER 2005

ANSWERS TO PAST CPA EXAMINATION PAPERS

- DECEMBER 2005

MOCK EXAMINATION

KASNEB SYLLABUS

OBJECTIVE

To ensure that the candidate has competence in preparing, analysing and evaluating financial statements using international standards

16.0 SPECIFIC OBJECTIVES

- A candidate who passes this subject should be able to:
- Explain the theory underlying financial accounting
- Prepare financial accounts for foreign currency transactions and price level changes
- Analyse all financial transactions involving taxation, financial reporting and valuation of inventory for an organisation
- Prepare and interpret specialised financial accounts
- Critically evaluate International Accounting Standards

CONTENT

The Theoretical Framework of Financial Accounting

- The theory of accounting in relation to measurement of income, capital and the valuation of assets
- A critical appraisal of accounting principles and concepts
- Users of financial accounting reports and their needs
- Desirable characteristics of good accounting information
- The theoretical and practical issues involved in development of accounting standards
- A critical appraisal of assumptions underlying the existing accounting standards, exposure drafts and discussion papers
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- Treatment in the financial statements of individual companies
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- Formulation and accounting for schemes of capital reconstruction and reorganisation
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- Value added statements
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- Evaluation of current issues and controversies relating to financial reporting

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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:

- recognise all assets and liabilities whose recognition is required by IFRSs;
- not recognise items as assets or liabilities if IFRSs do not permit such recognition;
- 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
- 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 judgements 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:

- measuring insurance liabilities on an undiscounted basis;
- 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;
- using non-uniform accounting policies for the insurance contracts of subsidiaries;
- 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:

- An entity need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.
- An entity is required to unbundle (ie account separately for) deposit components of some insurance contracts.
- An entity may apply shadow accounting (that is, account for both realised and unrealised gains or losses on assets in the same way relative to measurement of insurance liabilities).
- 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:

- The amounts in the entity's financial statements that arise from insurance contracts; and
- 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:

a) 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, intangible assets).
b) 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:

a) 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.

b) available-for-sale assets (ie 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.
c) 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.
d) 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:

a) 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.
b) Shadow accounting permits all recognised gains and losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether:
    (i) the gains and losses are realised or unrealised and
    (ii) 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.
c) 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.
d) 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.
e) 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) 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.
b) 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:

- in the development of future International Financial Reporting Standards and in its review of existing Standards; and
- 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 judgements 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.

Interpretations None.

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 oftrans actions denominated in a foreign currency and the cash flows of a foreignsubsidiary 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.
Interpretations None.

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 thebalance 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 non current 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 ordebt securities are publicly traded and to entities in the process of issuing securitiesto the public. Also, any entity voluntarilyproviding segment information must complywith the requirements of IAS 14.
• An enterprise must look to its organisationalstructure and internal reporting system forthe purpose of identifying its businesssegments and geographical segments.
• If internal segments are not geographical orproducts/service-based, then look to next lower level of internal segmentation toidentify reportable segments.
• Guidance is provided on which segmentsare reportable (generally 10% thresholds).
• One basis of segmentation is primary andthe other secondary.
• Segment information should be based onthe same accounting policies as theconsolidated group or entity.
• IAS 14 sets out disclosure requirements forprimary and secondary segments, with considerably less disclosure for thesecondary 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 arecredited to equity. Revaluation decreasesare charged first against the revaluationsurplus in equity, and any excess againstprofit and loss. When the revalued asset is disposed of, the revaluation surplus inequity remains in equity and is not recycledthrough 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 ischarged systematically over the asset'suseful life. The depreciation method mustreflect the pattern of benefit consumption.
The residual value must be reviewed atleast annually. If operation of an item ofproperty, plant, and equipment (forexample, an aircraft) requires regular majorinspections, when each major inspection is

performed, its cost is recognised in thecarrying amount of the asset as areplacement if the recognition criteria aresatisfied.
• Impairment of property, plant, andequipment must be assessed under IAS 36.
• All exchanges of property, plant, andequipment should be measured at fairvalue, including exchanges of similar items,unless the exchange transaction lackscommercial substance or the fair value ofneither the asset received nor the asset given up is reliably measurable.
• Disclosures include accounting policies;depreciation methods and lives;acquisitions, disposals, impairments, andreversals; amounts and details ofrevaluations; 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 theland and buildings elements is not requiredif the lessee's interest in both land andbuildings is classified as an investment property under IAS 40 and the fair valuemodel 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 amountequal to the net investment in the lease.
- Recognise finance income based on apattern reflecting a constant periodic rate of return on the lessor's net investment.
• Operating leases – Lessee's Accounting:
- Recognise lease payments as an expensein the income statement on a straight-line basis over the lease term, unless anothersystematic basis is more representativeof 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 revenuerecognition 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 profitsharing, 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 aspensions and health care) are categorized as either defined contribution plans ordefined benefit plans.
• Under defined contribution plans, expensesare recognised in the period the contribution is payable.
• Under defined benefit plans, a liability isrecognised 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 longterm 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 incomeand 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 datesof 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 ofborrowings.
• 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 drawattention 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 orhave 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 licence 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 linvestments 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 subsequentlyadjusted 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-acquisitionprofit or loss.
• Associate's accounting policies must be the same as those of the investor.
• Equity accounting is required in the separatefinancial statements of the investor even if consolidated accounts are not required, forexample, because the investor has no subsidiaries. However, the investor does notapply the equity method when presenting separate financial statements prepared inaccordance with IAS 27. Instead, the investor accounts for the investment either atcost 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 hyperinflationary economy, 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 venturer's separate financialstatements, interests in joint ventures should be accounted for either at cost or asinvestments 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.

IAS 32 Financial Instruments: Disclosure andPresentation (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 eitheras a liability or an equity instrument:
- Based on substance, not form of theinstrument.
- Classification is made at the time ofissuance and is not subsequently altered.
- An instrument is a financial liability if theissuer may be obligated to deliver cash oranother financial asset or the holder has aright to demand cash or another financialasset. An example is mandatorily redeemable preferred shares.
- An instrument that does not give rise tosuch a contractual obligation is an equityinstrument.
- Interest, dividends, gains, and lossesrelating 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 anet basis or simultaneously.
• Cost of treasury shares is deducted from equity, and resales 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 deductionof 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 whenthey 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 (seeIAS 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 cashgenerating units to which goodwill can beallocated on a reasonable and consistent basis.
• Reversal of prior years' impairment lossesallowed in certain instances (prohibited for goodwill).
• Disclose impairment losses by class ofassets 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 ofe conomic benefits is probable, but not virtually certain, and occurrence depends onan 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 economicbenefits 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 capitalised only after technical and commercial feasibility of the resulting product or service have beenestablished.
• 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. Ifthe 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, theasset is carried at revalued amount, which is fair value at revaluation date lesssubsequent 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 andMeasurement (revised 2003 and 2004)

Effective Date Annual periods beginning on or after 1 January 2005.

Objective To establish principles for recognising, derecognising, 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, suchas 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 HTMinvestments must be reclassified asavailable-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. Thisincludes all investments in equityinstruments 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 costsubject to a test for impairment.
- All financial assets in category 3 above arecarried at fair value, with value changesrecognised in profit or loss.
- All financial assets in category 4 above(AFS) are measured at fair value in thebalance sheet, with value changesrecognised in equity, subject toimpairment testing. If the fair value of an AFS asset cannot be measured reliably,the asset is carried at cost.
• After acquisition, most financial liabilities aremeasured at original recorded amount less principal repayments and amortisation.Three categories of liabilities are measuredat fair value with value changes recognisedin profit and loss:
- derivative liabilities;
- liabilities held for trading (short sales); and
- any liabilities that the entity designates, atissuance, to be measured at fair value through profit and loss (the "fair valueoption").
• Fair value is the amount for which an assetcould be exchanged, or a liability settled, between knowledgeable, willing parties in anarm's length transaction. The IAS 39 fair value hierarchy:
- Best is quoted market price in an activemarket.
- Otherwise use a valuation technique thatmakes maximum use of market inputs and includes recent arm's length markettransactions, reference to the current fair value of another instrument that issubstantially the same, discounted cash flow analysis, and option pricing models.• IAS 39 establishes conditions for determining when control over a financialasset or liability has been transferred to another party and, therefore, it should beremoved from the balance sheet (derecognised). Derecognition is not permitted to the extent to which the transferor has continuing involvement in anasset or a portion of an asset it hastransferred.
• Hedge accounting (recognising the offsettingeffects of fair value changes of both the hedging instrument and the hedged item inthe same period's profit or loss) is permitted in certain circumstances, provided that thehedging relationship is clearly defined, measurable, and actually effective. IAS 39provides for three types of hedges:
- Fair value hedge: If an entity hedges achange in fair value of a recognised asset or liability or firm commitment, the change in fair values of both the hedginginstrument and the hedged item arerecognised in profit or loss when theyoccur.
- Cash flow hedge: If an entity hedgeschanges in the future cash flows relating to a recognised asset or liability or aprobable forecast transaction, then the change in fair value of the hedginginstrument is recognised directly in equity until such time as those future cash flowsoccur.
• A hedge of foreign currency risk in a firmcommitment 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 incomestatement.
- 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-ofsale costs. Because harvested produce is a marketable commodity, there is no "measurement reliability" exception for produce.
• Change in fair value of biological assetsduring 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

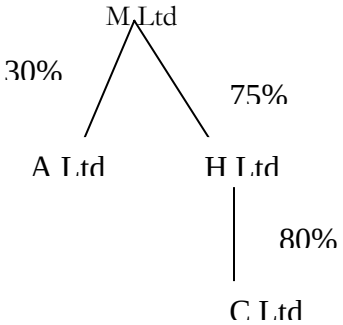
value of a biological asset or agricultural produce. If an active market does not exist, IAS 41 provides guidance for choosing another measurement basis.
• Fair value measurement stops at harvest.
IAS 2, Inventories, applies after harvest.
• Disclosures include:
- Description of an entity's biological 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.

MODEL ANSWERS TO REINFORCING QUESTIONS

LESSON ONE

QUESTION ONE

Structure



Holdings in C Ltd

Group	
75% x 80% =	60%
Minority	
Direct	20%
Indirect	
25% x 80%	20%
	100%

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		165,000
		Minority interest	
		20% x 10,200	20,400
		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	
Minority Interest – H Ltd		H Ltd 75% x 10,000	7,500
(25% x 40,400)	10,100	Preference	4,200
COC – C LTD	9,600	Debenture interest	300
Minority Interest- C Ltd		Depreciation adjustment	600
40% x 100,000	40,000	H Ltd	44,400
Good will amortized		C Ltd	100,000
31,050 x 20%	6,210	Investment in A Ltd	2,700
Pre-acquisition dividend	7,950	(30% x 30,000 – 21,000)	
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	
		(25% x 800)	200
Investment in C Ltd	20,400		
		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

		M Ltd	60,000
Overcharge (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	
Profit & Loss A/C	87,000	26,100
30% x		NIL

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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	
Provision for depreciation	(229,200)	436,800
Goodwill	31,050	
Amortization	(6,210)	24,840
Investment in Associate		28,800
Current Assets	407,700	
Current liabilities		
Trade payables	207,300	
Accrued debenture interest	900	
Proposed dividends	30,000	
	238,200	
Net current Assets		169,500
		659,940
Ordinary share of Sh. 10 each		300,000
General reserve		50,000
Profit and Loss Account		158,140
		508,140

Minority interest	136,800
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

QUESTION THREE

1. Translation

a) Income Statement for the year ended 31st Dec 2000

	TR Million	Rate	Kshs. Million
Turnover	3060	5.1	600
Costs of sales	(2550)	5.1	(500)
Gross profit	510		100
Administration & distributor costs	(51)	(5.1)	(10)
Interest payable	(102)	5.1	(20)
Operating profit before tax	357		70
Taxation	(153)	5.1	(30)
Profit on ordinary activities	204		40
Dividends paid	(52)	5.2	(10)
	152		30

b) Balance sheet as at 31st Dec 2000

	TR Million	Rate	Kshs. Million
Tangible Assets	1890	5	378
Net current Assets	645	5	129
Creditors fully due after 1 year	(1115)	5	(22)
	1420		284
Sheet capital	240	4	60
Share premium	80	4	20
Exchange rescue LSK			21.6
Profit and loss account			
- Pre-requisition	610	4	152.5
- Profit requisition	490	Balancing	73.1
	1420		284

a) Exchange difference

Operating equity TR	1268	
At opening rate	1268 x ¼.6	275.6
At closing rate	1268 x 1/5	253.6
		22

b) Profit for the year

As per income statement	30
At closing rate of 5	(30.4)
Exchange loss	0.4
	22 - 0.4 = 21.6

Cost of Control

Investment in Ugeni	270	Share capital	48
Limited loan	(50)	Share premium	16
		Profit and loss account	122
		Revaluation reserves	22
		Goodwill	12
	220		220

Minority Interest

Exchange loss	4.3	Share capital	12
CBs	59.1	Share premium	4
		Revaluation reserves	5.5
		Profit and loss account	41.9
	63.4		63.4

Tangible Assets

Umma Ltd	945	Depreciation adjustment	
Ugeni Ltd.	378	27.5/5x2	11
Revaluation reserves (1040 - 930) /4	27.5	CBs	1339
	1350		1350

Consolidated profit and loss account

Cost of control (80%x152.5)	122	Umma Ltd.	895
		Ugeni Ltd.	225.1
Depreciation adjustment	11		
Ups 26/3.2	5		
Minority interests	41.9		
Goodwill amortised 12/3x 20/12	6.7		
CBs	934		
	1120.6		1120.6

Net current Assets

Umma Ltd.	735	UPS	5
Ugeni Ltd.	129	CBS	872
Cash in transit	13		
	877		877

Creditors falling due after one year

Inter group	37	Umma Ltd.	375
CBs	561	Ugeni Ltd.	223
	598		598

Exchange Con

Balance	21.6	Minority interest (20%x21.6)	4.3
	___	CBS	17.3
	21.6		21.6.

Minority Interest

80%x(40+2-5-5.5)	25.2
Profit attributable to members	205
Dividends paid	20
	185.2

Reconciliation

Retained earnings	**B/F**	**Year**	**C/F**
Umma Ltd.	723	172	895
Goodwill amortized	2.7	4	6.7
	720.3	168	88.3
Ugeni Lltd.			
80%x(73.1-30)	34.5	24	58.5
Ups –Beginning	(1.6)	-	-
- Ending		(4)	(4)
Depreciation	(4.4)	(4.4)	(8.8)
	28.5	17.2	45.7
	748.8	41.2	934

Statement of Movement Resources

	Share Premium Kshs. Million	**Exchanger Reserves Kshs. Million**	**Accumulated profit Kshs. Million**	**Total Kshs. Million**
As at 1.1.2000	350	-	748.8	1098.8
For the period	-	(17.3)	185.2	167.9
As at 31.12.2000	350	17.3	934.0	1266.7

Umma ltd. and its subsidiary
Consolidated profit and loss account for the year ended 31st dec 2000

	Kshs. Million
Turnover (1650+600-20)	2230
Costs of sales (945+500-2-20+5)	1428
Gross profit	802
Goodwill impaired	(4)
Administration and distribution costs (420+10+5.5)	435.5
Operating profit	362.5
Interest payable	(42)
Profit before taxation	320.8
Taxation	109.0
Profit after taxation	211.5

Umma ltd. and its subsidiary
Consolidated balance sheet as at 31st December 2000

		Kshs. Million
Fixed Assets		1339.5
Goodwill arising on acquisition	12	
Impairement	6.7	5.3
Net current assets		872
Non Current liability		(561)
		1655.8

Financed by: -

Share capital	330
Share premium	350
Exchange loss	(17.3)
Profit and loss account	934
Shareholders funds	1596.7
Minority Interest	59.1
	1655.8

QUESTION FOUR

(a) Initial disclosure events is the occurrence of one of the following whichever occurs earlier.
   (i) The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation, or
   (ii) The enterprises board of directors or similar governing body has both (a) approved a detailed formal plan for the discontinuance and (b) made an announcement of the plan.

(b) No information that have been given in the question that states the date of the initial disclosure
event.

(c) (i) A description of the discontinuing operation
   (ii) The business segment in which it is reported
   (iii) The date and nature of the initial disclosure event.

(iv) The carrying amounts, as of the balance sheet date, of the total assets and liabilities to be disposed of.

(d) According to IAS 35, if an initial disclosure event occurs after the end of an enterprise financial reporting period are authorized for issue, those financial statements should include the disclosures
specified in the standard (paragraph 27) for the period covered by those financial statements.

(e) **Workings:**

(i) Goodwill arising on acquisition

	Q Ltd. Sh. 'million'	**R Ltd. Sh. 'million'**
Costs of investments	680	570
Net Assets acquired		
Share capital	500	400
Retained earnings	100	200
	600	600
Q Ltd.: 80% : R Ltd.: 75%	(480)	(450)
	200	120

(ii) Loss on sale of subsidiary

		Sh. 'million'	***Sh. 'million'***	
Proceeds from sale (570 + 200)				770
Dividends received not earned 200 x 0.75 x $^{4}/_{12}$				50
				820
Net assets disposed				
Share capitals			400	
Retained earnings brought forward			700	
Retained earnings for 8 months				
Profit for the year	210			
Dividends paid	(200)			
	10	6.67		
8/12 *				
		1106.67	(830)	
75% *			(10)	
			(84)	
Goodwill unammortised 120/10*7			(94)	

(iii) Consolidated profit and Loss Account

			Sh. 'million'
COC 80% X 100	80	P LTD	1510
M.I	128	Q Ltd	640
Goodwill amounted	100		
Consolidated balance sheet	1842		
	2150		2150

		Minority interest	
Consolidated Balance sheet	228	Ordinary shares	100
		Retained earnings	128
	228		228

P Limited and its subsidiaries
consolidated Balance Sheet
as at 31 December 2002.

Non-current Assets	**Sh. million**	**Sh. million**
Property, plant and equipment		2,300
Goodwill arising on acquisition	200	
Accumulated amortisation	(100)	100
Current assets		1,300
		3,700
Ordinary share capital		500
Retained earnings		1842
Shareholders funds		2342
Minority interest		228
		2570
Non-current liabilities		100
Current – liabilities		1030
		3700

(g)

P Limited and its subsidiaries
Consolidated Statement of changes in equity
for the period ended 31 December 2002.

	Retained earnings Sh. million
As at December 31.2001	1384
Net profit for the period	958
Dividend paid	(500)
As at December 31 2002	1842

P Limited and its Subsidiaries
consolidated income Statement
for the period ended as at 31 December 2002.

	Continuing operations Sh. million	**Discontinuing operation Sh. million**	**Enterprise as a whole Sh. million**
Sales	10200	2400	12600

Cost of sales	5900	1600	7500
Gross profit	4300	800	5100
Expenses	(2700)	(600)	(33000)
Amortisation of goodwill	(20)		
Operating profit	1580	200	1780
Finance costs	(75)		(75)
Loss on sale of subsidiaries	(94)		(94)
Profit before tax	1411	200	1611
Taxation	(460)	(60)	(520)
Profit after tax	951	140	1091
Minority interest	(98)	(35)	(133)
Net profit for the period	853	105	958

LESSON TWO

QUESTION ONE

(a)

- Historical costs are presumed to represent objective measurement of prices in an arm's length transactions.
- 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.
- 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.
- 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.
- 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:

1. 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.
2. Containing non-comparable items
   The financial statements contains 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 usin 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.

3. 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.
4. 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.

5. Failure to disclose gains on holding monetary liabilities and losses on holding net moteary assets.
   Holders of fixed monetary assets loose in periods of inflation while holders of fixed motary liabilities gain in periods of inflation.
   Historical cost accounting does not make any attempt to recognize such losses and gains.
6. 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) '000'	20X0 (Sh) '000'
Average net borrowings		
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 $\frac{2,000 + 10,100}{2}$

$= \underline{6,050}$

Average shareholders funds $= \frac{12,260 + 15,546}{2}$

$= \underline{13,903}$

Gearing adjustment $\frac{6,050}{6,050 + 13,903} \times (80 + 2,160 + 621 + 334)$

$= \underline{969}$

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

Current 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

20X0		19X9	
	Sh. '000'		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

QUESTION THREE

Master Smoke
Current Purchasing Power
Profit & Loss A/C For the year ended 30th September 20X7

	Kshs. million	Kshs. million
Sales		6,279
Cost of sales:		
Opening stock (380 x 180/190 x 242/183)	476	
Purchases (2,880 x 242/217)	3,212	
Goods available for sale	3,688	
Closing stock (690 x 220/230 x 242/233)	(685)	3,003
Gross profit		3,276
Expenses (1,410 x 242/217)	(1,572)	
Depreciation (2,100 – 1,350 – 540 – 120) x 242/110		
Or (2,100 x 120/280 – 1,350 x 120/200 x 242/110	(198)	
Interest (60 x 242/217 + 40)	(107)	(1,877)
		1,399
Gain/loss on net monetary assets/liabilities		55
		1,454
Taxation (560 x 242/217 + 20)		(645)
C.P.P profit after tax		809
Dividends		(350)
C.P.P retained earnings		459

Workings:

Gain/loss on net monetary position:

		Historical cost	restatement Factor	C.P.P
As at 30/09/X6	Monetary Assets	700		
	Monetary Liabilities	(1,230)		
		(530)	242/192	(668)
Sales		5,630		6,279
Purchases		(2,880)		(3,212)
Expenses		(1,410)		(1,572)
Interest		(100)		(107)
Tax		(580)	(560 x 242/217 + 20	(645)
Dividends		(350)		(350)
Adjusted Figure		(220)		(275)
At 30/09/X7	Monetary Assets	1,020		
	Liabilities	1,240	(220)	

∴ Gains (275 – 220) = 55

QUESTION FOUR

a) As per IAS 29, 'Financial Reporting in Hyper inflationary Economics' where the cumulative inflation rate over three years is approaching, or exceeds 100% restatement of financial statements is necessary. In Nairobi, the index rose from 211.12 to 494.96 over three years. This is an increase of 134.44% (i.e. 494.96 – 211.12/211.12. Thus there is need to comply with IAS 29.

b) KAT Limited

Current Purchasing Power
For the year ended 30th June 19X5

	Shs. M	Shs. M
Sales 800 x 494.96 / 440.025		900
Opening stock 40 x 494.96 / 376.29	53	
Purchases 425 x 494.96 / 440.025	478	
	531	
Less: Closing stock 60 x 494.96 / 488.095	(61)	(470)
Gross Profit		430
Administration, Selling & Distribution: 200 x 494.96 / 440.025	(225)	
Depreciation 40 x 494.96 / 211.12	(94)	
Loan Interest 25 x 494.96 + 25 / 440.02	(53)	(372)
		58
Gain/loss on monetary assets		26
		84
Taxation 22 x 494.96/440.02	(25)	
11 x 494.96/467.49	(12)	
11 x 1	(11)	(48)
		36
Dividends: Interim paid 25 x 494.96/467.49	(26)	
Final proposed	(25)	(51)
Over distribution		(15)

QUESTION FIVE

(a)

(i)

Future Ltd
Historical Cost Gross Profit

	Shs	**Shs**
Sales		200,000
Less: Cost of sales		
Opening stock	12,500	

Purchases	100,000	
Goods available for sale	112,500	
Closing stock	(17,600)	(94,900)
Gross profit		105,100

Future Ltd

Current cost profit

		Shs	Shs
Historical cost gross profit			105,100
Less: Cost of sales adjustment			
Opening stock	12,500 X 105/100 – 12,500 =	(625)	
Closing stock	17,600 X 105/110 – 17,600	(800)	(1,425)
			103,675

(ii)

Dr: Profit & Loss A/C 1,425
Cr: Current cost Reserve 1,425
(Being the cost of sales adjustment)

(b) Rising Value Ltd

(i) Depreciation charge (Assuming straight line approach)

900 X 225/150 = 1,350

500 X 225/200 = 562.5

1,912.5

Depreciation adjustment

Depreciation based on current cost	1,912.5
Depreciation based on current cost	(1,400)
	512.5

Furniture and equipment	(NBV)
$600x\frac{225}{150}$	900
$1{,}200x\frac{225}{200}$	1,350
	2,250

Amount credited to current cost reserve

Furniture & Equipment (NBV)	
Current cost	2,250
Less: Historical cost	(1,800)
Amount to be credited	450

The current cost accounting method requires each item to be restated in terms of the current value of that item. Current cost accounting does not recognize the effect of the changes in the general value of money or translate the figures into currency or purchasing power at a specific date. Changes in the general purchasing power of money are not recognized.

LESSON THREE

QUESTION ONE

Merryview Income statement (extracts) – year to 31 March 2002		
Note: workings in brackets are in Ksh.000	Ksh.000	Ksh.000
Depreciation: head office – 6 months to 1 October 2001 (1,200/25 × 6/12)	24,000	
– 6 months to 31 March 2002 (1,350/22·5 (w (i)) × 6/12)	30,000	54,000
training premises – 6 months to 1 October 2001 (900/25 × 6/12)	18,000	
– 6 months to 31 March 2002 (600/10 × 6/12)	30,000	
Impairment loss (w (ii))	210,000	258,000
Balance sheet (extracts) as at 31 March 2002		
Non-current assets		
Land and buildings – head office (700 + 1350 – 30)		2,020,000
– training premises (350 + 600 – 30)		920,000
		2,940,000
Revaluation reserve		
Head office land (700 – 500)	200,000	
Building (1,350 – 1,080 (w (i)))	270,000	
Training premises land (350 – 300)	50,000	520,000
Transfer to realised profit (270/22·5 (w (i)) × 6/12 re depreciation of buildings)		(6,000)
		514,000

Workings:

(i) The date of the revaluation is two and a half years after acquisition. This means the remaining life of the head office would be 22·5 years. The net book value of the head office building at the date of revaluation is Ksh.1,080,000 i.e. its cost less two and a half years at Ksh.48,000 per annum (Ksh.1,200,000 – Ksh.120,000).

(ii) Impairment loss: the net book value of training premises at date of revaluation is Ksh.810,000 i.e. its cost less two and a half years at Ksh.36,000 per annum (Ksh.900,000 – Ksh.90,000). It is revalued down to Ksh.600,000 giving a loss of Ksh.210,000.As the land and the buildings are treated as separate assets the gain on the land cannot be used to offset the loss on the buildings.

QUESTION TWO

(a) (i) Although the broad principles of accounting for non-current assets are well understood by the accounting profession, applying these principles to practical situations has resulted in complications and inconsistency. For the most part, IAS 16 codifies existing good practice, but it does include specific rules which are intended to achieve improved consistency and more transparency.

Cost The cost of an item of property, plant and equipment comprises its purchase price and any other costs directly attributable to bringing the asset into a working condition for its intended use. This is expanded upon as follows:
. purchase price is after the deduction of any trade discounts or rebates (but not early settlement discounts), but it does include any transport and handling costs (delivery, packing and insurance), non-refundable taxes (e.g. sale taxes such as VAT/GST, stamp duty, import duty). If the payment is deferred beyond normal credit terms this should be taken into account either by the use of discounting or substituting a cash equivalent price; . directly attributable costs are the incremental costs that would have been avoided had the assets not been acquired.

For self constructed assets this includes labour costs of own employees. Abnormal costs such as wastage and errors are excluded;
. installation costs and site preparation costs; and
. professional fees (e.g. legal fees, architects fees)
In addition to the .traditional. costs above two further groups of cost may be capitalised:
. IAS 23 .Borrowing Costs. allows (under the allowed alternative method), directly attributable borrowing costs to be capitalised. Directly attributable borrowing costs are those that would have been avoided had there been no expenditure on the asset.
. IAS 37 .Provisions, Contingent Liabilities and Contingent Assets. says that if the estimated costs of removing and dismantling an asset and restoring its site qualify as a liability, they should be provided for and added to the cost of the relevant asset.
Finally the carrying amount of an asset may be reduced by any applicable government grants under IAS 20 .Accounting for Government Grants and Disclosure of Government Assistance..
(ii) Subsequent expenditure:
Traditionally the appropriate accounting treatment of subsequent expenditure on non-current assets revolved around whether it represented a revenue expense, in effect maintenance or a repair, or whether it represented an improvement that should be capitalised. IAS 16 bases the question of capitalisation of subsequent expenditure on whether it results in a probable future economic benefit in excess of the amount originally assessed for the asset. All other subsequent expenditure should be recognised in the income statement as it is incurred. Examples of circumstances where subsequent expenditure should be capitalised are where it:

- represents a modification that enhances the economic benefits of an asset (in excess of its previously assessed standard of performance). This could be an increase in its life or production capacity;
- upgrades an asset with the effect of improving the quality of output; or
- is on a new production process that reduces operating costs.

In addition to the above the Standard says it is important to take into account the circumstances of the expenditure. For example normal servicing and overhaul of plant is a revenue cost, but if the expenditure represents a major overhaul of an asset that restores its previous life, and the consumption of the previous economic benefits has been reflected by past depreciation charges, then the expenditure should be capitalised (subject to not exceeding its recoverable amount). A further example of where subsequent expenditure should be capitalised is where a major component of an asset that has been treated separately (for depreciation purposes) is replaced or restored (e.g. new engines for an aircraft).
(b) Revaluation (particularly of properties) has been an area of great flexibility and inconsistency, often leading to misleading financial statements and accusations of .creative accounting.. Under IAS 16 revaluations are permitted under its allowed alternative treatment rules for the measurement of assets subsequent to their initial recognition. The Standard attempts to bring
some order and consistency to the practice of revaluations.

Where an entity chooses to revalue a tangible non-current asset, it must also revalue the entire class of assets to which it belongs. Further, sufficiently regular revaluations should be made such that the carrying amounts of revalued assets should not differ materially to their fair values at the balance sheet date. The Standard stops short of requiring annual valuations, but it does contain detailed rules on the basis and frequency of valuation. It should be noted that where an asset has been written down to its recoverable amount due to impairment, this is not classed as being a policy of revaluation. The effect of the above is that it prevents selective or favourable valuations being reported whilst ignoring adverse movements, and where a company has chosen to revalue its assets (or class thereof), the values must be kept up-to-date.

Surpluses and deficits:
These are measured as the difference between the revalued amounts and the book (carrying) values at the date of the valuation. Increases (gains) are taken to equity under the heading of revaluation surplus (this may be via a Statement of Total Recognised Gains and Losses (STRGL)), unless, and to the extent that, they reverse a previous loss (on the same asset) that has been charged to the income statement. In which case they should be recognised as income.
Decreases in valuations (revaluation losses) should normally be charged to the income statement. However, where they relate to an asset that has previously been revalued upwards, then to the extent that the losses do not exceed the amount standing to the credit of the asset in the revaluation reserve, they should be charged directly to that reserve (again this may pass through a STRGL).
Any impairment loss on revalued property, plant and equipment, recognisable under IAS 36 .Impairment of Assets., is treated as a revaluation loss under IAS 16.

Gains and losses on disposal:
The gain or loss on disposal is measured as the difference between the net sale proceeds and the carrying value of the asset at the date of sale. In the past some companies reverted to historic cost values to calculate a gain on disposal thus inflating the gain (assuming assets had increased in value). All gains and losses should be recognised in the income statement in the period of the disposal. Any revaluation surplus standing to the credit of a disposed asset should be transferred to accumulated realised profits (as a movement on reserves).
(c) (i) The initial measurement of the cost at which the plant would be capitalised is calculated as follows:

	Ksh.	Ksh.
basic list price of plant		240,000
less trade discount of 12·5% on list price		(30,000)
		210,000
shipping handling and installation costs		2,750
estimated pre-production testing		12,500
site preparation costs		
electrical cable installation (14,000- 6,000)		8,000
concrete reinforcement		4,500
own labour costs 7,500 20,000		
dismantling and restoration costs (15,000 + 3,000)		18,000
Initial cost of plant		263,250

Note: the early settlement discount is a revenue item (probably deducted from administration costs). The maintenance cost is also a revenue item, although a proportion of it would be a prepayment at the end of the year of acquisition (the amount would be dependent on the date on acquisition). The cost of the specification error must be charged to the income statement.
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(ii) Broadoak 30 September 2000 30 September 2001

Income statement extract Ksh.	Ksh.	
Amortisation	(20,000)	(21,000)
Revaluation loss		(25,000)
Balance sheet		
Leasehold	231,000	175,000
Revaluation reserve		
Balance 1 October 1999	50,000	
Revaluation gain (see below)	11,000	
Balance 30 September 2000	61,000	
Transfer to accumulated profits (11,000 x 1/11)	(1,000)	
Proportion of revaluation loss (see below)	(10,000)	
Balance 30 September 2001	50,000	
Workings:		
Cost 1 October 1999	240,000	
Amortisation to 30 September 2000 (240,000/12 years)	(20,000)	
	220,000	
Revaluation gain	11,000	
Carrying value 30 September 2000	231,000	
Amortisation to 30 September 2001 (231,000/11 years)	(21,000)	
	210,000	
Revaluation loss directly to revaluation reserve	(10,000)	
Remaining loss to income statement	(25,000)	
Carrying value 30 September 2001	175,000	

LESSON FOUR

(i) An impairment loss arises where the carrying amount of an asset is higher than its recoverable amount. The recoverable amount of an asset is defined in IAS 36 *Impairment of assets* as the higher of its fair value less costs to sell and its value in use (fair value less cost to sell was previously referred to as net selling price). Thus an impairment loss is simply the difference between the carrying amount of an asset and the higher of its fair value less costs to sell and its value in use.

Fair value:

The fair value could be based on the amount of a binding sale agreement or the market price where there is an active market. However many (used) assets do not have active markets and in these circumstances the fair value is based on a 'best estimate' approach to an arm's length transaction. It would not normally be based on the value of a forced sale.

In each case the costs to sell would be the incremental costs directly attributable to the disposal of the asset.Value in use:

The value in use of an asset is the estimated future net cash flows expected to be derived from the asset discounted toa present value. The estimates should allow for variations in the amount, timing and inherent risk of the cash flows. A major problem with this approach in practice is that most assets do not produce independent cash flows i.e. cash flows are usually produced in conjunction with other assets. For this reason IAS 36 introduces the concept of a cashgenerating

unit (CGU) which is the smallest identifiable group of assets, which may include goodwill, that generates (largely) independent cash flows.

Frequency of testing for impairment: Goodwill and any intangible asset that is deemed to have an indefinite useful life should be tested for impairment at least annually, as too should any intangible asset that has not yet been brought into use. In addition, at each balance sheet date an entity must consider if there has been any indication that other assets may have become impaired and, if so, an impairment test should be done. If there are no indications of impairment, testing is not required.

(ii) Once an impairment loss for an individual asset has been identified and calculated it is applied to reduce the carrying amount of the asset, which will then be the base for future depreciation charges.

The impairment loss should be charged to income immediately. However, if the asset has previously been revalued upwards, the impairment loss should first be charged to the revaluation surplus. The application of impairment losses to a CGU is more complex. They should first be applied to eliminate any goodwill and then to the other assets on a pro rata basis to their carrying amounts. However, an entity should not reduce the carrying amount of an asset (other than goodwill) to below the higher of its fair value less costs to sell and its value in use if these are determinable.

(b) (i) The plant had a carrying amount of Ksh.240,000 on 1 October 2004. The accident that may have caused an impairment occurred on 1 April 2005 and an impairment test would be done at this date. The depreciation on the plant from 1 October 2004 to 1 April 2005 would be Ksh.40,000 (640,000 x 121/2% x 6/12) giving a carrying amount of Ksh.200,000 at the date of impairment. An impairment test requires the plant's carrying amount to be compared with its recoverable amount. The recoverable amount of the plant is the higher of its value in use of Ksh.150,000 or its fair value less costs to sell. If Wilderness trades in the plant it would receive Ksh.180,000 by way of a part exchange, but this is conditional on buying new plant which Wilderness is reluctant to do. A more realistic amount of the fair value of the plant is its current disposal value of only Ksh.20,000. Thus the recoverable amount would be its value in use of Ksh.150,000 giving an impairment loss of Ksh.50,000 (Ksh.200,000 – Ksh.150,000). The remaining effect on income would be that a depreciation charge for the last six months of the year would be required. As the damage has reduced the remaining life to only two years (from the date of the impairment) the remaining depreciation would be Ksh.37,500 (Ksh.150,000/ 2 years x 6/12).

Thus extracts from the financial statements for the year ended 30 September 2005 would be:

Balance sheet	
Non-current assets	Ksh.
Plant (150,000 – 37,500)	112,500
Income statement	
Plant depreciation (40,000 + 37,500)	77,500
Plant impairment loss	50,000

(ii) There are a number of issues relating to the carrying amount of the assets of Mossel that have to be considered. It appears the value of the brand is based on the original purchase of the 'Quencher' brand. The company no longer uses this brand name; it has been renamed 'Phoenix'. Thus it would appear the purchased brand of 'Quencher' is now worthless. Mossel cannot transfer the value of the old brand to the new brand, because this would be the recognition of an internally developed intangible asset and the brand of 'Phoenix' does not appear to meet the recognition criteria in IAS 38. Thus prior to the allocation of the impairment loss the value of the brand should be written off as it no longer exists. The inventories are valued at cost and contain Ksh.2 million worth of old bottled water (Quencher) that can be sold, but will have to be relabelled at a cost of Ksh.250,000. However, as the expected selling price of these bottles will be Ksh.3 million (Ksh.2 million x 150%), their net realisable value is Ksh.2,750,000. Thus it is correct to carry them at cost i.e. they are not impaired. The future expenditure on the plant is a matter for the following year's financial statements.

Applying this, the revised carrying amount of the net assets of Mossel's cash-generating unit (CGU) would be Ksh.25 million (Ksh.32 million – Ksh.7 million re the brand). The CGU has a recoverable amount of Ksh.20 million, thus there is an impairment loss of Ksh.5 million. This would be applied first to goodwill (of which there is none) then to the remaining assets pro rata. However under IAS2 the inventories should not be reduced as their net realisable value is in excess of their cost. This would give revised carrying amounts at 30 September 2005 of:

	Ksh.'000
Brand	nil

Land containing spa (12,000 – (12,000/20,000 x 5,000))	9,000
Purifying and bottling plant (8,000 – (8,000/20,000 x 5,000))	6,000
Inventories	5,000
	20,000

QUESTION TWO

(a) Goodwill:

International Accounting Standards state that goodwill is the difference between the purchase consideration and the fair value of the acquired business's identifiable (separable) net assets. Identifiable assets and liabilities are those that are capable of being sold or settled separately, i.e. without selling the business as a whole. Purchased goodwill should be recognised on the balance sheet at this value and amortised over its estimated useful economic life. The useful economic life is the period of time over which an asset is expected to be used by the enterprise. There is a rebuttable presumption that the life should not exceed 20 years. However, in the rare cases where there is persuasive evidence where it can be demonstrated that the life is more than 20 years, then it should be amortised over the best estimate of its useful life. Where this occurs the estimated recoverable amount must be estimated at least annually and written down if it is impaired. IAS 38 specifically states that internally generated goodwill (but not necessarily other intangibles) cannot be capitalised.

Other intangibles:

Where an intangible asset other than goodwill is acquired as a separate transaction, the treatment is relatively straightforward. It should be capitalised at cost and amortised over its estimated useful economic life (similar rules apply to the lives of other intangible assets as apply to goodwill as referred to above). The fair value of the purchase consideration paid to acquire an intangible is deemed to be its cost.

Intangibles purchased as part of the acquisition of a business should be recognised separately to goodwill if they can be measured reliably. Reliable measurement does not have to be at market value, techniques such as valuations based on multiples of turnover or notional royalties are acceptable. This test is not meant to be overly restrictive and is likely to be met in valuing intangibles such as brands, publishing titles, patents etc. The amount of intangibles that may be recognised is restricted such that their recognition cannot create negative goodwill (as a balancing figure). Any intangible not capable of reliable measurement will be subsumed within goodwill.

Recognition of internally developed intangibles is much more restrictive. IAS 38 states that internally generated brands, mastheads, publishing titles, customer lists and similar items should not be recognised as intangible assets as these items cannot be distinguished from the cost of developing the business as a whole. The Standard does require development costs to be capitalised if they meet detailed recognition criteria.

(b) (i) The purchase consideration of Ksh.35 million should be allocated as: Ksh.m

Net tangible assets	15
Work in progress	2
Patent	10
Goodwill	8
	35

The difficulty here is the potential value of the patent if the trials are successful. In effect this is a contingent asset and on an acquisition contingencies have to be valued at their fair value. There is

insufficient information to make a judgment of the fair value of the contingent asset and in these circumstances it would be prudent to value the patent at Ksh.10 million. The additional Ksh.5 million is an example of where an intangible cannot be measured reliably and thus it should be subsumed within goodwill. The other issue is that although research cannot normally be treated as an asset, in this
case the research is being done for another company and is in fact work in progress and should be recognised as such.

(ii) This is an example of an internally developed intangible asset and although the circumstances of its valuation are similar to the patent acquired above it cannot be recognised at Leadbrand's valuation. Internally generated intangibles can only be recognised if they meet the definition of development costs in IAS 38. Internally generated intangibles are permitted to be carried at a revalued amount (under the allowed alternative treatment) but only where there is an active market of homogeneous assets with prices that are available to the public. By their very nature drug patents are unique (even for similar types of drugs) therefore they cannot be part of a homogeneous population. Therefore the drug would be recorded at its development cost of Ksh.12 million.

(iii) This is an example of a 'granted' asset. It is neither an internally developed asset nor a purchased asset. In one sense it is recognition of the standing of the company that is part of the company's goodwill. IAS 38's general requirementrequires intangible assets to be initially recorded at cost and specifically mentions granted assets. IAS 38 also refers to IAS 20 'Accounting for Government Grants and Disclosure of Government Assistance' in this situation. This standard says that both the asset and the grant can be recognised at fair value initially (in this case they would be at the same amount). If fair values are not used for the asset it should be valued at the amount of any directly attributable expenditure (in this case this is zero). It is unclear whether IAS 38's general restrictive requirements on the revaluation of intangibles as referred to in (a) above (i.e. the allowed alternative treatment) are intended to cover granted assets under IAS 20.

(iv) There is no doubt that a skilled workforce is of great benefit to a company. In this case there is an enhancement of revenues and a reduction in costs and if resources had been spent on a tangible non-current asset that resulted in similar benefits they would be eligible for capitalisation. However the Standard specifically excludes this type of expenditure from being recognised as an intangible asset and it describes highly trained staff as 'pseudo-assets'. The main reason is the issue of control (through custody or legal rights). Part of the definition of any asset is the ability to control it. In the case of employees (or, as in this case, training costs of employees) the company cannot claim to control them, as it is quite possible that employees may leave the company and work elsewhere.

(v) The benefits of effective advertising are often given as an example of goodwill (or an enhancement of it). If this view is accepted then such expenditures are really internally generated goodwill which cannot be recognised. In this particular case it would be reasonable to treat the unexpired element of the expenditure as a prepayment (in current assets) this would amount to 3/6 of Ksh.5 million i.e. Ksh.2·5 million. This represents the cost of the advertising that has been paid for, but not yet taken place. In the past some companies have treated anticipated continued benefits as deferred revenue expenditure, but this is no longer permitted as it does not meet the Standard's recognition criteria for an asset.

QUESTION THREE

(a) IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' only deals with those provisions that are regarded as liabilities. The term provision is also generally used to describe those

amounts set aside to write down the value of assets such as depreciation charges and provisions for diminution in value (e.g. provision to write down the value of damaged or slow moving inventory).
The definition of a provision in the Standard is quite simple; provisions are liabilities of uncertain timing or amount. If there is reasonable certainty over these two aspects the liability is a creditor. There is clearly an overlapbetween provisions and contingencies. Because of the 'uncertainty' aspects of the definition, it can be argued that to someextent all provisions have an element of contingency. The IASB distinguishes between the two by stating that a contingencyis not recognised as a liability if it is either only possible and therefore yet to be confirmed as a liability, or where there is a liability but it cannot be measured with sufficient reliability. The IASB notes the latter should be rare.
The IASB intends that only those liabilities that meet the characteristics of a liability in its Framework for the Preparation and Presentation of Financial Statements should be reported in the balance sheet.
IAS 37 summarises the above by requiring provisions to satisfy all of the following three recognition criteria:
– there is a present obligation (legal or constructive) as a result of a past event;
– it is probable that a transfer of economic benefits will be required to settle the obligation;
– the obligation can be estimated reliably.
A provision is triggered by an obligating event. This must have already occurred, future events cannot create current liabilities.
The first of the criteria refers to legal or constructive obligations. A legal obligation is straightforward and uncontroversial, but constructive obligations are a relatively new concept. These arise where a company creates an expectation that it will meet certain obligations that it is not legally bound to meet. These may arise due to a published statement or even by a pattern of past practice. In reality constructive obligations are usually accepted because the alternative action is unattractive or may damage the reputation of the company. The most commonly quoted example of such is a commitment to pay for environmental damage caused by the company, even where there is no legal obligation to do so.
To summarise: a company must provide for a liability where the three defining criteria of a provision are met, but conversely a company cannot provide for a liability where they are not met. The latter part of the above may seem obvious, but it is an area where there has been some past abuse of provisioning as is referred to in (b).
(b) The main need for an accounting standard in this area is to clarify and regulate when provisions should and should not be made. Many controversial areas including the possible abuse of provisioning are based on contravening aspects of the above definitions. One of the most controversial examples of provisioning is in relation to future restructuring or reorganisation costs (often as part of an acquisition). This is sometimes extended to providing for future operating losses. The attraction of providing for this type of expense/loss is that once the provision has been made, the future costs are then charged to the provision such that they bypass the income statement (of the period when they occur). Such provisions can be glossed over by management as 'exceptional items', which analysts are expected to disregard when assessing the company's future prospects. If this type of provision were to be incorporated as a liability as part of a subsidiary's net assets at the date of acquisition, the provision itself would not be charged to the income statement. IAS 37 now prevents this practice as future costs and operating losses (unless they are for an onerous contract) do not constitute past events.
Another important change initiated by IAS 37 is the way in which environmental provisions must be treated. Practice in this area has differed considerably. Some companies did not provide for such costs and those that did often accrued for them on an annual basis. If say a company expected environmental site restoration cost of Ksh.10 million in 10 years time, it might argue that this is not a liability until the restoration is needed or it may accrue Ksh.1 million per annum for 10 years (ignoring discounting). Somewhat controversially this practice is no longer possible. IAS 37 requires that if the environmental costs are a liability (legal or constructive), then the whole of the costs must be

provided for immediately. That has led to large liabilities appearing in some companies' balance sheets.
A third example of bad practice is the use of 'big bath' provisions and over provisioning. In its simplest form this occurs where a company makes a large provision, often for non-specific future expenses, or as part of an overall restructuring package. If the provision is deliberately overprovided, then its later release will improve future profits. Alternatively the company could charge to the provision a different cost than the one it was originally created for. IAS 37 addresses this practice in two ways:
by not allowing provisions to be created if they do not meet the definition of an obligation; and specifically preventing a provision made for one expense to be used for a different expense. Under IAS 37 the original provision would have to be reversed and a new one would be created with appropriate disclosures. Whilst this treatment does not affect overall profits, it does enhance transparency.
Note: other examples would be acceptable.

(c) Guarantees or warranties appear to have the attributes of contingent liabilities. If the goods are sold faulty or develop a fault within the guarantee period there will be a liability, if not there will be no liability. The IASB view this problem as two separate situations. Where there is a single item warranty, it is considered in isolation and often leads to a discloseable contingent liability unless the chances of a claim are thought to be negligible. Where there are a number of similar items, they should be considered as a whole. This may mean that whilst the chances of a claim arising on an individual item may be small, when taken as a whole, it should be possible to estimate the number of claims from past experience. Where this is the case, the estimated liability is not considered contingent and it must be provided for.
(i) Bodyline's 28-day refund policy is a constructive obligation. The company probably has notices in its shops informing customers of this policy. This would create an expectation that the company will honour its policy. The liability that this creates is rather tricky. The company will expect to give customers refunds of Ksh.175,000 (Ksh.1,750,000 x 10%). This is not the liability. 70% of these will be resold at the normal selling price, so the effect of the refund policy for these goods is that the profit on their sale must be deferred. The easiest way to account for this is to make a provision for the
unrealised profit. This has to be calculated for two different profit margins:
Goods manufactured by Header (at a mark up of 40% on cost):
Ksh.24,500 (Ksh.175,000 x 70% x 20%) x 40/140 = Ksh.7,000
Goods from other manufacturers (at a mark up of 25% on cost)
Ksh.98,000 (Ksh.175,000 x 70% x 80%) x 25/125 = Ksh.19,600
The sale of the remaining 30% at half the normal selling price will create a loss. Again this must be calculated for both group of sales:
Goods manufactured by Header were originally sold for Ksh.10,500 (175,000 x 30% x 20%). These will be resold (at a loss) for half this amount i.e. Ksh.5,250. Thus a provision of Ksh.5,250 is required.
Goods manufactured by other manufacturers were originally sold for Ksh.42,000 (175,000 x 30% x 80%). These will be resold (at a loss) for half this amount i.e. Ksh.21,000. Thus a provision of Ksh.21,000 is required.
The total provision in respect of the 28 day return facility will be Ksh.52,850 (7,000 + 19,600 + 5,250 + 21,000).
(ii) Goods likely to be returned because they are faulty require a different treatment. These are effectively sales returns. Normally the manufacturer will reimburse the cost of the faulty goods. The effect of this is that Bodyline will not have made the profit originally recorded on their sale. This applies to all goods other than those supplied by Header. Thus these sales returns would be

Ksh.128,000 (160,000 x 80%) and the credit due from the manufacturer would be Ksh.102,400 (128,000 x 100/125 removal of profit margin). The overall effect is that Bodyline would have to remove profits of Ksh.25,600 from its financial statements.
For those goods supplied by Header, Bodyline must suffer the whole loss as this is reflected in the negotiated discount. Thus the provision required for these goods is Ksh.32,000 (160,000 x 20%), giving a total provision of Ksh.57,600 (25,600 + 32,000).
(d) The Directors' proposed treatment is incorrect. The replacement of the engine is an example of what has been described ascyclic repairs or replacement. Whilst it may seem logical and prudent to accrue for the cost of a replacement engine as the old one is being worn out, such practice leads to double counting. Under the Directors' proposals the cost of the engine is being depreciated as part of the cost of the asset, albeit over an incorrect time period. The solution to this problem lies in
IAS 16 'Property, Plant and Equipment'. The plant constitutes a 'complex' asset i.e. one that may be thought of as having separate components within a single asset. Thus part of the plant Ksh.16·5 million (total cost of Ksh.24 million less Ksh.7·5 assumed cost of the engine) should be depreciated at Ksh.1·65 million per annum over a 10-year life and the engine should be depreciated at Ksh.1,500 per hour of use (assuming machine hour depreciation is the most appropriate method). If a further provision of Ksh.1,500 per machine hour is made, there would be a double charge against profit for the cost of the engine.
IAS 37 also refers to this type of provision and says that the future replacement of the engine is not a liability. The reasoning is that the replacement could be avoided if, for example, the company chose to sell the asset before replacement was due. If an item does not meet the definition of a liability it cannot be provided for.

LESSON FIVE

QUESTION ONE

a. Argument in favour of provision for deferred taxation:

- Deferred taxation is consistent with the revenue – list matching principle.
- Based on the exception principle of prudence, full provision ought to be made for tax liability, present or future before distributing profits to shareholders.
- The object is to make the total corporation tax charge in any year correspond as closely as possible with reported net profit of that year.
- To avoid fluctuations from after tax profit caused by economic or political reasons.

Arguments against provision for deferred taxation:

- Determination of foreseeable future is subjective
- Directors opinion may or may not be correct
- Not easy to keep records of each category of temporary differences.

b. Taxable profit

Year	1	2	3	4
	Shs '000'	Shs '000'	Shs '000'	Shs '000'
Profit before tax	13,860	15,840	15,840	17820
Diallowable expenses	990	990	990	990
Depreciation	4,950	4,950	4,950	4,950
	19,800	21,780	21,780	23,760
Wear and tear	(9,900)	(4,950)	(4,950)	-

	9,900	16,830	16,830	23,760
Tax liability	3,217.50	5,469.75	5,469.75	7,722

Deferred tax

Year	Wear & Tear	Depreciation	Timing difference	Deferred tax
Year	Sh '000'	Sh '000'	Shs '000'	Sh '000'
1	9,900	4,950	4,950	1,608.75
2	4,950	4,950	-	-
3	4,950	4,950	-	-
4	-	4,950	(4,950)	(1,608.75)

Pundamix Limited
Income Statement for the period ended

	Shs '000'		Shs '000'		Shs '000'		Shs '000'	
Profit before tax		13,860		15,840		15,840		17,820
Taxation								
Current tax	3,217.50		5,469.75		5,469.75		7,722	
Deffered tax	1,608.75	(4,826.25)	-	(5,469.75)	-	(5,469.75)	(1,608.75)	(6.113.25)
Profit after tax		9,033.75		19,370.25		10,370.25		11,706.75

Deferred tax A/C

Year 1	Balance c/d	1,608.75	Year 1	P & L A/C	1,608.75
Year 2	Balance c/d	1,608.75	Year 2	Balance c/d	1,608.75
Year 3	Balance c/d	1,608.75	Year 3	Balance c/d	1,608.75
Year 4	P & L	1,608.75	Year 4	Balance c/d	1,608.75

QUESTION TWO

K Ltd

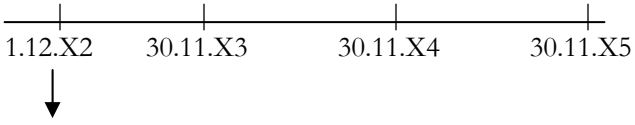
Profit and Loss Account for the year ended 30 November 20X5

	20X4	**20X5**
	Sh m	**Sh m**
Profit and loss for the year	(40)	160
Taxation		
Provision for tax payable	-	56
Adjustment to deferred tax		
Balance transfer to/from	-	(2)
Deferred tax account	16	-
	16	(54)
	(24)	106
Proposed dividends	10	60
	34	46
Statement of retained profit:		
Balance b/f	340	290
Prior period adjustment	(32)	(16)
As retained	308	274
Retained for the year	(34)	46

Retained profit c/f	274	320

K Ltd
Balance sheet as at 30 November

	20X4	20X5
	Sh m	Sh m
Non current assets	300	260
Current assets	270	320
Current liabilities	(180)	(146)
Current portion of deferred tax	-	(7)
	(180)	(153)
Net current liabilities	90	163
	390	427
Ordinary Share capital	100	100
Profit & Loss account	274	320
Shareholders funds	374	420
Deferred tax	16	7
	390	427



(100)

Originating T.D (100)

Reverse T.D.	(120)	20	20
Originating T.D	10		
Reversing		(10)	
Less: Original T.D	40		
Reversing T.D			(40)
	(80)	70	(30)

Year ended	**30-11.X4**	**30.11.X5**
	Sh m	**Sh m**
Accounting profit	(40)	160
Add back depreciation	20	20
General Provision for Bad debts	10	(10)
Tax profit	(10)	(170)
Loss c/f/b/f	10	(10)
Taxable profit	-	160
Tax thereon	0	

b) Corporation tax

20X5	**Sh.m**	**20X5**	**Sh.m**
31.5 Cashbook	28	30.11 P & L	56
31.8 Cashbook	14		
30.11 Cashbook	14		
20X6		**20X6**	
31.5 Cashbook	35	30.11 P&L	70
31.8 Cashbook	17.5		
30.11 Cashbook	17.5		
	70		70

Deferred Tax Account

20X4	**Sh.m**	**20X3**	**Sh.m**
30.11 P&L (40 x 40%)	16	31.12 P&L (80 x40%)	32
30.11 Bal c/d	16		
	32		32

20X5		**20X5**	
30.11 P&L a/c	2	1.12 bal b/d	16
30.11 Bal c/d	14		
	16		16

QUESTION THREE

a) i) IAS 12 requires that whenever the account carrying value (ACV) of an asset is greater than the tax base (or the tax carrying value = TB) and this temporary difference is taxable, deferred tax must be provided for using the accruals concept and or the fact that a tax liability exists at the balance sheet date. If an item of fixed asset is increased in accounting value by being revalued upwards than in Kenya, firstly a tax value is not changed: hence the difference between the ACV andTB is increased using the IAS 12 approach a taxable temporary difference comes into existence. The ACV which is recovered through use is greater than the amount allowable for tax purposes hence tax should be provided.

In Kenya there is no capital gain tax; however if a fixed asset is sold after revaluation and a dividend is paid out of the realized profit, compensation tax becomes payable on this dividend. However exposure draft (ED) 68 doe not require deferred tax to be provided for because of the potential compensating tax liability. It should be disclosed by way of note to the accounts. As a result some argue that since no liability to Corporation tax crystallises no deferred should be provided for however IAS12 requires deferred tax to be set aside on the revaluation because of the effect of tax rate being applied to the accounting profit differing as a result of the increased depreciation resulting from revaluation.

ii) The merits of the full provision for deferred tax are that the tax effect for all transactions in the period are recognized and the amount involved can be precisely qualified. The demerits for the full provision method are that this approach can lead to a purely arithmetical computation – certainty of calculation is given preference over a reasoned assessment of what a tax effect of transactions will actually be. If an asset or a liability will not crystallize then the profit or loss after tax would have been misreported if the asset or liability is included in the balance sheet. On the other hand if a tax asset or liability does actually exist at balance sheet date then the profit or loss reported for the period would be misreported if the asset or liability was omitted. This is the background to the argument in relation to the partial provision i.e. providing a liability will crystallize in the foreseeable future.

b) **Mauzo Ltd**

Profit & Loss Account for the year ended 30 April

		20X7	20X8	20X9	20X0
	Accounting profit (after depreciation)	5,850	5,200	4,306	4,200
	Taxable profit	4,250	5,600	5,100	2,200
i)	Flow through/Nil provision method				
	Taxation 33%	1,402.5	1,848	1,683	726
	Profit after tax	4,447.5	3,352	2,617	3,474
ii)	Full provision method				
	Current tax at 33%	1,402.5	1,848	1,683	726
	Deferred tax	528	132	264	660
	(Total = tax rate x A/c profit)	1,930.5	1,716	1,419	1,386
	Profit after tax	3,919.50	3,484	2,881	2,814
iii)	Partial provision				
	Current tax at 33%	1,402.5	1,848	1,683	726
	Deferred tax at 33%	396	(132)	(264)	-
		1,798.5	1,716	1,419	726
	Profit after tax	4,051.5	3,484	2,881	3,274

Assumption: No corporation tax is paid during the year. The whole of the current tax liability is outstanding at the year- end.

LESSON SIX

(a) Amounts recognised in the Balance Sheet at 31 October 2005 at 31 October 2004

	$m	$m
Present value of the obligation	3,375	3,000
Fair value of plan assets (3,170 – 8)	3,162	2,900
Liability recognised in balance sheet	213	100

Expense recognised in profit or loss for year ended 31 October 2005

	$m
Current service cost	40
Interest cost	188
Expected return on assets	(232)
Past service cost – vested benefits	125
Expense in profit or loss	121

Movement in net liability in balance sheet

	$m
Opening net liability (above)	100
Expense in profit or loss	121
Contributions (28 – 8)	(20)
Actuarial loss	12
Closing liability	213

Analysis of amount recognised in Statement of Recognised Income and Expense

	$m
Actuarial loss on obligation	(64)
Actuarial gain – plan assets	52
Actuarial loss to SRIE	(12)

Workings
The company will recognise $125 million past service costs immediately as the benefits vest on 1 November 2004. The interest cost should be based on the discount rate and the present value of the scheme liabilities at the beginning of the year but should reflect changes in scheme liabilities during the period. Hence the past costs have been included in scheme liabilities for this purpose. The return on plan assets should be calculated based on the expected rate of return on the plan assets at the beginning of the period but should reflect changes in scheme assets during the period. As the contributions and benefits were assumed to be paid at the end of the period, no adjustment is required to the opening balance.

The contributions that have not been paid will not count as an asset of the fund IAS19 (para 103).
Workings
Changes in the present value of the obligation and fair value of plan assets 31 October 2005

	$m
Present value of obligation 1 November 2004	3,000
Interest cost (6% of 3,000 +125 below)	188
Past service cost	125
Current service cost	40
Benefits paid	(42)
Actuarial loss on obligation (balance)	64
Present value of obligation 31 October 2005	3,375

	$m
Fair value of plan assets 1 November 2004	2,900
Expected return on plan assets (8% of 2,900) 2	32
Contributions	20
Benefits paid	(42)
Actuarial gain on plan assets (balance)	52
Fair value of plan assets 31 October 2005	3,162

The fair value of the plan assets is (3,170 – 8) i.e. net of contributions not paid.

The company wishes to recognise actuarial gains and losses under IAS19, outside of profit or loss.

(b) The contributions payable by Savage to the trustees will not count as an asset for the purposes of the valuation of the fund. IAS19 (paragraph 103) states that plan assets should not include unpaid contributions due from the reporting entity to the fund. Thus in the financial statements of Savage the contributions would be shown as an amount payable to the trustees and there may be legal repercussions if the amount is not paid within a short period of time. Following the introduction of changes to a defined benefit plan, a company should recognise immediately past service costs where the benefit has vested. In the case where the benefits have not vested then the past service costs will be recognised as an expense over the average period until the benefits vest. The company will therefore recognise $125 million at 1 November 2004.

LESSON SEVEN

QUESTION ONE

Squire Group
Group Statement of Cash Flows for the year ended 31 May 2002

	$m	$m
Cash flows from operating activities		
Net profit before taxation	415	
Adjustments for		
Share of profit in associate	(65)	
Exchange differences on tangible non-current assets	9	
Depreciation	129	
Amortisation of goodwill (Working 2)	25	
Interest expense	75	
Retirement benefit expense	20	
	193	
Operating profit before working capital changes	608	
Increase in trade receivables (1,220 – 1,060)	(160)	
Decrease in inventories (1,300 – 1,160 – 180)	40	
Increase in trade payables (2,355 – 2,105)	250	
	130	
Cash generated from operations	738	
Interest paid (Working 6)	(51)	
Income taxes paid (Working 4)	(140)	
Cash paid to retirement benefit scheme	(26)	
Net cash from operating activities		(217)
Cash flows from investing activities		
Acquisition of subsidiary (200 + 30)	230	
Purchase of tangible non-current assets (Working 1)	451	
Dividends received from associate (Working 3)	(50)	
Net cash used in investing activities		(631)
Cash flows from financing activities		
Proceeds from issue of share capital	60	
Repayment of long-term borrowings	(50)	
Dividends paid	(85)	
Minority interest dividends (Working 2)	(5)	
Net cash used in financing activities		(80)
Net decrease in cash and cash equivalents		(190)
Cash and cash equivalents at beginning		280

Cash and cash equivalents at the end of period	90

Working 1

	$m
Tangible non-current assets	
Balance at 1 June 2002	2,010
Impairment losses	(194)
Depreciation	(129)
Purchases (by deduction)	793
Acquisition – Hunsten	150
Closing balance	2,630

Cash flow is purchases ($793m) plus the exchange difference of $9 million less trade payables for the purchase of non-current assets $351 million, i.e. $451 million.

Working 2

	$m
Purchase of subsidiary	
Net assets acquired	300
Group's share of net assets (70%)	210
Goodwill	40
Purchase consideration (200 + 50)	250
Intangible assets	
Balance at 1 June 2001	65
Goodwill on subsidiary	40
Amortisation	(25)
Balance at 31 May 2002	80
Minority Interest	
Balance at 1 June 2001	345
Acquisition of Hunsten	90
Profit for year	92
Dividend	(5)
Closing balance	522

Working 3

	$m
Dividend from associate	
Balance at 1 June 2001	550
Income (net of tax) (65 – 20)	45
Foreign exchange loss	(10)
Dividends received	(50)
Balance at 31 May 2002	535

Working 4

	$m
Taxation	
Balance at 1 June 2001 – Income Tax	160

– Deferred tax	175
Income Statements (225 – 20)	205
Tax paid	(140)
Balance at 31 May 2002	
– Income Tax	200
– deferred tax	200
	400

Working 6

	$m
Interest paid	
Balance at 1 June 2001	45
Income statement	75
Unwinding of discount on purchase consideration	(4)
Cash paid	(51)
Closing balance	65

QUESTION TWO

(a) (i) Earnings per share (EPS) is a ratio that is widely used by both present and future investors to gauge the profitability of a company. A lack of standardisation internationally in the way in which EPS is calculated can make comparisons among companies very difficult. It seems only logical that if the IASB is producing standards which purport to bring consistency in accounting policies world-wide, then a standard on EPS was a priority. There has been demand from investors for a meaningful and concise summaryindicator of the performance of the enterprise.

There was no IAS on the subject, and therefore it seemed an opportune moment to develop a standard based on joint research by national and international standard setting bodies, and thus to standardise the methods of computing EPS. IAS33 was introduced in 1997.

It seemed inevitable that as EPS is an important component of the P/E ratio which analysts seem to place so much reliance upon, then IASC has attempted to discourage reliance on such a measure or any other single condensed indicator, but eventually the demand for such a criterion became critical and the IASB has attempted to develop guidelines which would at least ensure that any such measure is valid and consistently applied.

(ii) Basic EPS takes account only of those shares which are in issue and does not take account of obligations that could dilute the EPS in future. The company could have convertible stock, options or warrants to subscribe for shares. Additionally, a company could have entered into deferred consideration agreements under which additional shares may be issued at a future date. Investors are not only interested in past performance but also with forecasting future earnings per share. Thus it is important to disclose the effect of any dilution in the future. Many companies use convertible stocks to achieve the illusion of growth in basic EPS. Where convertible loan stock and shares are used to finance expansion, the securities normally carry a low rate of interest due to the fact that they can be converted into shares. If current performance is sustained and the incremental finance cost is covered, then EPS can be increased. Diluted EPS however, will reveal the true growth in earnings as an attempt is made to show the true cost of using convertible stock to finance growth in earnings.

The disclosure is intended to help users assess the potential variability of future EPS and the risk attaching to it. It can function as an indicator to users that the current level of basic EPS may not be sustainable in future. However, it is also felt that the objectivesof the basic and diluted EPS should be the same and act as a performance measure. The diluted EPS is a theoretical measure of the effect of dilution on basic EPS and analysts do not use this measure as much as basic EPS because of its hypothetical nature. However, the diluted EPS can serve as a warning device to equity shareholders that future earnings will be affected by diluting

factors.

(b) Earnings per share – basic

			$000
Profit attributable to the members of the parent company.			12,860
less preference dividend			(210)
other appropriations			(80)
Earnings – basic			12,570
Weighted average number of shares.			(000)
Shares Weight No.			
1 June 1998 10,100 x 1		10,100	
1 January 1999 – issued 3,600 x 5/12		1,500	
1 March 1999 – options 1,200 x 3/12		300	
1 April 1999 – purchased (2,400) x 2/12		(400)	
31 May 1999		12,500	11,500
Bonus issue 1 July 1999 1 for 5			2,300
Number of shares			13,800
Basic Earnings Per Share 12,570 =			91c
13,800			

IAS33 states that the shares used in the basic EPS calculation should be based on the weighted average number of equity shares in issue. IAS33 also states that a bonus issue should be taken into account in calculating basic EPS if the issue was before the publication of thefinancial statements.

Diluted Earnings per Share.
Computation of whether potential ordinary shares are dilutive or antidilutive.

			$000
Net profit Ordinary Per sharefrom continuing Shares cents operations (000)			
Net profit from continuing operations	18,270	13,800	132
Options			
5 – 2			
1,200 x —— x 9/12		540	
5			
5 – 3			
2,000 x ——		800	
5			
5 – 4			
1,000 x ——		200	
5			
	18,270	15,340	119
Dilutive			
6% Bonds			
(6% x 6,000 x ·65)	234	12,000	

	18,504	27,340	67·7c
Dilutive			
Convertible Redeemable	210		
Preference Shares	80	2,000	
	18,794	29,340	64·1
	Dilutive		

Therefore all adjustments are dilutive and should be taken into account. IAS33 states that potential ordinary shares which increaseearnings per share from continuing operations are deemed to be anti dilutive and are ignored in calculating diluted EPS. However in this case all dilutive elements would be taken into account.

Diluted Earnings Per Share Calculation.

	$000
Profit/Earnings – basic	12,570
6% Bonds – interest	234
Convertible preference shares	290
Earnings – diluted EPS	13,094
Ordinary shares	29,340
Diluted Earnings per Share	44·6c

Working

Net-Profit from continuing operations.

	$000
Operating Profit – continuing operations	26,700
Profit on fixed assets	2,500
Interest payable	(2,100)
Taxation (7,500 – 100)	(7,400)
Minority Interest (540 + 600)	(1,140)
Dividends – preference	(210)
other appropriations	(80)
Net profit from continuing operations	18,270

QUESTION THREE

Notes to the accounts at 31 December 20X1
Segmental analysis – Sema International plc

Geographical area	Local	Uganda	Total
Turnover	Sh. '000'	Sh. '000'	Sh. '000'
Turnover by destination:			
Sales to third partied			
Continuing	150,858	70,992	221,850

Discontinued	54,853	-	54,853
	205,711	70,992	276,703
Turnover by origin			
Continuing operations:			
Total sales	157,311	81,039	238,350
Intersegment sales	(13,200)	(3,300)	(16,500)
Sales to third parties	144,111	77,739	276,703
Profit			
Segment profit:			
Continuing operations	12,920	4,080	17,000
Discontinued operations	(708)	-	(708)
	12,212	4,080	16,292
Common costs			(2,400)
Profits before tax of associated undertakings	3,575	-	3,575
Operating profit			17,467
Non-operating items			(1,998)
Interest payable and income from investments			216
Profit on ordinary activities before taxation			15,685
Net assets			
Net assets by segment:			
Continuing operations (see working 1)	48,116	25,806	73,922
Unallocated liabilities			(7,800)
			66,122
Net assets of associated undertaking	26,670	-	26,670
			92,792
Minority interest			(812)
Total net assets			91,980

Candidates will be given credit for alternative presentations of the above information. As the associated undertakings net assets are greater than 20% of the groups net assets and results, the entity's share of the results and net assets of the associate have to be segmentally analysed. There is insufficient information in the question to classify operating and non operating assets.

Working 1	**Local Sh. '000'**	**Uganda Sh. '000'**	**Total Sh. '000'**	**Apportionment**
Intangible assets	2,010	670	2,680	75:25
Tangible assets	39,955	10,985	43,940	75:25
Current assets	50,330	21,570	71,900	70:30
Creditors within one Year (32,530 – 7,800)	(17,311)	(7,419)	(24,730)	70:30
Creditors more than one Year	(16,338)	-	(16,338)	-
Deferred government Grants	(3,530)	-	(3,530)	
	48,116	25,806	73,922	

QUESTION FOUR

Expected realizations if company liquidated

	Shs
Goodwill	-
Patents, trademarks	40,000
Freehold land	3,000,000
Plant and vehicles	720,000
Stock and debtors	1,160,000
Shares	280,000
	5,200,000
To mortgage	(1,200,000)
Preferential creditors	(380,000)
Other creditors	(2,800,000)
	(1,020,000)
Preference shares: Capital	(1,020,000)
Dividends (7% x 1 x 3)	(210,000)
Deficit on preference	(190,000)

Deficit per share $\frac{190,000}{50,000} = Sh3.8$

Ordinary shareholders suffer total deficit of Shs 20.

Goodwill	600,000
Patents, Trademarks	180,000
Freehold land	(600,000)
Plant	280,000
Stock and debtors	120,000
Listed shares	20,000
Preference dividends	210,000
Profit and loss	4,580,000
Share premium	(1,200,000)
Net write off	4,190,000
Total write off	4,190,000
Preference share w/off (deficit) 50,000 x 4	(200,000)
Write off required: Ordinary shares	3,990,000

Write off per ordinary shares $\frac{3,990,000}{200,000} = Shs19.95$

PROPOSED SCHEME

- Reduce the nominal value of preference shares by Shs 4 to Shs 16
- Reduce the par value of ordinary shares by Shs 19.95 to Shs 0.05
- Write off goodwill
- Revalue the remaining assets to fair values
- Invite the bank to advance Shs 1 million, repay the overdraft and the scheme costs of Shs 96,000
- Invite the existing ordinary shareholders to subscribe for additional shares to improve liquidity by at least Shs 700,000 necessary to finance plant and stock increase/expansion.

QUESTION FIVE

a) Disaggregation Reporting is the reporting of financial information by segment-information about the different types of products and services an enterprise produces and the different geographical areas in which it operates

b) i) Benefits

Segment reporting helps users of financial statements

- Better understand the enterprise's past performance.
- Better assess the enterprise's risks and returns
- Better asses the level of investments made in the different segments
- Make more informed judgments about the enterprise as a whole
- Identify whether further investment is being made in profitable areas or whether divestment is being made out of non-profit areas.

ii) Objections and problems

- It is time consuming and costly for companies to provide segmental information, if it is not already available internally
- Subjectively is inevitable in disaggregating information to segments. This may lead to reduced comparability between companies
- Segmental information would not only be available to potential investors but also to competitors
- It is sometimes difficult to define and keep separate the different industries and geographical segments.

c) i) According to subsection 2 of section 150 of the Companies Act, a subsidiary may be excluded from consolidation if:

a) The directors are of the opinion that:
   - It is impractical or would be of no real value to members of the company, in the view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company; or
   - The result would be misleading, or harmful to the business of the company or any of its subsidiaries; or
   - The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

   Approval of the registrar shall be required for not dealing in group accounts with a subsidiary on ground (ii) and (iii).

However IAS 27 prohibits the exclusion of subsidiary companies under these grounds. Please refer to the study text in Lesson 1 for further guidance.

LESSON EIGHT

QUESTION ONE

(a)

Regulated accounting information market is a financial market operating under a regulated stated from various sources. These include legislative regulations, accounting standards and stock exchange rules for companies quoted on the stock market.
Unregulated accounting information is a financial market operating under no regulations.

(b)

Market failure arises when the market is unable to

- Efficiently allocate resources due to imperfections that exist in that market or because the way the market is structured is poor
- Provide information to those who are in need of it

Specific reasons why market failure occurs include the following:

- The monopoly in the supply of such information by the accounting entity. The reporting entity is the enterprise that is in control of the supply of internal information about the entity. This introduces certain imperfections in the supply of such information. There will be restriction in the supply of absolute information about the accounting entity and the information may not be available to those who need it.
- Where suppliers of such accounting information were to charge prices fears have been expressed that such prices will be prohibitive for most users.
- 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 capital markets are not well developed.

(c) Arguments for unregulated accounting profession

- Agency theory

The theory 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 and management 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, is compelled to report regularly so as to enhance their image and compensation. Thus firms will disclose all information regularly.

- Competitive capital market
  Firms have to raise capital funds from a competitive environment in the capital markets. This will compel them to disclose voluntarily so as to attract such funds from investors. It is generally accepted that firms that report regularly in the capital markets 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 regulated accounting will be imposing rules in a self-regulating profession.
- Private contracting opportunities theory
  It has been argued that users who need information may enter into a contract with private organisations 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' need. Under such circumstances there is no need to regulate accounting profession.

QUESTION TWO

(a)

The development of International Accounting Standards

Board representatives, member bodies, members of the consultative group, other organisations and individuals and the IASB staff are encouraged to submit suggestions for new topics which might be 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 IASB'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.

During this process, the board may decide that the needs of the subject under consideration warrant additional consultation or would be better served by issuing an issues paper or a discussion paper for comment. It may also be necessary to issue more than one exposure draft before developing an International Accounting Standard.

(b)

Issues in developing an agricultural accounting standard.

- Categorisation of farming activity e.g. animal husbandry, poultry keeping, ostrich farming, fish farming, bee keeping.
- Appraisal of farming activity – overall profitability, analysis of costs as a ratio of sales and tax implications
- Separation of farming activity from personal affairs of owners
- Maintenance of full set of financial statements
- Valuation of stocks and costs involved e.g. direct costs (seeds, fertilizer/manure, labour), indirect costs (administrative costs, selling distribution and general overheads).
- Valuations of work in progress may be left out due to uncertainties inherent in farming. Profit should be based on finished and harvested crops only.
- Providing for depreciation on plant and machinery as appropriate
- Valuing existing products (e.g. 75% of market price for own livestock and 85% of market price for home grown grains).

QUESTION THREE

(a)

A conceptual framework has been identified as 'a constitution, a coherent system of interrelated objectives and fundamentals that can lead to a consistent standard and that prescribes the nature, function and limits of financial accounting and financial accounting statements."

The main steps which one should undertake in developing a conceptual framework involves:

- Establishment of the objective of financial statements
  It is necessary to determine
  - For what purposes financial statements are intended
  - To whom they should be directed
  - What information should be included
  - The limitation of financial statements
- Determination of the essential qualitative characteristics of financial statements information
- What qualities (such as relevance, reliability, understandability and comparability) make accounting information useful to financial statement readers and what are the appropriate trade offs that are necessary when conflicts between these characteristics (such as relevance and reliability) occur?
- Definition of the basic elements of accounting
- What is an asset, liability, equity, revenue or expense? Are some of these elements more important than others in determining net income? For example, should net income be defined in terms of changes in an enterprise's net assets (excluding capital transaction) over a period of time, or should assets and liabilities be determined only after revenues, expenses and net income are defined?
- Determination of the basis of recognition and measurement
- Even after the basic elements are developed, when should the elements be recognised and how should they be measured? For example, should historical cost, replacement cost, current selling price, expected cash flows, present value of expected cash flows, or some other valuation system be used?
- Change in measuring unit
- Should the basic measuring unit of accounting be adjusted for changes in the purchasing power of the shilling, should these changes be ignored, or should information on a supplementary basis be presented?

(b)

Objectives of income measurement

- To assess potential changes in the economic resources that an enterprise is likely to control in the future. The information about variability of income is important in this respect.
- To assist predicting the capacity of the enterprise to generate cash flows from its existing resource base
- Useful in forming judgements about the effectiveness with which the enterprise might employ additional resources
- Assist in assessing the stewardship or accountability of management

QUESTION FOUR

(a)

Definition: 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 practice. Accounting standards usually consist of three parts:

- A description of the problem to be tackled
- A reasonable discussion of ways of solving the problem
- The prescribed solution in line of decision or theory

Their purpose is to reduce the number of acceptable alternative treatments of an accounting issue and facilitate comparison in financial statements.

Advantages of accounting standards

They provide the accounting profession with useful working rules

- They force improvement in the quality of the work of accountants
- They strengthen the accountants' resistance against pressure to use an accounting application application which may be inappropriate in the circumstances
- They ensure that users of financial statements get more complete and clearer information on a consistent basis from period to period
- They assist in the comparison users may make between the financial statements of one organisation and another
- They direct financial statement towards establishing the economic trust of the organisation performance
- They provide a focal point for debate and discussion about accounting practice
- They are a less rigid alternative to enforcing conformity by means of legislation

Disadvantages of accounting standards

- Accounting standards are bureaucratic and lead to rigidity. The quality of the work of accountants is restricted since firms and industries differ and change as do environments within which they operate
- The official acceptance of an accounting standard reduces the accountant's power to resist the use of accounting applications of inappropriate standard when the directors wish to follow it.
- Accounting standards reduce the scope for professional judgement of accountants. Accountants are thus reduced to technicians rather than being professionals.

- Most users of financial reports are made to believe that financial statements produced using accounting standards are infallible. This is misleading.
- Standards have been derived through social or political pressures, which may reduce the freedom or lead to the manipulation of the profession.
- Standards inhibit the developments of critical thought.
- The more standards there are the more costly the financial statements are to produce.

(b)

Council of ICPAK believed that there were compelling reasons why the change to International Standards was necessary.

- International trends: many countries, which previously had their own national standards have adopted international standards as IAS, become accepted as a common yardstick for International reporting. International flows of investment capital and capital instruments across geographical boundaries have and will add a new impetus to the current push for adoption of international standards.
- Regional considerations: Kenya is a member of both IFAC and ECSAFA, organisations that strongly support adoption, rather than adaptation, of International standards.
- Local pressure: Regulators (particularly the Central Bank of Kenya and Capital Markets Authority) continuously turned to International standards rather than Kenyan standards, as an indicator of what best practice should be.
- Resource limitations: Updating Kenyan Standards to comply with International Standards and to also cover areas, which were not covered, was a monumental task.
- Past experience: Every Kenyan standard issued was intended to comply with IAS. ICPAK never found it necessary to challenge any International Standards and no Kenyan standard was ever designed to deviate from IAS. This begged the question as to whether it was worthwhile expending scarce resources and energy in paraphrasing of existing IAS.

(c)

Advantages of adopting International Standards

By adopting International Standards, ICPAK is expected to reap certain benefits.

- Kenya will be recognised as a leading international player in cross border reporting in the region
- The institute has remained on top of events taking place in the accounting and auditing fields, particularly where international players or regulators are concerned
- The scale and voluntary human resources available to the Institute have been relieved of Standard development responsibilities and is therefore available to devote their energy to helping members interpret International Standards and to communicating their implications in technical bulletins.

QUESTION FIVE

(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.

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATION BOARD

CPA PART III

FINANCIAL ACCOUNTING IV

December 2005 **Time allowed: 3 Hours.**

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings.

QUESTION ONE

Mzalendo Ltd., a company quoted on the Nairobi Stock Exchange, ahs a foreign subsidiary, Mgeni Ltd., whose reporting currency is the Dime. The reporting currency of Mzalendo Ltd., is the Kenya shilling (Ksh.). The financial statements of the two companies for the year ended 31 October 2005 were as follows:

Income Statements for the year ended 31 October 2005:

	Ksh. "million"	Dime "million"
Revenue	40,425	97,125
Cost of sales	(35,500)	(77,550)
Gross profit	4,925	19,575
Other income	277	200
	5,202	19,775
Distribution costs	(2,640)	(3,159)
Administration expenses	(1,640)	(2,100)
Finance cost	(120)	(600)
Profit before tax	802	13,925
Tax expense	(300)	(4,725)
Dividends: Interim paid	(300)	(1,448)
Final proposed	(400)	(2,304)
Retained profit for the period	(198)	5,448

Balance Sheets as at 31 October 2005:

	Ksh. "million"	Dime "million"
Non-current assets:		
Property, plant and equipment	3,240	4,860
Investment in Mgeni Ltd.	470	-
	3,710	4,860
Current assets:		
Inventory	1,990	8,316
Accounts receivable	1,630	4,572
Cash at bank	240	2,016
Total assets	7,570	19,764
Equity and liabilities:		
Ordinary share capital	118	1,348
Retained profits	502	9,260

	620	10,608
Non-current liability:		
12% loan stock	1,000	4,860
Current liabilities:		
Accounts payable	5,550	1,932
Current tax	50	60
Proposed dividends	400	2,304
Total equity and liabilities	7,570	19,764

Additional information:

1. Mzalendo Ltd. Acquired 75% of the ordinary share capital of Mgeni Ltd. On 1 November 2002 when the retained profits of Mgeni Ltd. Were Dime 2,876 million. The goodwill arising on the acquisition of Mgeni Ltd., is considered to be an asset of Mgeni Ltd. No amortisation of goodwill is charged on profits.
2. Other income reported by Mzalendo Ltd., is made up of interim dividend received from Mgeni Ltd., Mgeni Ltd., aid the dividend on 15 July 2005. Other income reported by Mgeni Ltd. is made up of the exchange gain on retranslating the 12% loan stock. The loan stock was obtained form a foreign country.
3. During the year ended 31 October 2005, Mzalendo Ltd., sold goods worth Ksh.900 million to Mgeni Ltd. Mzalendo Ltd. Reported a profit of 25% on cost. Half of these goods were still in the inventory of Mgeni Ltd. As at 31 October 2005.

4. The relevant exchange rates at select dates were as follows:

Date	**Dime to 1 Kenya Shilling**
1 November 2002	4.40
31 October 2004	4.00
15 July 2005	3.92
31 October 2005	3.60
Average for the year ended 31 October 2005	3.75

Required:

a) Consolidated income statement for the year ended 31 October 2005 in Kenya Shillings. **(13 marks)**

b) Consolidated balance sheet as at 31 October 2005 in Kenya Shillings. **(12 marks)**
(Round the figures to the nearest 1 million where necessary)

(Total: 25 marks)

QUESTION TWO

Biashara Ltd. Operates in a business environment where prices have had a consistent upward trend in the past years. The company has therefore adopted a policy of supplementing historical cost accounting financial statements with current cost accounting financial statements.

Provided below are the financial statements of the company for the dates shown.

Biashara Ltd.
Balance Sheet as at 31 December 2003
(Current cost accounting basis)

	Sh. '000'	Sh. '000'
Assets:		
Non-current assets:		
Land	2,500	
Buildings	6,600	
Motor vehicles	4,800	
		13,900
Current assets:		
Stock	610	
Debtors	860	
Bank balance	150	
		1,620
		15,520
Equity and liabilities		
Capital and reserves:		
Ordinary share capital	5,000	
Preference share capital	2,000	
Share premium	1,000	
Current cost reserve	1,250	
Retained earnings	2,270	
		11,520
Non-current liability:		
Loan		3,000
Current liabilities:		
Creditors	380	
Current tax	170	
Interest payable	150	
Proposed dividends	300	
		1,000
		15,520

Profit and loss account for the year ended 31 December 2004
(Historical cost accounting basis)

	Sh. '000'	Sh. '000'
Sales		
Opening stock	600	
Purchases	23,620	
	24,220	
Closing stock	560	
		23,660
Gross profit		10,140
Expenses:		
Depreciation	1,580	

Interest on loan	250	
Other operating expenses	5,480	
		7,310
Operating profit		2,830
Profit on disposal of a motor vehicle		50
Profit before tax		2,880
Tax		870
Profit after tax		2,010
Dividends paid:		
Preference	100	
Ordinary	200	
Dividends proposed:		
Preference	100	
Ordinary	300	
		700
Retained profit		1,310

Additional Information:

1. On 30 September 2004, the company sold a motor vehicle at a profit of Sh.50,000. The motor vehicle had cost Sh.1 million and had accumulated depreciation of Sh.400,000 by the date of sale. No depreciation was provided on the vehicle in the year of sale and the price index on the date of sale was 108.
2. The company issued ordinary shares of a nominal value of sh.2 million at a premium of 25% on 30 September 2004.
   The shares issued did not rank for dividend in the year ended 31 December 2004.
3. The following information is relevant in relation to the non-current assets of the company:

	Buildings	**Motor vehicles**
Historical cost accounting		
Cost	Sh.10 million	Sh.6.4 million
Accumulated depreciation		
On 31 December 2003	Sh.4 million	Sh.2.56 million
Index		
On date of purchase	100	80
On 31 December 2003	110	100
On December 2004	120	110

   Land was purchased at a cost of sh.2.2 million and had a market value of Sh.2.75 million on 31 December 2004.

   All motor vehicles, including the one sold on 30 September 2004, were purchased on the same date.

4. The company provides for depreciation on the non-current assets on cost using the straight line method at the following rates per annum:

Buildings	-	5%
Motor vehicles	-	20%

The depreciation adjustment for current cost accounting is based on the year end current cost values.

5. The average age of stocks is one month and the following are the relevant prices indices on selected dates:

	Index
30 November 2003	120
31 December 2003	122
30 November 2004	140
31 December 2004	142

The average index for the year ended 31 December 2004 was 132.

The company applies the same indices on stocks and monetary working capital (which includes bank balances).

6. On 1 July 2004, the company made a loan repayment of sh.1 million.
7. The company had the following balances in its books as at 31 December 2004:

	Sh. '000'
Debtors	750
Creditors	560
Bank balance	5,590
Current tax	240
Interest payable	100

Required:

a) Current cost accounting profit and loss account for the year ended 31 December 2004. **(10 marks)**

b) Current cost accounting balance sheet as at 31 December 2004. **(10 marks)**

(Total: 20 marks)

QUESTION THREE

Delta Ltd., a private limited company, decides to raise funds for the expansion of its operations by floating its ordinary shares to public. Mhasibu and Associates, a firm of Certified Public Accountants, was contracted to prepare the accountants report to appear in the prospectus.

The following information has been provided with respect to Delta Ltd.,

1. Extracts from the accounts of Delta Ltd. For the last five financial years ended 30 June 2005:

	2001	**2002**	**2003**	**2004**	**2005**
	Sh. '000'	**Sh. '000'**	**Sh. '000'**	**Sh. '000'**	**Sh. '000'**
Turnover	9,650	10,700	12,700	15,300	17,500

Cost of sales	7,720	8,560	10,160	12,240	14,000
Administration costs	480	520	550	580	620
Selling and distribution costs	298	390	410	470	510
Investment income	20	30	40	40	60
Finance costs	180	180	240	300	300
Tax	302	330	400	530	650
Ordinary share capital (Sh.10 par value)	8,000	8,000	10,000	10,000	10,000
Dividend rate	5%	6%	6%	8%	8%

2. Balance Sheet as at 30 June 2005

	Sh. '000'	**Sh. '000'**
Assets		
Non-current assets:		
Freehold property (at valuation)	12,000	
Plant and machinery (at cost less depreciation)	6,000	
Motor vehicles (at cost less depreciation)	4,800	
Furniture (at cost less depreciation)	1,500	
		24,300
Current assets:		
Stock (at lower of cost and net realisable value)	2,800	
Debtors (net of provision for doubtful debts)	1,600	
Quoted investments (at market price)	650	
Bank balance and cash in hand	150	
		5,200

Total assets		29,500
Equity and liabilities		
Capital and reserves:		
Ordinary share capital	10,000	
Share premium	4,000	
Revaluation reserve	2,000	
Investment price fluctuation reserve	190	
Profit and loss account balance	3,850	20,040
Non-current liabilities		
6% Debentures	5,000	
Bank loan	850	
Deferred tax	1,950	7,800
Current liabilities:	710	
Trade creditors	550	
Current tax	400	
Proposed dividends		1,660
Total equity and liabilities		29,500

3. On June 2003, the company received a sales order of Sh.300,000 and immediately invoiced the customer for the value of the goods. The amount of the sales order was recorded as sales for the month of June 2003.
The goods were excluded from the closing stock on 30 June 2003 and delivered to he customer on 2 July 2003. The policy of the company is to recognise a sale when goods are delivered to a customer. The company charges a profit margin of 25% on cost.

4. Due to a technical problem in June 2005, a sale of Sh.253,000 was incorrectly recorded in both sales account and sales ledger as Sh.235,000. The error is yet to be corrected.
5. Stock taking errors resulted in the overstatement of closing stock by Sh.150,000 on 30 June 2004 and the understatement of closing stock by 180,000 on 30 June 2005.
6. A vehicle which had cost Sh.500,000 and had an accumulated depreciation of Sh.150,000 on 30 June 2003 was withdrawn from use on 1 July 2003 pending re-conditioning and subsequent sale.

   The vehicle has, however, not been sold. Despite not being used, the vehicle has been subjected to depreciation at the rate of 10% per annum based on cost.

   Depreciation of the vehicle is included in the selling and distribution costs.
7. On 2 January 2003, the company issued 200,000 ordinary shares ofSh.10 each to a private investor at fair value. The shares issued ranked for dividend in the year ended 30 June 2003 at 50% of the normal dividend rate.
8. Quoted investments were sold in August 2005 and the proceeds used to repay the bank loan. All the investment income reported in the five years had been generated form these investments.
9. Investment price fluctuation reserve attributable to investments sold is treated as realised on sale of the investments.
10. Depreciation is provided on the non-current assets on a straight line basis on cost or valuation at the following rates.

Plant and machinery	-	5% per annum
Motor vehicles	-	10% per annum
Furniture	-	12.5 per annum

11. Mhasibu and Associates (Certified Public Accountants), have been auditors of the company for the past three years ended 30 June 2005. Prior to the appointment of Mhasibu and Associates, Mkaguzi and Associates (Certified Public Accountants), were the auditors of the company for many years.
12. The company has an authorized share capital of sh.20 million composed of 2 million ordinary shares of sh.10 each.
    All the issued ordinary shares of the company are fully paid.
13. The turnover is the net aggregate amount receivable for goods supplied and services rendered net of value added tax.
14. The company makes both domestic and export sales. The export sales in the five years ended 30 June 2005 were as follows:

	2001	**2002**	**2003**	**2004**	**2005**
	Sh. '000'	**Sh. '000'**	**Sh. '000'**	**Sh. '000'**	**Sh. '000'**
Export sales	3,800	4,500	5,200	6,400	7,200

All export transactions were denominated in Kenya shillings.

15. Professional valuation carried out in June 2005 estimated the value of the freehold property at Sh.13.5 million.
16. On 30 June 2005, the company had capital commitments of Sh.8 million of which sh.6 million had been contracted for.

Required:
Accountants report for inclusion in the prospectus. **(20 marks)**

QUESTION FOUR

Provided below are the consolidated income statement and the consolidated income statement and the consolidated balance sheet of Leta group for the financial year ended 31 October 2005.

Leta Ltd.
Consolidated income statement for the year ended 31 October 2005:

	Sh. 'million'	Sh. 'million'
Revenue		5,106
Cost of sales		3,628
Gross profit		1,478
Other incomes: Share of profit after tax in associate company	40	
Investment income	50	90
		1,568
Expenses:	250	
Distribution costs	528	
Administration expenses	150	(928)
Finance costs		640
Profit before tax expense		(280)
Profit for the year		360
Profit attributable to: the holding company		330
The minority interest		30
		360

Leta Ltd.
Consolidated balance sheet as at 31 October 2004

	2005 Sh. '000'	2004 Sh. '000'
Non-current assets:		
Property, plant and equipment	760	610
Intangibles (including goodwill)	500	400
Investments: Others	-	50
Investment in associate company	130	100
	1,390	1,160
Current assets:		
Inventories	300	204
Receivables	780	630
Short term investments	100	-
Cash in hand	4	2
Total assets	2,574	1,996
Equity and liabilities:		
Share premium	400	300
Revaluation reserve	320	300
Retained profits	200	182
	350	240
Minority interest	1,270	1,022
	100	60

Non-current liability		
Long-term loan	340	100
Current liabilities		
Trade payables	454	398
Bank overdraft	170	196
Taxation	240	220
Total equity and liabilities	2,574	1,996

Additional information:

1. During the year ended 31 October 2005, Leta Ltd. Acquired 80% of the share capital of Pili Ltd. The assets of Pili Ltd. Were as follows as at the date of acquisition:

	Sh. 'million'
Property, plant and equipment	120
Inventory	80
Receivable	60
	260
Long-term loan	(50)
Payables	(80)
Bank balance	(20)
Taxation	(10)
	100

2. The total purchase price was sh.90 million paid by issuing Sh. 20 million worth of shares at par value. The balance was paid in cash.
3. Some items of plant with an original cost of Sh.170 million and a net book value of Sh.90 million were sold for Sh.64 million during the year ended 31 October 2005. The investments were sold for Sh.60 million during the same period.

The following information relates to property, plant and equipment.

	31 October 2005 Sh. '000'	**31 October 2004 Sh. '000**
Cost	1,440	1,190
Depreciation	(680)	(580)
	760	610

The cost of plant of Pili Ltd. On the date of acquisition was Sh.200 million and depreciation was Sh.80 million. During the year ended 31 October 2005, there was a revaluation gain of Sh.20 million attributable to the holding company's plant.

Required:

Consolidated cash flow statement, in conformity with IAS7 (Cash Flow Statement), for the year ended 31 October 2005 using the indirect method of presentation. **(20 marks)**

QUESTION FIVE

a) Outline the merits of including a value added statement in the annual financial reports of a company **(4 marks)**

b) The information below relates to Ujuzi Limited, a company listed on the Nairobi Stock Exchange, for the year ended 30 June 2005.

	Sh. '000'
Purchase of raw materials	10,200
Turnover	25,160
Salaries and wages	6,800
Taxation for the year	2,040
Dividends	816
Depreciation	1,360
Water, power and insurance	2,040
Finance charge on leases	680

Required:

Using the two alternative approaches to the treatment of depreciation, prepare value added statements for the year ended 30 June 2005. **(8 marks)**

c) Outline the nature and purpose of segmental reporting. **(3 marks)**

(Total: 15 marks

SUGGESTED SOLUTION
KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

FINANCIAL ACCOUNTING IV

December 2005

QUESTION ONE

(a) Mzalendo and its subsidiary
Consolidated income statement for year to 31 October 2005

		Kshs. 'million'	Kshs. 'million'
Revenue			65,425
Cost of sales			(55,370)
Gross profit			10,055
Other incomes			56
			10,111
Distribution costs		3,480	
Administration expenses		2,200	
Finance cost		280	(5,960)
Profit before tax			4,151
Income tax expense			(1,560)
Profit for the period			2,591
Profits attributable to:	Holding company		1,977
	Minority interest		614
			2,591

Statement of changes in equity (extract)

	Retained profits Kshs. "million"
Balance as at 1 November 2004	1,153
Profit for the period	1,977
	3,130
Dividends: Interim paid	(300)
Final proposed	(400)
Balance as at 31 October 2005	2,430

(b) Mzalendo Ltd.

Consolidated Balance Sheet as at 31 October 2005

Non-current assets	Ksh. 'million'	Ksh. 'million
Property, plant and equipment		4,590
Current assets		
Inventory	4,210	
Accounts receivables	2,900	
Cash at bank	800	7,910
Total assets		12,500

Ordinary share capital		118
Foreign exchange reserve		202
Retained profits		2,430
		2,750
Minority interest (25% x 2,947)		737
		3,487
Non-current liabilities		
12% loan stock		2,350
Current liabilities		
Accounts payable	6,036	
Current tax	67	
Dividends proposed	560	6,663
Total equity and liabilities		12,500

Workings

1. **Translated income statement of subsidiary**

	Dime "million"	Exchange Rate	Ksh. "million"
Revenue	97,125	3.75	25,900
Cost of sales	(77,550)	3.75	(20,680)
Gross profit	19,575		5,220
Other income	200	3.6	56
	19,775		5,276
Distribution costs	(3,150)	3.75	(840)
Administration	(2,100)	3.75	(560)
Finance costs	(600)	3.75	(160)
Profit before tax	13,925		3,716
Tax	(4,725)	3.75	(1,260)
Profit after tax	9,200		2,456
Dividends: Interim paid	(1,448)	3.92	(369)
Final proposed	(2,304)	3.6	(640)
	5,448		1,447

Translated balance sheet

Non-current assets	**Dime "million"**	**Exchange Rate**	**Ksh. "million"**
Property, plant and equipment	4,860	3.6	1,350
Current assets			
Inventory	8,316	3.6	2,310
Receivables	4,572	3.6	1,270
Cash at bank	2,016	3.6	560
	19,764		5,490
Share capital	1,348	4.4	306
Retained profits: Pre-acquisition	2,876	4.4	654
Post-acquisition	6,384	Bal. Fig	1,987
	10,608		2,947

Loan stock	4,860	3.6	1,350
Current liabilities			
Accounts payable	1,932	3.6	536
Current tax	60	3.6	17
Dividends	2,304	3.6	640
	19,764		5,490

2. Workings for consolidated income statement

	Revenue	Cost of sales	Distribution	Administration	Finance
	Kshs.	Kshs.	Kshs.	Kshs.	Kshs.
Mzalendo	40,425	35,500	2,640	1,640	120
Mgeni (Translated)	25,900	20,680	840	560	160
Less: Inter Co. Sales	(900)	(900)	-	-	-
Add unrealized profit	-	90	-	-	-
Group	65,425	55,370	3,480	2,200	280

Profit attributable to minority interest:

25% x share of profit after tax in Mgeni = 25% x 2,456 = 614 million

3. Statement of changes in equity workings

Retained profits as at 1 November 2004

	Ksh. 'million'	Ksh. 'million'
Retained profit b/f in Mzalendo (502 + 198)		700
Share in Mgeni		
Opening net assets of Mgeni $\frac{5,160}{4}$	1,290	
Less: net assets on acquisition (306 + 654)	(960)	
	330	
Share of Mzalendo @ 75%		248
Add negative goodwill		205
		1,153

Goodwill	**Kshs. "million"**	**Kshs. "million**
Investment in Mgeni		470
Less: ordinary share capital	306	
Retained profits on acquisition	654	
	960	
Share of Mzalendo at 75%		(720)
Negative goodwill		(250)

Note that it is an asset of subsidiary therefore it has to be restated at closing rate (3.6).

Goodwill at historical rate (4.4) (250)

$$\text{Closing rate} = (250) \times \frac{3.6}{4.4} = (205)$$

The difference between the two is exchange gain to foreign exchange reserve (250 – 205) = 45.

The remaining goodwill of 205 is credited to retained profits of subsidiary.

4. Balance sheet workings:

Group inventory	**Ksh. "million"**
Mzalendo	1,990
Add Mgeni (translated)	2,310
	4,300
Less unrealized profit	(90)
	4,210

Foreign exchange reserve	**Ksh. 'million'**
Net closing assets of Mgeni (translated B/sheet)	2,947
Net opening assets $\frac{5,160}{4}$	(1,290)
Increase in net assets	1,657
Less increase due to profits (translated P & L)	(1,447)
Foreign exchange gain	210
Share of Mzalendo Ltd. 75%	157
Add Gain on retranslating goodwill to closing rate	45
	202
Minority interest in balance sheet	
Net assets in subsidiary's translated balance sheet	2,947
Share of minority interest @ 25%	737

QUESTION TWO

(a) **Biashara Ltd.**

Profit and loss account for year ended 31 December 2004

	Shs. '000'	**Shs. '000'**
Turnover		33,800
Operating profit before interest and tax		3,130
Current cost operating adjustments		1,200
		1,930
Gearing adjustment	200	
Interest payable	(250)	
		(50)
Current cost profit before tax		1,880
Tax		870
		1,010
Dividends paid		
- preference	100	
- ordinary	200	
Dividends proposed		
- Preference	100	
- Ordinary	300	
		700
Current cost retained profit for the year		310

(b) Biashara Ltd.
Current cost balance sheet as at 31 December 2004

ASSETS	**Sh. '000'**	**Sh. '000'**
Non-current assets		
Land	2,750	
Buildings	6,600	
Motor vehicles	2,970	
		12,320
Current assets		
Inventory	568	
Receivables	750	
Bank	5,590	
		6,908
		19,228
EQUITY AND LIABILITIES		
Capital and reserves		
Ordinary shares	7,000	
Preference shares	2,000	
Share premium	1,500	
Current cost reserve	2,848	
Retained profit	2,580	
		15,928
Non-current liability		
Loan		2,000
Current liabilities		
Payables	560	
Current tax	240	
Interest payable	100	
Proposed dividend	400	
		1,300
		19,228

Workings
Computation of current cost operating adjustments

(a) On stocks

(i)

Cost of sales Adjustment	**HCA Sh. '000'**	**Ratio**	**CCA Sh. '000'**
Opening stock	600	132/120	660
Closing stock	560	132/140	528
Decrease in stock	(40)		(132)

COSA = (40) – (132)
= Sh. 92,000

(ii)

Revaluation surplus on 31 Dec. 2003	**HCA**	**Ratio**	**CCA**	**Rev. Surplus**
Stock	600	122/120	610	10
On 31 Dec. 2004				
Stock	560	142/140	568	8

(b) (iii) On monetary working capital
Monetary working capital adjustment

		HCA Sh. '000'	**RATIO**	**CCA Sh. '000'**
Opening – MWC				
Receivables		860		
Bank		150		
Payables		(380)	132	
	(a)	630	120	693
Closing – MWC				
Receivables		750		
Bank		5,590		
Payables		(560)	132	
	(b)	5,780	140	5,450
Increase in MWC (b) – (a)		5,150		4,757

MWCA = 5,150 – 4,757
= Shs. 393,000

(c) On fixed assets
(iv) Depreciation adjustment

	HCA Sh. '000'	**RATIO**	**CCA Sh. '000'**	**DEP. ADJ. Sh. '000'**
Depreciation				
- Buildings	500	120/100	600	100
- Motor vehicles	1,080	110/80	1,485	405
	1,580		2,085	505

Depreciation expense is determined as follows:

Buildings = $\frac{5}{100}$ x Sh. 10,000,000
= Sh. 500,000

Motor vehicles = $\frac{20}{100}$ x Sh. (6.4 – 1.0)m
= $\frac{20}{100}$ x Sh. 5,400,000
= Sh. 1,080,000

(v) Revaluation surplus

On buildings	HCA Sh. '000'	Ratio	CCA Sh. '000'	Rev. Surplus Sh. '000'
On 31 Dec. 2003				
Buildings – cost	10,000	110/100	11,000	
Accum. Dep.	(4,000)	110/100	4,400	
	6,000		6,600	600
On 31 Dec. 2004				
Buildings – cost	10,000	120/100	12,000	
Accum. Dep.	4,500	120/100	5,400	
	5,500		6,600	1,100

On motor vehicles still held On 31 December 2003	HCA Sh. '000'	RATIO	CCA Sh. '000'	REV. SURPLUS Sh. '000'
Vehicles –cost	5,400	100/80	6,750	
Accum. Dep.	2,160	100/80	2,700	
	3,240		4,050	810

On 31 Dec. 2004	HCA Sh. '000'	RATIO	CCA Sh. '000'	REV. SURPLUS Sh. '000'
Vehicles – cost	5,400	110/80	7,425	
Accum. Dep.	3,240	110/80	4,455	
	2,160		2,970	810

Motor vehicle sold

On 31 December 2003

Vehicle – cost	1,000	100/80	1,250		
Accum. Dep.	400	100/80	500		
	600		750		150
On 30 Sep. 2004					
Vehicle - cost	1,000	100/80	1,350		
Accum. Dep.	400	100/80	540		
	600		810		210

(vi) Computation of prior years backlog depreciation adjustment

	Sh. '000'	**Sh. '000'**
CCA – accumulated depreciation c/f 31.12.04 (Sh. 5,400 + Sh. 4,455)		9,855
Less:		
CCA – accum. Depreciation b/f (Sh. 4,400 + Sh. 2,700)	7,100	
HCA depreciation expense	1,580	
Depreciation adjustment (Sh. 100 + Sh. 405)	505	
		9,185
		670

(vii) Computation of adjustment on profit on disposal of motor vehicle

	Sh. '000'
Proceeds from disposal of motor vehicle (Sh. 600,000 + Sh. 50,000)	650
Less: CCA – net book value on date of disposal	810
CCA – Loss on disposal	160

	Sh. '000'
CCA loss on disposal	160
Less: HCA profit on disposal	50
Adjustment	210

(d) Computation of gearing adjustment

(i) Preparation of current cost reserve account to determine the balance to be used in the computation of gearing adjustment

Current cost reserve account

	Sh. '000'		Sh. '000'
Revaluation surplus		Balance b/d	1,250
- Stock	2	Revaluation surplus	
(8 – 10)		- Land	250
		- Building (1,100 – 600)	500
Balance c/d	2,058	- Motor vehicle sold (210 – 150)	60
	2,060		2,060

(ii) Determination of average shareholders funds and average borrowings:

Shareholders funds

	31.12.2003 Sh. '000'	31.12.2004 Sh. '000'
Ordinary share capital	5,000	7,000
Preference share capital	2,000	2,000
Share premium	1,000	1,500
Current cost reserve	1,250	2,058
Retained profit	2,270	3,580
Proposed dividends	300	400
	11,820	16,538

Average shareholders funds = ½ x Sh. (11,820 + 16,538)
= Sh. 14,179

Borrowings

	31.12.2003 Sh. '000'	31.12.2004 Sh. '000'
Loan	3,000	2,000
Current tax	170	240
Interest payable	150	100
	3,320	2,340

Average borrowings

$$= \frac{Sh.3,320 + Sh.2,340}{2}$$

= Sh. 2,830,000

(iii) Calculation of gearing percentage and gearing adjustment.

Gearing percentage

$$= \frac{\text{Average borrowings}}{\text{Average borrowings + average shareholders funds}}$$

$$= \frac{\text{Sh.2,830}}{\text{Sh.2,830 + Sh.14,179}} \text{x100}$$

$$= \underline{16.64\%}$$

Gearing adjustment

= Gearing percentage x Current cost operating adjustments

$$= \frac{16.64}{100} \text{xSh.}(92 + 393 + 505 + 210)$$

$$= \frac{16.64}{100} \text{xSh.1,200}$$

= Shs. 200

(iv) Preparation of current cost reserve account to determine the balance to appear in the CCA balance sheet.

Current cost reserve account

	Sh. '000'		Sh. '000'
Revaluation surplus		Balance b/d	1,250
- Stock (8-10)	2		
		Revaluation surplus	
Backlog depreciation		- Land	
Adjustment	670	- Buildings (12,000 – 11,000)	
		- Motor vehicle sold (210 – 150)	
Profit and loss account			
- Gearing adjustment	200	Profit and loss account	
		- COSA	92
Balance c/d	2,848	- MWCA	393
	3,720		3,720

QUESTION THREE

ACCOUNTANTS' REPORT

The Directors
Delta Ltd.
P.O. Box
NAIROBI

18 October 2005

Gentlemen,

1. We have examined the audited financial statements of Delta Ltd. (The company) for the five financial years ended 30 June 2005.
2. We are the auditors of the company and have acted as auditors of the company for the three years ended 30 June 2005. Prior to our appointment, Mkaguzi and Associates were the auditors of the company.
3. No audited financial statements for submission to the members of the company have been prepared in respect of any period subsequent to 30 June 2005.

4. The information set out in paragraphs 7 to 10 is based on the audited financial statements of the company after making all the adjustments we consider appropriate for the inclusion of our report in the prospectus.
5. The audited financial statements have been prepared on the basis of the accounting policies set out in paragraph 7.
   For all the accounting periods dealt with in this report, the audited financial statements have been prepared in accordance with International Accounting Standards issued by the International Accounting Standards Committee.
6. In our opinion, the information set out in paragraphs 8 to 10 gives for the purpose of the prospectus, a true and fair view of the profit of the company for the period 1 July 2000 to 30 June 2005 and the state of affairs of the company as at 30 June 2005.
7. ACCOUNTING POLICIES
   The significant accounting policies that have been adopted in arriving at the financial information set out in this report are as follows:

   (i) BASIS OF ACCOUNTING
   The company prepares its financial statements on the historical cost basis of accounting modified to include the revaluation of certain assets.

   (ii) TURNOVER
   Turnover represents net aggregate amount receivable for goods supplied and services rendered net of value added tax.

   (iii) TAXATION
   The company uses deferred taxation method to account for its tax expense.

   (iv) NON-CURRENT ASSETS
   Non-current assets are stated at cost or valuation less depreciation.

   (v) DEPRECIATION
   No depreciation is provided on freehold property.

   Depreciation is provided on other non-current assets on a straight line basis on cost at the following rates per annum:

Plant and machinery	5%
Motor vehicles	10%
Furniture	12.5%

   (vi) STOCKS
   Stocks are stated at the lower of cost and net realizable value.

   (vii) DEBTORS
   Debtors are stated net or provision for doubtful debts.

   (viii) QUOTED INVESTMENTS
   Quoted investments are stated at market price.

8. PROFIT AND LOSS ACCOUNTS
   The profit and loss account for each of the five years ended 30 June 2005 after making necessary adjustments to the audited accounts are set out below:

	Notes	2001 Sh. '000'	2002 Sh. '000'	2003 Sh. '000'	2004 Sh. '000'	2005 Sh. '000'
Turnover	10(a)	9,650	10,700	12,400	15,600	17,518
Cost of sales		7,720	8,560	9,920	12,630	13,670
Gross profit		1,930	2,140	2,480	2,970	3,848
Administration costs		480	520	550	580	620
Selling and distribution costs		298	390	410	420	460
		778	910	960	1,000	1,080
Operating profit		1,152	1,230	1,520	1,970	2,768
Investment income		20	30	40	40	60
Finance costs		(180)	(180)	(240)	(300)	(300)
Profit before tax		992	1,080	1,320	1,710	2,528
Tax		302	330	400	530	650
Profit after tax		690	750	920	1,180	1,878
Dividends	10(b)	400	480	540	800	800
Retained profit		290	270	380	380	1,078
Earnings per share	10 (c)	Sh. 0.86	Sh. 0.94	Sh. 1.02	Sh. 1.18	Sh. 1.88

9. BALANCE SHEET

The balance sheet of the company as at 30 June after making necessary adjustments to the audited balance sheet is set out below:

ASSETS	**Notes**	**Sh. '000'**	**Sh. '000'**
Non-current assets			
Freehold property	10 (d)	12,000	
Plant and machinery		6,000	
Motor vehicles	10 (e)	4,900	
Furniture		1,500	
			24,400
Current assets			
Stock	10 (f)	2,980	
Debtors	10 (g)	1,618	
Quoted investments	10 (h)	650	
Bank and cash		150	
			5,398
			29,798
EQUITY AND LIABILITIES			
Capital and reserves			
Share capital	10 (i)	10,000	
Share premium		4,000	
Revaluation reserve		2,000	
Investment price			
Fluctuation reserve	10 (j)	190	
Profit and loss account	10 (k)	4,148	
			20,338
Non-current liabilities			
Debentures		5,000	

Bank loan	10 (l)	850	
Deferred tax		1,950	
			7,800
Current liabilities			
Trade creditors		710	
Current tax		550	
Proposed dividends		400	
			1,660
			29,798

10. NOTES TO THE FINANCIAL STATEMENTS

(a) TURNOVER

Turnover is composed of both domestic and export sales as shown below:

	2001 Sh. '000'	2002 Sh. '000'	2003 Sh. '000'	2004 Sh. '000'	2005 Sh. '000'
Domestic Sales	5,850	6,200	7,200	9,200	10,318
Export Sales	3,800	4,500	5,200	6,400	7,200
	9,650	10,700	12,400	15,600	17,518

(b) DIVIDENDS

Dividends were paid at the following rates on ordinary shares of Sh. 10 each.

	2001	2002	2003	2004	2005
Dividend Rate	5%	6%	6%	8%	8%

(c) EARNINGS PER SHARE

Earnings per share for each of the five years ended 30 June 2005 were computed based on reported net profit after tax and on weighted average number of ordinary shares outstanding in the year which were as shown below:

	2001 '000'	2002 '000'	2003 '000'	2004 '000'	2005 '000'
Number of Ordinary shares	800	800	900	1,000	1,000

(d) FREEHOLD PROPERTY

The market value of the freehold property was Sh. 13.5 million on 30 June 2005.

(e) MOTOR VEHICLES

The value of motor vehicles appearing in this report was determined as follows:

	Sh. '000'
Balance in the audited balance sheet as at 30 June 2005	4,800
Add: Depreciation on motor vehicle put out of use	100
	4,900

(f) STOCKS

The value of stocks appearing in this report was determined as follows:

	Sh. '000'

Balance in the audited balance sheet as at 30 June 2005	2,800
Add: understatement of stock on 30 June 2005	180
	2,980

(g) DEBTORS
The value of debtors appearing in this report was determined as follows:

	Sh. '000'
Balance in the audited balance sheet as at 30 June 2005	1,600
Add: Error in sales invoice	18
	1,618

(h) QUOTED INVESTMENTS
The quoted investments were sold in August 2005 and the proceeds used to repay the bank loan.

Investment income reported in each of the five years ended 30 June 2005 was generated by the quoted investments.

(i) SHARE CAPITAL
The company has an authorized share capital, of Sh. 20 million all composed of ordinary shares of Sh. 10 each. All the issued and outstanding ordinary shares are fully paid.

(j) INVESTMENT PRICE FLUCTUATION RESERVE
The balance in the reserve account has been realized following the sale of the quoted investments.

(k) PROFIT AND LOSS ACCOUNT
The balance in the profit and loss account in this report was determined as follows:

	Shs. '000'
Balance in the audited balance sheet as at 30 June 2005	3,850
Add: Effect of overprovision for depreciation	100
Error in sales invoice	18
Effect of understatement of stock	180
	4,148

(l) BANK LOAN
The bank loan was repaid in August using proceeds from sale of quoted investments.

(m) CAPITAL COMMITMENTS
The company has the following capital commitments on 30 June 2005.

	Sh. '000'
Authorized and contracted for	6,000
Authorized and uncontracted for	2,000
	8,000

Yours faithfully

MHASIBU AND ASSOCIATES
CERTIFIED PUBLIC ACCOUNTANTS OF KENYA

Workings:

	2001 Sh. '000'	2002 Sh. '000'	2003 Sh. '000'	2004 Sh. '000'	2005 Sh. '000'
1. Adjusted turnover					
Turnover	9,650	10,700	12,700	15,300	17,500
Sales order			(300)	300	
Technical error					18
	9,650	10,700	12,400	15,600	17,518
2. Adjusted cost of sales					
Cost of sales	7,720	8,560	10,160	12,240	14,000
Sales order			(240)	240	
Overstatement of stock				150	(150)
Understatement of stock					(180)
	7,720	8,560	9,920	12,630	13,670
3. Adjusted selling and distribution costs					
Selling and distribution	298	390	410	470	510
Less: Depreciation on motor vehicle				(50)	(50)
	398	390	410	420	460

QUESTION FOUR

Leta Ltd.

Consolidated cash flow statement for year ended 31 October 2005

Cash flows from operating activities	**Sh. 'million'**	**Sh. 'million**
Profit before tax	840	
Adjustments		
Share of profit after tax in associate company	(40)	
Investment income	(50)	
Finance cost	150	
Depreciation charge	100	
Loss on sale of property, plant and equipment	26	
Profit on sale of investments,	(10)	
	816	
Changes in working capital		
Increase in inventory	(16)	

Increase in receivables	(90)	
Decrease in payables	(24)	
Cash from operations	686	
Interest paid	(150)	
Tax paid	(270)	
Net cash received from operations		266
Cash flows from investing activities		
Purchase of PPE	(200)	
Investment income	50	
Dividends from associate (100+40-130)	10	
Proceeds on sale of investments	60	
Proceeds on sale of PPE	64	
Purchase of subsidiary (70 + 20)	(90)	
Purchase of intangible assets	(90)	
Net cash used in investing activities		(196)
Cash flows from financing activities		
Issue of shares	100	
Long-term loan (100 + 50 – 340)	190	
Dividends: Holding company	(222)	
Minority interest (60 + 30 + 20 – 100)	(10)	
Net cash from financing activities		58
Net increase in cash and cash equivalents		128
Cash and cash equivalents b/f		(194)
Cash and cash equivalents c/f		(66)

Cash and cash equivalents	b/f	c/f
	Shs. 'million'	**Shs. 'million'**
Cash	2	4
Bank	(196)	(170)
Short-term investments	-	100
	(194)	(66)

Workings (Figures in millions)

Depreciation A/C

	Shs. '000'		**Shs. '000'**
Disposal	80	Balance b/d	580
		Subsidiary	80
Balance c/d	680	P & L (Bal. figure)	100
	760		760

Inventory A/C

	Shs. '000'		**Shs. '000'**
Balance b/d	204		
Subsidiary	80		
Increase	16	Balance c/d	300
	300		300

Receivables A/C

Balance b/d	630

Subsidiary	60		
Increase	90	Balance c/d	780
	780		780

Payables

	Shs. '000'		Shs. '000'
Decrease	24	Balance b/d	398
Balance c/d	454		
		Subsidiary	80
	478		478

PPE (cost)

	Sh. m.		Sh. m.
Balance b/d	1,190	Disposal	170
Subsidiary	200		
Revaluation	20		
Purchase (bal. fig)	200	Bal. c/d	1,440
	1,610		1,610

Tax A/C

	Sh. m.		Sh. m.
Cash book	270	Balance b/d	220
Balance c/d	240	Subsidiary	10
		P & L	280
	510		510

Intangibles A/C

	Sh. m		Sh. m.
Balance b/d	400		
G/will			
90 – (80% x 100)	10		
Purchase	90	Bal. c/d	500
	500		500

Dividend Minority Interest A/C

	Sh. m.		Sh. m.
Dividend to MI	10	Balance b/d	60
Balance c/d	100	Share of profit	30
		Net subsidiary	20
		(20% x 100)	
	110		110

Dividends to holding company

	Sh. m.
Retained profits b/f	240
For the year	330
Transfer from revaluation reserve	2
	572
Less balance c/d	(350)
Dividend paid	222

Revaluation reserve

	Sh. m		Sh. m
To retained profit	2	Balance b/d	182
Balance c/d	200	PPE	20
	202		202

Long term loans

	Shs. m.		Shs. m.
		Balance b/d	100
		Subsidiary	50
Balance c/d	340	New loan	190
	340		340

Cash proceeds from issue of shares

	Sh. m
Increase in share capital (400 – 300)	100
Increase in share premium (320 – 300)	20
	120
Less: purchase of subsidiary	(20)
	100

QUESTION FIVE

(a) Merits of the Value Added Statement include:

- It is an effective tool of predicting managerial efficiency.
- It enables negotiators assess a company's ability to pay wages and salaries in case of industrial disputes.
- It is an effective tool of evaluating the rewards to stakeholders of the company relative to each other.
- It helps to determine a company's social responsibility in terms of distribution of the rewards.

(b) Ujuzi Ltd.
Value Added Statement for the year ended 30 June 2005

VIEW (i)	**Sh. '000'**
Turnover	25,160
Cost of sales (10,200 + 2,040)	(12,240)
Value added	12,920
To employees:	
Salaries and wages	(6,800)
To Government:	
Taxation	(2,040)
To Financiers:	
Dividends and interest (816 + 680)	(1,496)
To firm	
Depreciation and retained profits	(2,584)

Ujuzi Ltd. Value Added Statement for the year ended 30 June 2005

VIEW (ii)	Sh. '000'
Turnover	25,160
Cost of sales (10,200 + 1,360 + 2,040)	(13,600)
Value Added	11,560
To employees:	
Salaries and wages	(6,800)
To government:	
Taxation	(2,040)
To Financiers:	
Dividends and interest (816 + 680)	(1,496)
To firm:	
Retained profits	(1,224)

(c) Segmental report – it involves preparing supplementary information to the financial statements for each distinguishable component of an enterprise that is subject to risks and returns different from those other segments.

STRATHMORE UNIVERSITY
FINANCIAL ACCOUNTING IV
MOCK EXAMINATION

Time Allowed: 3 Hours
Answer ALL questions. Marks allocated are shown at the end of the question.

To be carried out under examination conditions at home and is TO BE SENT to the Distance Learning Administrator for marking by Strathmore University.

QUESTION ONE
Memo, a public limited company, owns 75% of the ordinary share capital of Random, a public limited company which is situated in a foreign country. Memo acquired Random on 1 May 2003 for 120 million crowns (CR) when the retained profits of Random were 80 million crowns. Random has not revalued its assets or issued any share capital since its acquisition by Memo. The following financial statements relate to Memo and Random:
Balance Sheets at 30 April 2004

	Memo sh.m	Random CRm
Tangible non current assets	297	146
Investment in Random	48	–
Loan to Random	5	–
Current Assets	355	102
	705	248
Capital and Reserves		
Ordinary shares of sh.1/1CR	60	32
Share premium account	50	20
Accumulated profit	360	95
	470	147
Non current liabilities	30	41
Current liabilities	205	60
	705	248

Income Statements for year ended 30 April 2004

	Memo sh.m	Random CRm
Revenue	200	142
Cost of sales	(120)	(96)
Gross profit	80	46
Distribution and administrative expenses	(30)	(20)
Operating profit	50	26
Interest receivable	4	–
Interest payable	–	(2)

Profit before taxation	54	24
Income tax expense	(20)	(9)
Profit after taxation	34	15

The following information is relevant to the preparation of the consolidated financial statements of Memo:

(a) The directors wish to treat goodwill in accordance with recent proposals as a foreign currency asset. Goodwill is written off over five years.

(b) During the financial year Random has purchased raw materials from Memo and denominated the purchase in crowns in its financial records. The date of purchase was on 1 February 2004 at a purchase price of sh.6million. The profit as a percentage of the selling price was 20%.
At the year end, half of the raw materials purchased were still in the inventory of Random. The inter-companytransactions have not been eliminated from the financial statements and the goods were recorded by Random at the exchange rate ruling on 1 February 2004. A payment of sh.6 million was made to Memo when the exchange rate was 2·2 crowns to sh.1. Any exchange gain or loss arising on the transaction is still held in the current liabilities of Random.

(c) Memo had made an interest free loan to Random of sh.5 million on 1 May 2003. The loan was repaid on30 May 2004. Random had included the loan in non-current liabilities and had recorded it at the exchange rate at 1 May 2003.

(d) The fair value of the net assets of Random at the date of acquisition is to be assumed to be the same as the carrying value.

(e) Random operates with a significant degree of autonomy in its business operations.

(f) The following exchange rates are relevant to the financial statements:

	Crowns to sh.
30 April/1 May 2003	2·5
1 November 2003	2·6
1 February 2004	2
30 April 2004	2·1
Average rate for year to 30 April 2004	2

(g) Memo has paid a dividend of sh.8 million during the financial year and this is not included in the incomestatement.

Required:
Prepare a consolidated income statement for the year ended 30 April 2004 and a consolidated balance sheet at that date in accordance with International Financial Reporting Standards.

(Candidates should round their calculations to the nearest sh.100,000)

(25 marks)

QUESTION TWO

Jallam Co. Ltd. had been preparing its financial statements using the flow through method for computing tax expense. In the year ended 30 June 2005, the company changed to Full provision method and the new policy was to be applied retroactively to the accounts of the years ended 30 June 2004 and 2005

The following are the balance sheets of the company for the two years ended 30 June 2004 and 2005 before incorporating tax expense for the year 2005

	Year ended 30 June	
	2005	**2004**
	Sh. '000'	**Sh. '000'**
Non-current assets		
PPE	47,000	53,500
Goodwill	3,000	3,500
Current assets		
Inventory	13,500	7,500
Receivables	8,700	6,000
Prepayments	5,000	3,500
Bank and cash	3,000	2,000
	80,200	76,000
Equity and liabilities	**Sh. '000'**	**Sh. '000'**
Shares capital	30,000	30,000
Revaluation reserve	10,000	8,000
Revenue reserve	16,200	10,000
	56,200	48,000
Long-term loan	10,000	15,000
Trade payables	8,000	6,000
Accruals	6,000	4,500
Current tax	-	2,500
	80,200	76,000

The following additional information is provided:

1. The company reported profits before tax of Sh.6,200,000 in the year ended June 2005
2. Included in PPE are the following assets:

	30 June 2005	**30 June 2004**
	Sh. '000'	**Sh. '000'**
Leasehold property	7,500	9,000
PPE without capital allowances	14,500	17,000

No acquisition or disposal of PPE took place in the year ended 30 June 2005

3. Written down value of PPE were Sh.22,500,000 and Sh.18,000,000 as at 30 June 2004 and 2005 respectively

4. Inventory as at 30 June 2005 are net of a general provision for price fluctuation of 10% of the cost.. The provision is not allowed for tax purposes.

5. Accruals include leave passage provision of Sh.2,500,000 as at 30 June 2004 and Sh.1,800,000 as at June 2005

6. Prepayments for the year 2005 include Sh.2,000,000 allowed as a deduction on computation of current tax.

7. Assets subjects to wear and tear allowance were first revalued in 2004 and revaluation repeated in 2005. No adjustments were made to the tax base of the assets following the revaluations.
8. Foreign exchange loss balances amounted to Sh.3, 600,000 and Sh.2,800,000 on 30 June 2004 and 2005 respectively.
9. Donations in the year 2005 was Sh.5, 000,000.
10 Tax rates in 2004 and 2005 were 40% and 50% respectively.
Current tax for a year is paid on 15 September of the following financial year.

Required:

(a) Current tax for the year ended 30 June 2005 (5 marks)
(b) Using the method recommended by the revised IAS 12, calculate deferred tax expense or income for the years 2004 and 2005 (10 marks)
(c) The current tax account, deferred tax account and revaluation account for the years 2004 and 2005 (5 marks)

(Total: 20 marks)

QUESTION THREE

Ambush, a public limited company, is assessing the impact of implementing the revised IAS39 'Financial Instruments: Recognition and Measurement'. The directors realise that significant changes may occur in their accounting treatment of financial instruments and they understand that on initial recognition any financial asset or liability can be designated as one to be measured at fair value through profit or loss (the fair value option). However, there are certain issues that they wish to have explained and these are set out below.

Required:
(a) Outline in a report to the directors of Ambush the following information:
how financial assets and liabilities are measured and classified, briefly setting out the accounting method used for each category. (Hedging relationships can be ignored.) (10 marks)

(b) Ambush loaned sh.200,000 to Bromwich on 1 December 2003. The effective and stated interest rate for this loan was 8 per cent. Interest is payable by Bromwich at the end of each year and the loan is repayable on 30 November 2007. At 30 November 2005, the directors of Ambush have heard that Bromwich is in financial difficulties and is undergoing a financial reorganisation. The directors feel that it is likely that they will only receive sh.100,000 on 30 November 2007 and no future interest payment. Interest for the year ended 30 November 2005 had been received. The financial year end of Ambush is 30 November 2005.

Required:
(i) Outline the requirements of IAS 39 as regards the impairment of financial assets. (6 marks)

(ii) Explain the accounting treatment under IAS39 of the loan to Bromwich in the financial statements of Ambush for the year ended 30 November 2005. (4 marks)
(20 marks)

QUESTION FOUR

Hewa Ltd a public limited company, is considering whether to invest in an overseas group, Baridi Ltd . The current year's cash flow statement of Baridi does not conform with IFRS and is set out below.
Beel's presentation currency is the Tazans (TZ)
Baridi
Group Cash Flow Statement for the year ended 30 November 2005

	TZ.m	TZ.m
Net cash flow from operating activities		1,895
Extraordinary cash flow – environmental damage		(80)
Dividends from associates (note v)		(10)
Interest paid	(150)	
Interest received	110	
		(40)
Taxation		(1,500)
Capital expenditure and financial investment (note iv)		(75)
Acquisitions and disposals (note ii)		(250)
Equity dividends paid including minority interest (note v)		(20)
Cash outflow before management of liquid resources and financing		(80)
Management of liquid resources (note i)		(26)
Financing – issue of ordinary shares (note ii)	130	
– proceeds from long term borrowing (note ii)	35	
– payment of zero dividend bond (note iii)	(45)	
		120
Increase in cash in the period		14

Analysis of net cash flow from operating activities

	TZ.m
Net profit before tax and extraordinary item from income statement	2,385
Adjustments to operating activities for:	
Investment income	(20)
Interest expense	30
	2395
Increase in inventory	(400)
Decrease in trade receivables	300
Decrease in trade payables	(500)
Increase in insurance claims provision	100
Net cash flow from operating activities	1,895

The following information is relevant to the group cash flow statement:
(i) The amount for the management of liquid resources has been derived from the following balance sheet amounts:

	2005 TZ.m	2004 TZ.m
Cash with banks on short term deposit (one week's notice)	90	70
Investments in money market instruments	81	75
	171	145

There have been no sales of money market instruments in the year but there have been purchases of TZ.6 million. Cash at bank at 30 November 2004 was TZ.30 million and at 30 November 2005 was TZ.44 million.
(ii) Baridi had purchased a subsidiary company in the year. The figure in the cash flow statement for the acquisition of the subsidiary comprises the following:

	TZ.m
Cash	160
Loan notes	20
Ordinary Shares in Baridi	100
Purchase consideration	280
less cash balance of subsidiary	(30)
Cash flow	250

The issue of the loan notes and ordinary shares in Baridi, above, has also been included in cash flows from 'Financing'.
The other net assets acquired have been adjusted in the cash flow statement.
(iii) Baridi had issued a ten year zero dividend bond at a discount. The bond matured in the year and it had been treated in the cash flow statement as follows:

	TZ.m
Issue price	19
Premium on redemption	31
Face value at issue date	50
less interest charge for year at effective yield of 10% (rounded)	(5)
Net cash flow	45

(iv) The cash flow attributed to purchases of property, plant and equipment was calculated by reference to the movement in the balance sheet values from 2004 to 2005 as adjusted for the purchase of the subsidiary. The actual movement on property, plant and equipment in the period is as follows:

	TZ.m
Net book value at 30 November 2004	1,600
New subsidiary – addition	45
Other additions	265
Disposals	(125)
Depreciation	(65)

Net book value at 30 November 2005	1,720

The disposal proceeds relating to property, plant and equipment were TZ.80 million.

	TZ.m
Cash flow statement entry	
Net book value at 30 November 2005	1,720
Net book value at 30 November 2004	(1,600)
	120
less addition from subsidiary	(45)
Net purchases of property, plant and equipment	75

(v) The entries in the cash flow statement for dividends paid to/from the minority interest and the associated company are as follows:

	Minority Interest TZ.m	Associated Company TZ.m
Balance at 30 November 2005 in group balance sheet	346	65
Balance at 30 November 2004 in group balance sheet	(355)	(55)
Shown in cash flow as dividend paid	(9)	10

The loss attributable to the minority interest in the year was TZ.7 million and the share of the associated company's profit after tax was TZ.16 million.

Required:
Redraft the group cash flow statement for Beel in accordance with IAS7 'Cash flow statements' using the indirect method after taking into account the information set out above. (20 marks)

QUESTION FIVE

Historically financial reporting throughout the world has differed widely. The International Accounting Standards Committee Foundation (IASCF) is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. The various pronouncements of the IASCF are sometimes collectively referred to as International Financial Reporting Standards (IFRS) GAAP. Currently, there is a foucs on providing global accounting standards.

Required:
(a) Describe the functions of the various internal bodies of the IASCF, and how the IASCF interrelates with other national standard setters. (7 marks)
(b) Describe the IASCF's standard setting process including how standards are produced, enforced and occasionally supplemented. (3 marks)
(c) Comment on whether you feel the move to date towards global accounting standards has been successful. (5 marks)

(Total 15 Marks)

END OF MOCK EXAMINATION

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