STUDY MANUAL
ADVANCED CORPORATE REPORTING (PEB I)

ASSOCIATION OF NATIONAL ACCOUNTANTS OF NIGERIA (ANAN)

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MODULE 1

1.00 LEGISLATION

1.01 Learning Outcomes

On successful completion of this Module, Students should be able to:

i. Explain the legal and content requirements for an acceptable corporate report
ii. Explain the statutory components and compliance need of statements of accounting standards
iii. Demonstrate their knowledge in those basic requirements of corporate reporting.

1.02 Company Law Relating to Preparation of Financial Statements

i. PREPARATION OF THE FINANCIAL STATEMENTS AND DIRECTORS' RESPONSIBILITIES

Directors are responsible for preparing the Annual Report Company Financial Statements, in accordance with IFRS and the applicable laws and regulations.

Company law requires the Directors to prepare Group and Company Financial Statements for each financial year. Under the law the Directors are required to prepare the Group Financial Statements in accordance with IFRS.

The Group Financial Statements are required by law and IFRS to present fairly the financial position and performance of the Group. The Companies and Allied Matters Act 1990 (as amended) provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

The Company Financial Statements are required by law to give a true and fair view of the state of affairs of the Company.

In preparing each of the Group and Company Financial Statements, Directors are required to:

- Select suitable accounting policies and then apply them consistently.
- Make judgements and estimates that are reasonable and prudent.
- State whether they have been prepared in accordance with IFRS, for the Group Financial Statements.
- State whether applicable IFRS have been followed, subject to any material departures disclosed and explained in the Company Financial Statements, for the Company Financial Statements.
- Prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the Group and the Company will continue in business.

Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company, and enable them to ensure that its financial statements comply with the Companies and Allied Matters Act 1990 (as amended). They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and the Company, and to prevent and detect fraud and other irregularities.

Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website.

Under applicable laws and regulations, Directors are also responsible for preparing a Directors' Report, Directors' Remuneration Report and Corporate Governance Statement that comply with that law and those regulations.

ii. RESPONSIBILITIES IN RESPECT OF THE PREPARATION OF FINANCIAL STATEMENTS

Directors are responsible for preparing financial statements in accordance with applicable law and regulations. They prepare financial statements for the Group in accordance with International Financial Reporting Standards.

International Accounting Standard 1 requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions, and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements'.

In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRSs. Directors are also required to:

- Properly select and apply accounting policies;
- Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- Provide additional disclosures, when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- Make an assessment of the Company's ability to continue as a going concern.

Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company, for safeguarding the assets, for taking reasonable steps for the prevention and detection of fraud and other irregularities, and for the preparation of a directors' report and directors' remuneration report.

Directors are responsible for the maintenance and integrity of the Company website.

Directors confirm that so far as they are aware, there is no relevant audit information of which the Company's auditors are unaware. Each director has taken all the steps that he or she ought to have taken, as a director, in order to make him or her aware of any relevant audit information, and to establish that the Company's auditors are aware of that information.

The above information, together with the statements regarding Directors' responsibilities and statement of going concern set out above, and the directors' remuneration and interests in the share capital of the Company are included in the Directors' report.

iii. INFORMATION TO BE DISCLOSED IN FINANCIAL STATEMENTS (SAS 2)

Definition and Terminology

- Financial Statement refers to media or means of communicating to interested parties information on resources, obligations and financial performance of the reporting entity. The financial statement consists of the balance sheet; income statement (profit and loss account); note on the accounts, sources and application of funds statements; value added statements, and historical financial summary.
- Accounting period refers to time span, usually one year, covered by financial statements.
- Accounting information refers to data that are found on the financial statements.
- Long term relates to the period in excess of 12 months.

Information to be Disclosed (SAS 2)

Clear and comprehensible information about the nature and ownership of an enterprise or entity reported on are usually disclosed in one or more of the contents of financial statements described in the following paragraphs.

I. **The Statement of Financial Position**

This is a statement which shows the assets and liabilities and the proprietor's interest at a point in time. Generally, an enterprise presents its balance sheet in the form of assets, and the claims against those assets by creditors and owners.

II. **The Statement of Comprehensive Income**

This is an account that reports revenue, earnings or turnover and the expenses of an enterprise, the difference being the profit or loss for a given accounting period.

III. **Notes to the Accounts**

These usually form an integral part of financial statements and provide detailed or supplementary information in respect of items disclosed in the balance sheet.

IV. **Cash Flow Statement**

It is a statement which provides information on the derivation and utilisation of funds during the period covered by the financial statement. When the statement of sources and application of funds are taken with the balance sheet and the income statement, a better insight is gained as to how the activities of an enterprise have been financed.

Note this: Before the introduction of cash flow statement by Statement of Accounting Standard (SAS 18 and IAS 7), Companies were required to prepare 'sources' and application of fund (fund flow) statements to appraise their liquidity position.

The fund flow primarily addresses movement in the working capital such as cash and its equivalents, stocks, debtors, creditors etc. It focuses on the general changes in the working capital rather than on cash specially. This runs short of properly appraising the liquidity situation of the company.

The main advantage of cash flow over fund flow therefore is that the latter over-emphasises movement in working capital to assess liquidity, such that favourable movement in other working capital items (stocks, debtors, etc) could seriously obscure the cash position of the company.

Cash flow has the additional advantage of excluding the use of the accrual concept which confuses many users of financial statements.

There are two methods of preparing the cash flow statement: the direct and the indirect methods.

The layout of a typical cash flow identifies:

a. Cash flows from operating activities which deal with inflow from trading activities and extraordinary items;
b. Cash flows from purchase of investment fixed assets and all income on investment, and
c. Cash flow from financing activities dealing with cash inflow/outflows from capital structures, redemption of capital and all interest due and paid.

NB: Interest Received on Investment is an investing activity while Interest Payment constitutes a financing activity.

The difference between the indirect and direct methods is the approach adopted for deriving the cash flows from operation. Once this is derived, there is a confluence between the two approaches. It is interesting to note that the illustration of cash-flows demonstrated in the IFRS red book is the direct method, which is why some have implied that the direct method is the recommended format. This is far from the truth.

V. Value Added Statement: No Longer a Requirement under IFRS

VI. Historic and Financial Summary

This enables an instant comparison over a period of five years, of vital financial information about an enterprise particularly with regard to its

- Turnover
- Profit before and after taxation
- Dividends
- Assets employed
- Issued and paid up capital
- Company (where applicable)

Legal Requirements
The requirements of this standard are complementary to any disclosed requirements of the Companies and Allied Matters Act 1990 (as amended) and related regulations.

Compliance with International Accounts Standard
The requirements of this standard also accords substantially with the requirements of the International Accounting Standard No. 5 – "Information to be Disclosed in Financial Statement"

Contents of Annual Report
The contents of annual report and information to be disclosed therein are similar to those set out in information to be disclosed in their financial statements.
A conventional Annual report should contain

- The mission statement
- The chairman's report
- The director report
- Report of the audit committee
- The report of the auditors (all of which are given in the appendices)

SYSTEM OF ENFORCEMENT
A Regulatory framework is a system of regulations and the means that are used to enforce them. They are usually established by government to regulate specific activities or functions. In Nigeria, accounting is regulated through a combination of accounting standards and company law.

Structure of the IFRS Foundation
The International Financial Reporting Standards Foundation, or IFRS Foundation, is an independent not-for-profit accounting organization. Its main objectives include the development and promotion of the International Financial Reporting Standards (IFRS) through the International Accounting Standards Board (IASB), which it supervises.

The foundation was formerly called the International Accounting Standards Committee (IASC) Foundation until it's renaming in July 2010, and since 2012, it has been governed by a board of 22 trustees, who are required to have a comprehensive understanding of international issues relevant to accounting standards for use in the world's capital markets.

The trustees' responsibilities include:

i. Appointing members to and establishing the operating procedures of the IASB interpretations committee and advisory council; and

ii. Approving the Foundation's budget.

The members are accountable to a monitoring board of public authorities, and their effectiveness is assessed by the Trustees' Due Process Oversight Committee.

The IFRS Foundation sets out the IFRSs and their interpretations, which include the following:

i. The International Financial Reporting Standards (IFRSs);
ii. The International Accounting Standards (IASs);
iii. The International Financial Reporting Standards Interpretations (IFRICs); and
iv. The Standing Interpretation Committee interpretations (SICs).

Of these, the IASs and S1Cs are previously-developed standards and interpretations that have been accepted by the IASB and IFRS Interpretations Committees. The IFRSs are developed and published by the IASB, the 15-member standard-setting body of the IFRS Foundation, while the IFRICs are provided by the IFRS Interpretations Committee.

Through the IASB, the IFRS Foundation also sets out the IFRS for small and medium-sized entities (SMEs) to better meet the needs of SMEs and relieve the burden imposed on them by the IFRSs.

Objectives of the IFRS Foundation

The objectives of the IFRS Foundation are:

i. To develop, in the public interest, a single set of high quality, understandable enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, participants in the world's capital market and other users of financial information to make economic decisions.

ii. To promote the use and rigorous application of those standards.

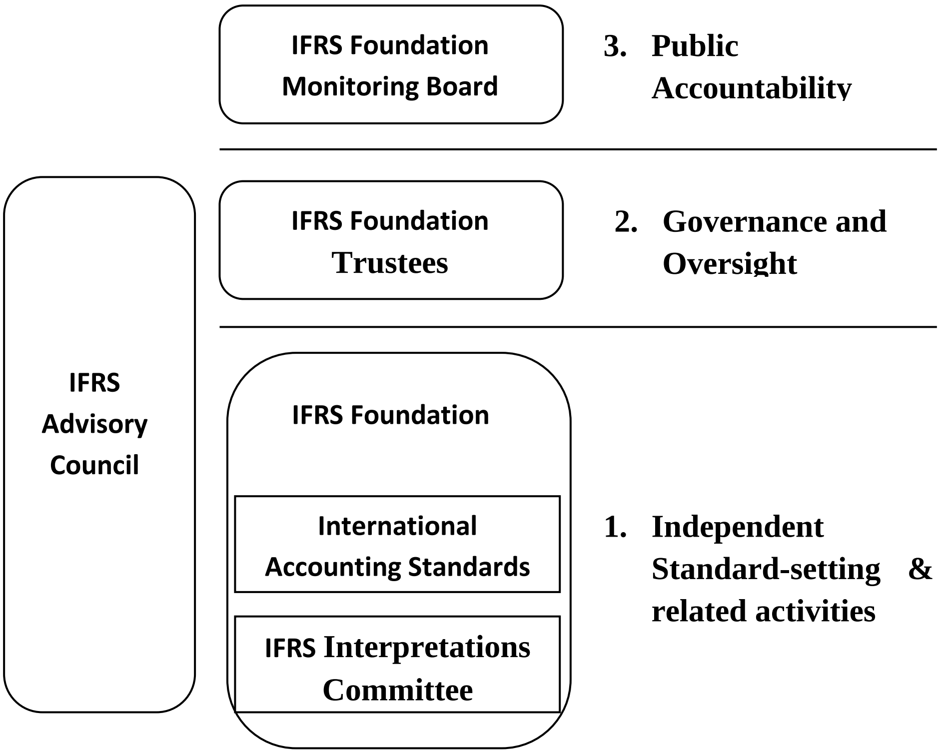
iii. To fulfil the above objectives, as appropriate, bearing in mind the needs of a range of sizes and types of entities in diverse economic settings

iv. To promote and facilitate the adoption of International Financial Reporting Standards (IFRSs), through the convergence of national accounting standards and IFRSs

The IFRS Foundation has a number of subsidiary bodies:

i. The International Accounting Standards Board (IASB)
ii. The International Financial Reporting interpretations Committee (IFRIC)
iii. The IFRS Advisory Council (AC)

OVERVIEW OF HIERARCHY



The International Accounting Standards Board (IASB) is an independent group of 16 experts with an appropriate mix of recent practical experience in setting accounting standards', in preparing, auditing, or using financial reports, and in accounting education. Broad geographical diversity is also required. Members were appointed by the Trustees in January 2009, and the Trustees voted to expand the IASB to 16 members in July 2012.

The IASB has the same objectives as the IASC foundation. It has sole responsibility for issuing International Financial Reporting Standards (IFRIS's), following a rigorous and open due process. The IASB cannot enforce compliance with its standard, and therefore it relies upon the co-operation of national standard setters.

All the most important national standard setters are represented on the IASB and their views are taken to account so that a consensus is reached. These national standard setters can also issue discussion papers and exposure drafts for comment in their own countries so that the views of all preparers and users of financial statements can be represented.

With all the major national standard setters now committed to the international convergence project, the IASB aims to develop a single set of understandable and enforceable, high quality worldwide accounting standards.

Under the IFRS Foundation Constitution, the IASB has complete responsibility for all technical matters of the IFRS Foundation including:

i. Full discretion in developing and pursuing its technical agenda, subject to certain consultation requirements with its trustees and the public;

ii. The preparation and issuing of IFRSs (other than interpretations) and exposure drafts, following the due process stipulated in its constitution;

iii. The approval and issuing of interpretations developed by the IFRS Interpretations Committee.

The IFRS Advisory Council

The IFRS Advisory Council is the formal advisory body to the IASB and the Trustees of the IFRS Foundation. It is comprised of a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups that are affected by and interested in the IASB's work. Members of the Advisory Council are appointed by the Trustees.

The Advisory Council normally meets three times a year for a period of two days. The Chairman of the IASB, the Director of Technical Activities, the Director of Research, and those IASB members and staff who are responsible for items on the Advisory Council meeting agenda are normally required to attend the meetings.

In essence, the Advisory Council provides a forum for experts from different countries and different business sectors with an interest in international financial reporting to offer advice when drawing up new standards. Its main objective is to give advice to the Trustees and the IASB on agenda decisions and work priorities and on major standard- setting projects.

The IFRIC

The IFRS Interpretations Committee is the interpretative body of the IASB. The Interpretations Committee comprises 14 voting members appointed by the Trustees and drawn from a variety of countries and professional backgrounds. The mandate of the Interpretations Committee is to review on a timely basis widespread accounting issues that have arisen within the context of current IFRSs and to provide authoritative guidance (IFRICs) on those Issues. Interpretation Committee meetings are open to the public and webcast. In developing interpretations, the Interpretations Committee works closely with similar national committees and follows a transparent, thorough and open due process, in accordance with its approved procedure.

This committee has taken over the work of the previous Standing Interpretations Committee. In reality, it is a compliance body whose role is to provide rapid guidance on the application and interpretation of international accounting standards where contentious or divergent interpretations have arisen. Its pronouncements (known as SICs and IFRIC) are important because financial statements cannot be described as being in compliance with IFRSs unless they also comply with the interpretations.

Other Bodies

The IASB has enhanced its reputation and credibility even further by developing its relationship with the International Organization of Securities Commissions (IOSCO). This is a very influential organization of the world's stock exchanges.

In 1995, the then International Accounting Standards Committee agreed to develop a core set of standards which, when endorsed by IOSCO, would be used as an acceptable basis for cross-border listings. This was achieved in 2000, arguably making the international accounting standards….the first step towards global accounting harmonisation. Furthermore, since 2005, as part of its harmonisation process, the European Union has required all listed companies in all member states to prepare their consolidated financial statements using IFRSs.

National standard setters (such as the UK's Accounting Standards Board and The USA's Financial Accounting Standards Board) have a role to play in the formulation of international accounting standards. Seven of the leading national standard setters work closely with the IASB, which the IASB sees as a "partnership' between the IASB and the national standard setters, as they work towards the convergence of accounting standards worldwide. Often the IASB asks members of national standard setting bodies to work on particular projects in which those countries have greater experience or expertise. Many countries that are committed to closer integration with IFRSs publish domestic standards equivalent (if not identical) to IFRSs on a concurrent timescale.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

In everyday usage, the term 'International Financial Reporting Standards' (IFRSs), has both a narrow and a broad meaning. Narrowly, IFRSs refers to the new numbered series of pronouncements that the IASB is issuing (as distinct from the International Accounting Standards (IASs) series issued by its predecessor, the International Accounting Standards Committee). More broadly, IFRSs refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB and IASs and SIC interpretations approved by the predecessor International Accounting Standards Committee.

Compliance with IFRSs

IASB requires any entity whose financial statements comply with IFRS to make an explicit and unreserved statement of such compliance in the notes. The entity must not describe financial statements as complying with IFRS unless they comply with all the requirements of IFRS.

DEVELOPMENT OF AN IFRS

As mentioned above, the IASB is responsible for the development and publication of international accounting standards. The standards require the vote of at least a majority of the sixteen IASB members.

The following steps are followed in developing an accounting standard

1. The IASB (advised by the IFRS Advisory Council) identifies a subject and appoints an advisory committee to advice on the issues relevant to the subject area. The IASB evaluates the merits of adding or amending an accounting issue mainly by reference to the needs of investors.

   The IASB considers the relevance to users of the information and the reliability of information that could be provided; the availability of existing guidance; the possibility of increasing convergence with other standard setters most notably US accounting requirements, the quality of the standard to be developed, and resource constraints.

2. If the subject matter is complex and of great importance, a discussion paper is issued to include:

   - A comprehensive overview of the accounting issue;
   - Possible approaches in addressing the accounting issue;
   - The preliminary views of its authors or the IASB, and
   - An invitation to comment on the discussion paper.

3. Following the receipt and reviews of comments, the IASB then develops and publishes an Exposure Draft for public comment. The Exposure Draft is a draft version of the intended subject, which sets out a specific proposal in the form of a proposed standard (or amendment to an existing standard). The normal comment period for both the discussion documents and the Exposure Draft is ninety days.
4. The development of an IFRS is carried out during IASB meetings, when the IASB considers the comments received on the exposure draft.

5. An accounting standard is published

It is important to remember that the IFRS Foundation, the IASB and the accountancy profession itself do not have the power to enforce compliance with the IFRS. However, some countries do adopt the IFRS as their local standards, with others ensuring that there is no significant difference between their standards and IFRs.

Over the last decade or so, the profile and status of the IASB has increased with the result being a commensurate increase in the persuasive force of the IFRS globally.

1.03 Statutory Requirements and Compliance with International Financial Reporting Standards

i. THE REGULATORY FRAMEWORK

The purpose of a regulatory framework is to regulate both the format and content of financial statements. Accounting disclosure is regulated through a combination of:

i. Company law

ii. Stock exchange rules

iii. IFRS

Accounting standards by themselves would not be a sufficient regulatory framework. Legal and market regulations are also required to ensure the full regulation of both the preparation and publication of financial statements.

A regulatory framework is desirable for the following reasons

1. Financial statements are based on principles and rules that can vary significantly from country to country are prepared for users. There is also a wide range of users of these financial statements (investors, lenders, customers, government). Preparation of accounts based on different principles makes it difficult, if not impossible, for investors to analyse and interpret the information. A regulatory framework would ensure consistency in financial reporting.

2. The information needs to be comparable, as without this quality the credibility of the financial reports would be undermined. This could have a negative impact on investment. A regulatory framework would increase the users understanding of and confidence in the financial statements.

3. Increasingly, globalization has resulted in trans-national financing, foreign direct investment and securities trading. Thus, a single set of rules for the measurement and recognition of assets, liabilities, income and expenses is required.

4. A regulatory framework would also regulate the behaviour of companies towards their investors, protecting the users of the financial statements. It would help ensure that the financial statements give a true and fair view of the company's financial performance and position.

IRELAND AND THE UK

Accounting rules and regulations in Ireland and the United Kingdom are governed by the Financial Reporting Council (FRC)

The Financial Reporting Council is an independent regulator responsible for promoting high quality corporate governance and reporting. It promotes high standards of corporate governance through the UK Corporate Governance Code. It sets standards for corporate reporting and actuarial practice, and monitors and enforces accounting and auditing standards.

In addition to overseeing the regulatory activities of the actual profession and the professional accountancy bodies, it operates independent disciplinary arrangements for public interest cases involving accountants and actuaries.

The Accounting Council (AC)

The Accounting Council replaced the former Accounting Standards Board, and is responsible for:

- Providing strategic input and thought leadership, both in the field of accounting and financial reporting and in the work-plan of the FRC as a whole;
- Considering and advising the FRC Board upon draft codes and standards (or amendments thereto) to ensure that a high quality, effective and proportionate approach is taken;
- Considering and commenting upon proposed developments in relation to international codes of standards and regulations; and
- Considering and advising on research proposals and other initiatives undertaken to inform the FRC on matters material to its research and any resultant publications.

The Financial Reporting Council assumed responsibility for accounting standards on 2 July 2012. Accounting standards that were formerly developed by the Accounting Standards Board are contained in 'Financial Reporting Standards' (FRS).

Soon after it started its activities, the AC adopted the standards issued by the ASB, so that they also fall within the legal definition of accounting standards. These are designated Statements of Standard Accounting Practice (SSAP). Whilst some of the SSAP have been superseded by FRSs, some remain in force.

Accounting standards apply to all companies, and other entities that prepare accounts which are intended to provide a true and fair view. The Foreword to Accounting Standards explains the authority, scope and application of accounting standards.

Recently the Financial Reporting Council, issued FRS 102 *the Financial Reporting Standard applicable in the UK and Republic of Ireland* providing succinct accounting and reporting requirements for enlisted entities. The standard completed a fundamental modernization of

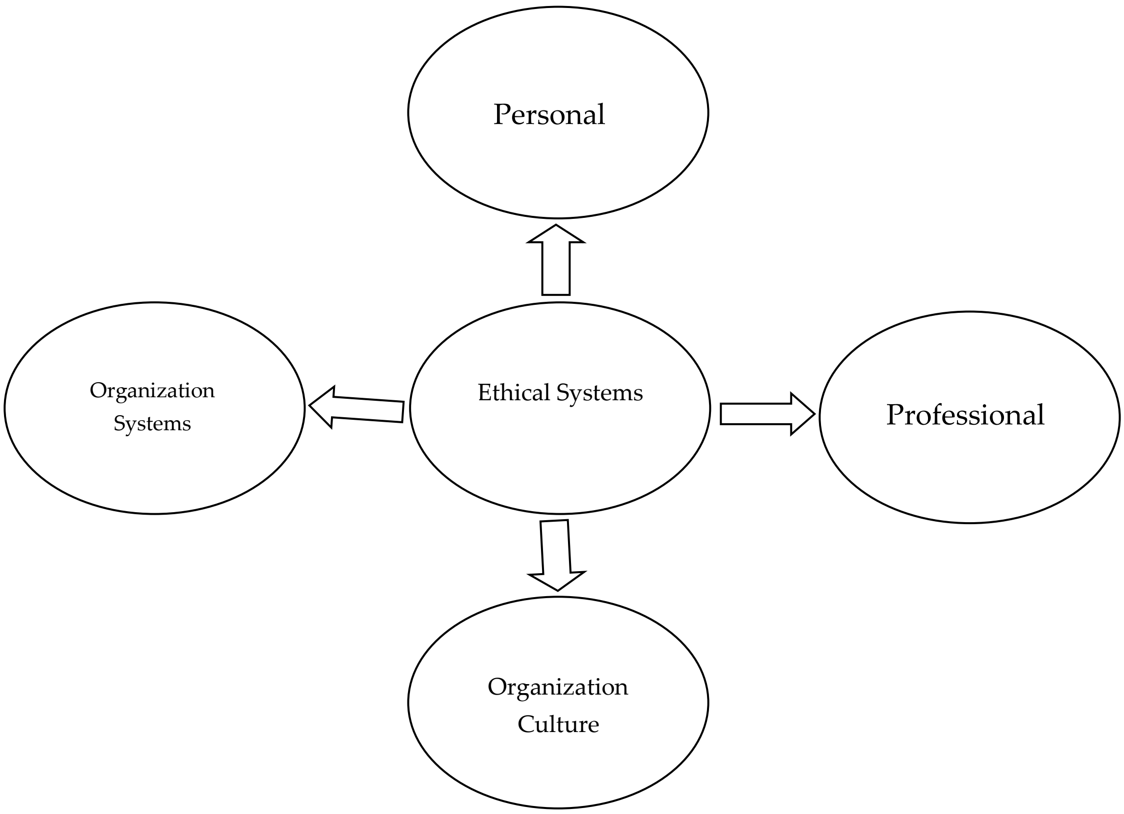
UK and Irish accounting standards and was formally approved at a meeting of the FRC Board on 5 March 2013.

FRS 102 modernizes and simplifies financial reporting for unlisted companies and subsidiaries of listed companies as well as public benefit entities such as charities. The standard updates UK and Irish accounting to take account of evolving business practices. It is based on the International Standard for Small and Medium Sized businesses. At around 350 pages, the standard replaces close to 3,000 pages of UK and Irish GAAP.

ETHICS

Ethics can be described as a code of moral principles that people follow with respect to what is right or wrong. They are not necessarily enforced by law.

There are different types of ethical systems that can be identified, as illustrated below:



Personal Ethics:	For example, deriving from upbringing or political/religious beliefs
Professional Ethics:	For example, medical ethics
Organization Culture:	For example, Enron (none!)
Organization System:	May be in a formal code, reinforced by the overall statement of values

1.04 The Accounting Profession and the Role of the Accountant

Professional independence is a concept fundamental to the accountancy profession. It is essentially an attitude of mind characterised by integrity and an objective approach to professional work. Practising members should both be and appear to be, in each professional assignment they undertake, free of any interest, which might be regarded, whatever its actual effect, as being incompatible with objectivity. The fact that this is self-evident in the exercise of the reporting function must not obscure its relevance in respect of other professional work.

Accountants cannot avoid external pressures on their integrity and objectivity in the course of their professional work, but they are expected to resist these pressures. **They must, in fact, retain their integrity and objectivity in all phases of their practice and, when expressing 'opinions' on financial statements avoid involvement in situations that would impair the credibility of their independence in the minds of reasonable people familiar with the facts.**

The accountancy profession exists to ensure that all interested parties entitled to knowledge of certain facts, have those facts presented objectively. That is the essence of high professional standards and is as appropriate to the accountant in commerce and industry as to the accountant in public practice. Anything which tends to impair or might appear to impair objectivity, in relation to any particular assignment or client, must cast grave doubt on the propriety of the accountant acting in the assignment for the client in question. Examples of undesirable financial involvement are

- An accountant making a loan to a client or guaranteeing a client's overdraft
- An accountant accepting loan from a client
- An accountant giving advice to a client, where such advice, if acted upon would result in receipt of commission by the accountant, unless the client is made aware of the receipt of such commission.

The conduct towards which accountants should strive is embodied in six broad principles stated as affirmative *Ethical Principles:*

1. **Independence, Integrity and Objectivity** Accountants should maintain their integrity and objectivity and, when engaged in the practice of public accounting, be independent of those they serve.
2. **Competence and Technical Standards** Accountants should observe the profession's technical standards, and strive continually to improve this competence and the quality of their services.

3. **Responsibilities to Clients** Accountants should be fair and candid with their clients, and serve them to the best of their ability, with professional concern for the client's best interests, consistent with the accountants' responsibilities to the public.

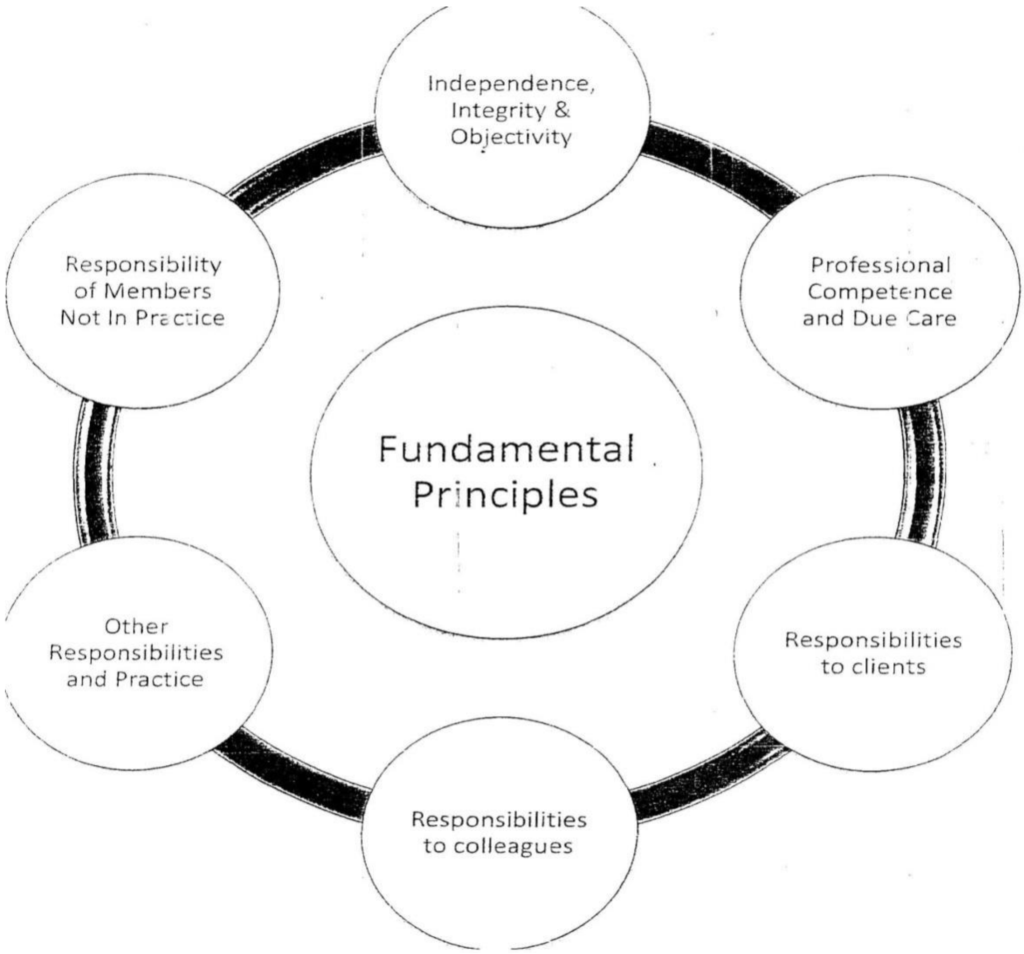
4. **Responsibilities to Colleagues** Accountants should conduct themselves in a manner which will promote co-operation and good relations among members of the profession.

5. **Other Responsibilities and Practice** Accountants should conduct themselves in a manner which will enhance the stature of the profession and its ability to serve the public

6. **Responsibility of Members not in Practice** Accountants not in practice must uphold the standards and etiquette of the profession.

The foregoing Ethical Principles are intended as a broad guideline. They represent the philosophical foundation upon which the professional conduct of accountants is based.

Ethical Principles Summary



1.05 The Conceptual Framework

A conceptual framework can be defined as a coherent system of interrelated objectives and fundamental principles, a framework which prescribes the nature, function limits at financial accounting and financial statements. It can be thought of as an outline of the generally accepted principles which form the theoretical foundation for financial reporting. The IASB follows the principles-based approach to financial reporting (as opposed, say, to the rules-based approach favoured by the FASB in the USA).

The establishment of these principles provides the basis for both the development of new accounting standards and appraisal of the standards already in issue.

There are a number of arguments in favour of having a conceptual framework:

- It allows both accounting standards and generally accepted accounting practice (GAAP) to be developed in line with agreed principles. It would be extremely difficult to attempt to address all technical issues that would satisfy the needs of every user.

- It helps avoid a situation where accounting standards are developed in an ad hoc and piece-meal fashion, as kneejerk response to specific problems and/or abuses. This sort of 'fire-fighting" can lead to inconsistency between different accounting standards.

- The conceptual framework enables critical issues to be addressed. For example until relatively recently, accounting standards contained a definition of basic terms such as "asset" or "liability".

- With certain types of transactions becoming more and more complex over the years, a conceptual framework aids accountants and auditors dealing with transactions not covered per se by an accounting standard. It can give guidance of the general principles on how transactions should be recorded and presented in the financial statements.

- Where a conceptual framework exists, an issue not yet covered by an accounting standard can be dealt with temporary by providing an interim approach until a specific standard is issued.

- It is believed that standards that are based on principles are more difficult to circumvent than a rules-based approach (the "cookbook" approach).

- The conceptual framework makes it less likely that the standard setting process can be influenced or even hijacked by vested interests, for example large corporations or business sectors. This enhances the credibility of the IFRSs and the accounting profession.

i. THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING 2010

A framework is a real or conceptual structure intended to act as a support or guide.

The Conceptual Framework for Financial Reporting describes the basic concepts that underpin the preparation and presentation of financial statements for external users. The Framework acts as a guide to the International Accounting Standards Board in the development future IFRS and also as a guide in the resolution of accounting issues that are not addressed directly in an International Accounting Standard or International Financial Reporting Standard or Interpretation.

Where a Standard or an Interpretation does not specifically apply to a transaction, management must use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable in making that judgment IASB requires that management consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, arid expenses in the IFRS Framework.

It is worth noting that the Conceptual framework is not a Financial Reporting Standard and as a result, it does not override specific standards.

While the Conceptual Framework prescribe of financial accounting and financial statements

1. Nature,
2. Function, and
3. Limits

The IFRS Framework addresses the following issues:

1. Objective of financial reporting
2. The reporting entity (this chapter has not yet been published)
3. Qualitative characteristics
4. Elements of financial statements
5. Recognition of elements
6. Measurement of elements
7. Concepts of capital maintenance

The Objective of Financial Reporting

The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making economic decisions about providing resources to the entity

Financial reports provide information about the financial position, economic resource and claims of a reporting entity. They also provide information about the effects of transactions and other events that change an entity’s financial position.

The Framework notes that general purpose financial reports cannot provide all the information that users may need to make economic decisions. They will need to consider pertinent information from other sources as well, for example:

1. general economic conditions and expectations
2. political events and political climate
3. industry and company outlook

The IFRS Framework notes that other parties, for example market regulators, may find general purpose financial reports useful. However, the IFRS Board considered that the objectives of general purpose financial reporting and the objectives of financial regulation may not be consistent. Therefore, regulators are not considered as primary users and general purpose financial reports are not primarily directed to regulators or other parties

Financial Reports limitations

The main limitations of financial statements to consider are:

1. They are not designed to show the value of the reporting entity.
2. They *are* based on estimates, judgments and models rather than exact depictions

Cost is the main constraint to providing useful information and as a result, a cost/benefit analysis is appropriate when establishing the level of information to provide users.

Accrual Accounting

Financial performance is reflected by accrual accounting.

Accrual accounting depicts the effects of transactions, other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

1. The reporting entity's economic resources and claims are reported in the statement of financial position.
2. The changes in the entity's economic resources and claims are presented in the statement of comprehensive income.
3. The changes in the entity's cash flows are presented in the statement of cash flows.
4. The changes in the entity's economic resources and claims not resulting from financial performance is presented in the statement of changes in equity. For example, the issue of equity instruments or distributions of cash or other assets to shareholders.

Fundamental Qualitative characteristics of useful financial information

The qualitative characteristics of useful financial reporting identify the types of information that are likely to be most useful to users in making decisions about the reporting entity or the basis of the information in its financial report.

Financial information is useful when it is relevant, and when it represents faithfully what it purports to represent (previously reliability)

The usefulness of financial information is enhanced if it is:

1. Comparable
2. Verifiable
3. Timely
4. Understandable

The two fundamental characteristics of financial information are relevance and faithful representation is further explained.

Relevance

Relevant financial information is capable of making a difference in the decisions made by users, if it has

1. Predictive value or
2. Confirmatory value or
3. Both predictive and confirmatory value

Information has predictive value if it can be used as an input to processes employed by users to predict a future outcome.

Information has confirmatory value if it provides feedback about previous evaluations (it confirms or changes these evaluations).

Predictive value and confirmatory value are *interrelated,* for example revenue for the current year can be used to predict revenue for future years, and can be compared with revenue predictions that were made in the past.

Materiality is essential in establishing the relevance of financial information. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. It is an entity-specific aspect of relevance, based on the nature or magnitude or both of items. There is no uniform quantitative threshold, and information must be put into context in order to decide its materiality, or otherwise.

Faithful representation

Financial reports represent economic phenomena/events in words and numbers. To be useful, financial information must faithfully represent the phenomena that it purports to represent.

This fundamental characteristic seeks to maximise the underlying characteristics of:

- Completeness
- Neutrality and
- Freedom from error

The objective should be to maximise these qualities.

Information must be both relevant and faithfully represented if it is to be useful.

A **complete** depiction includes information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A complete depiction of a group of assets, for example, would include:

a. The nature of the assets in the group

b. A numerical description of all the assets in the group

c. A description of what the numerical depiction represents: Original cost, Adjusted cost or Fair value

A **neutral** depiction is without bias in the selection or presentation of financial information **Free from error** means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. It does not mean the information is perfectly accurate in all respects. Some information may have to be estimated.

However, a representation of an estimate can be faithful if:

1. The amount is described clearly and accurately as being an estimate,

2. The nature and imitations of the estimating process are explained,

3. No errors have been made in selecting and applying a process for developing the estimate, consider impairment of an asset

Applying the fundamental qualitative characteristics requires

1. Identify an economic phenomenon that has the potential to be useful to users;

2. Identify the type of information about the phenomenon that would be most relevant if it was available and could be faithfully represented;

3. Determine whether that information is available and can be faithfully represented.

Enhancing Qualitative Characteristics

Comparability, verifiability, timeliness and comprehensibility are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

Comparability

Information about a reporting entity is more useful if it can be compared with similar information about other entities, or with similar information about the same entity for another period or date. Consistency is not the same as comparability (it refers to the same methods for the same items).

Comparability enables users to identify and understand similarities in, and differences among, items.

Verifiability

Verifiability helps assure users that information faithfully represents the economic phenomenon it purports to represent. Verifiability means that different knowledgeable and independent observers could reach a consensus that a particular depiction is a faithful representation (although not necessarily complete agreement).

To help users decide whether they want to use information, it would normally be necessary to disclose:

The underlying assumptions,

The methods of compiling the information, and

Other factors that support the information verification (these may be direct or indirect)

Timeliness

Timeliness refers to having the information available to decision makers in time to be capable of influencing their decisions. The older the information, the less useful it will be.

Comprehensibility

Classifying, characterizing and presenting information clearly and concisely make it understandable. While some phenomena are complex and cannot be made easy to understand, to exclude such information would make financial reports incomplete and potentially misleading.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information with diligence.

SUMMARY

QUALITATIVE CHARACTERISTICS	
Fundamental	**Enhancing**
1. Relevance • Predictive value • Confirmatory value • Materiality **2. Faithful Representation** • Completeness • Neutrality • Freedom from Error	 1. Comparability 2.Verifiability 3. Timeliness 4. Comprehensibility

Underlying Assumption

The Framework states that the going concern assumption is an underlying assumption. This means that the financial statements presume that an entity will continue in operation indefinitely or, if that presumption is not valid, disclosure and a different basis of reporting are required.

Accrual Basis

When financial statements are prepared on the accrual basis of accounting, the effects of transactions and other events are recognized when they occur (as opposed to when 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 accrual basis assumption is also addressed in IAS 1, Presentation of Financial Statements, which clarifies that when the accrual basis of accounting is used, items are recognized as assets, liabilities, equity, income, and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Framework.

Going Concern

When financial statements are prepared on a going concern basis, it is presumed that the entity will continue in operation for the foreseeable future. In other words, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations, in the foreseeable future, which, according to IAS1, is at least a period of twelve months from the end of the reporting period.

However, when significant doubts are cast on the ability of the entity to continue as a going concern, and thus such an assumption is not appropriate, the financial statements may need to be prepared on a different basis and, if so, that basis used is required to be disclosed.

The going concern assumption is also addressed in IAS 1, which requires management to make an assessment of an entity's ability to continue as a going concern when preparing financial statements.

The Elements of Financial Statements

The Framework provides definitions of the elements of financial statements. When applied with the recognition criteria, the definitions provide guidance on how and when the financial effect of transactions or events should be recognized in the financial statements.

The financial statement outlines the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the "elements of financial statements".

The elements directly related to the financial position (balance sheet) of an entity are:

Asset

Liabilities

Equity

The elements directly related to performance (income statement) of an entity are:

Income

Expenses

Assets

Assets are resources controlled by the entity as a result of past events, from which future economic benefits are expected to flow to the entity.

Liabilities

Liabilities are an entity's obligations to transfer economic benefits, as a result of past transactions and/or events, the settlement of which is expected to result in an outflow of economic benefits.

Equity interest

Equity interest is the residual amount found by deducting all liabilities of the entity from all of the entity's assets.

ASSETS AND LIABILITIES

1. Attention needs to be given to the underlying substance and economic reality of an asset, and not merely its legal form. An example would be the case of a finance lease, where the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life.

2. The existence of a physical form is not essential to the existence of an asset. Hence, patents and copyrights are *assets,* if future economic benefits are expected to flow to the entity, and if they are controlled by the entity

3. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. The irrevocable nature of the agreement means that because of the economic consequences of failing to honor the obligation (for example a substantial penalty), the entity cannot avoid the outflow of resources.

4. Liabilities result from past transactions or other past events. An entity may recognise future rebates based on annual purchases by customers as liabilities *(the sale of the goods in the past is the transaction that gives rise to the liability).*

5. Some liabilities can be measured only by using a substantial degree of estimation, referred to as provisions (for example, warranties and pensions)

Income
Income is an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decrease in liabilities that result in increases in equity (other than those relating to contributions from equity participants)

Expenses
Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity (other than those relating to contributions from equity participants).

INCOME AND EXPENSES

The definition of income includes both revenue and gains.

Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of names including sales, fees, interest, dividends, royalties and rent.

Gains represent other items that meet the definition of income and May, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in the IFRS Framework.

The definition of expenses includes losses as well as those expenses that arise in the course of the ordinary activities of the entity.

Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.

Losses represent other items that meet the definition of expenses and may, or may not, arise in the course or the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in the Framework.

Recognition of the Elements of Financial Statement

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- The item cost or value can be measured with reliability.

Show an element by words and by a monetary amount and include that amount in the financial statements

Both assets and liabilities are recognized if

1. They meet the definition of an asset/liability;

2. It is probable that any future economic benefit associated with the item will flow to or from the entity;

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

Measurement of the Elements of Financial Statements

Measurement involves assigning monetary amounts at which the elements of the financial statements are to be recognized and reported.

The IFRS Framework acknowledges that a variety of measurement bases are used today to different degrees and in varying combinations in financial statements, including:

Historical cost

Assets are recorded as the amount of cash paid or the fair value of the consideration given at the time of their acquisition.

Liabilities are recorded as the amount of the proceeds received in exchange for the obligation or as the amount of cash expected to be paid to satisfy the liability.

Current cost

Assets are carried as the amount of cash that would have to be paid if the same or equivalent asset was acquired currently.

***3.* Net realisable (settlement) value**

Assets are carried as the amount of cash that could currently be obtained by selling the asset in an orderly disposal.

4. Present value (discounted)

Assets are carried as the discounted present value of the future net cash inflows that the item is expected to generate.

Liabilities are carried at the discounted present value of the future net cash outflows that are expected to be required to settle the liabilities

Historical cost is the measurement basis most commonly used today, but it is usually combined with other measurement bases.

The IFRS Framework does not include concepts or principles for selecting which measurement basis should be used for particular circumstances. Individual standards and interpretations do provide this guidance, however.

Concepts of Capital Maintenance

The Framework refers to two concepts of capital: the *financial* concept of capital and the *physical* concept of capital.

The great majority of enterprises adopt the financial concept of capital, which deals with the net assets of the entity. The physical concept of capital may be more applicable where the users of the financial information are more concerned with the operating capability of the enterprise.

The needs of the user should determine she most appropriate basis to adopt.

Financial concept

A Profit is earned if the financial amount of the net assets a: the end of the period is greater than that at the beginning of the period (excluding any distributions to and contributions from the owners). Financial capital maintenance measured in either nominal monetary units or units of constant purchasing power.

Physical concept

A profit is earned if the physical productive capacity (operating capacity) of the enterprise (or the resources needed to achieve that capacity) at the end of the period is greater than at the beginning of the period (excluding and distributions to and contributions from the owners).

<u>Reasons for Framework</u>

- Enables accounting standards to be developed in accordance with agreed principles.
- Avoids standards being developed in response to specific problems.
- Helps consistency between standards.
- Helps to deal with transactions that are not the subject of an accounting standard.
- Critical issues such as the definition of an asset may not be addressed without a framework.

- Standard setting process less likely to be influenced by vested interests; very large companies cannot influence standards.
- Strengthens credibility of the accounting profession.
- Standards based on principles are harder to abuse.
- Assists the IASB in its role of developing future accounting standards and reviewing existing lFRSs/lASs.
- Assists the IASB by providing a basis for reducing the number of alternative accounting treatments permitted by the FRS.
- Assist national standard setting bodies in developing national standards.
- Assists those preparing financial statements to apply IFRs and also to deal with areas where there is no relevant standard.
- Assist auditors when they are forming an opinion as to whether financial statements conform to IFRS
- Assist users of financial statements when they are trying to interpret the information in financial statements which have been prepared in accordance with IFRS
- Provide information to other parties that are interested in the work of the IASB

Commonly Used Concepts in Financial Reporting

Though the Framework mentions two accounting concepts (accruals and going concern) that underpin the financial statements of the company, students should familiarize themselves with other concepts that can be employed by varying degree.

Prudence:	Cautious presentation of the entity's financial position. Profits are recognized only when realised while losses are provided for as soon as they are foreseen.
Consistency:	There is similar accounting treatment of like items within each constituent accounting period and from one period to the next.
Entity:	The accounts recognise the business as a distinct separate entity from its owners.
Money Measurement	Accounts only deal with those items to which a monetary value can be attributed.
Materiality:	If omission, misstatement or non-disclosure affects the view given item is material and disclosure is required.
Substance over Legal Form:	Recognizes economic substance from legal form e.g. assets acquired on hire purchase

Monetary Unit	The value of the monetary unit used is consistent over time
Stable Monetary Periods	Accounts are prepared for discrete time periods

1.06 Environmental Reporting

Environmental reporting can be described as the public discloser of information concerning an entity's environment performance. Environmental reporting can make organizations appear more accountable for the economic, environmental and social consequences of their activities. The reports may include information such as:

- The company's profile (e.g. its size, its industry, the markets in which it operates and so on)
- Goals are objectives (like the kind of image the organisation wants to portray)
- Targets and achievements.
- Performance and compliance.

In an exam, you generally will not be asked to prepare a report, but to display a general understanding of its usual contents.

Characteristics of a Good Environmental Report

When preparing an environmental report it is important to bear in mind who the report is being prepared for. But from the user's point of view, the characteristics of a good report will be:

- Timeliness (conveying the most up-to-date information)
- Objectivity (providing a balanced view of the organisation, both in terms of successes and failures)
- Trustworthiness (possibly with some sort of verification from an independent reviewer)
- Understandability (providing both- narrative as well as numerical information)

Even though the publication of environmental reports is currently not mandatory, many organisations still proceed to do so. Their motives are varied and include:

- Communication with its stakeholders regarding its general approach to environmental responsibility;
- Increasing competitive advantage;
- Enhancing levels of recognition (this means recognising that there is increased public awareness of environmental issues, and thereby allaying any fears the public may have regarding the organisations credibility in this area);

- Setting targets (publicising objectives acts as a motivator towards achieving those targets);

- Ensuring that reports are well prepared in the event that environmental reports become mandatory. (In the UK, the government has suggested that they will become compulsory if it becomes dissatisfied with the quality and quantity of voluntary disclosures);

- Improving access to lists of preferred suppliers;

- Managing corporate risk. (If the company is clearly aware of the environmental risks it faces, it is more likely to have effective procedures in place to prevent disasters, thereby reducing their likelihood, and the consequent need for emergency funding to meet the costs of such disasters. This could have the knock-on benefit of reducing finance costs and perhaps making it more attractive to investors);

- Increasing profitability if revenues grow as a result of an improvement in consumer perceptions;

- Attracting and retaining high quality staff (There is some evidence to suggest employees are much more likely to want to work for an environmentally friendly organisation, which means that making such disclosures could help a company to recruit the best workforce).

Disadvantages of Environmental Reporting

- Cost, in particular, the labor hours and printing costs are likely to be substantial.

- Because reports are voluntary, it can include whatever material it wants to, thereby focusing only on the positives and ignoring any negatives in terms of impact on the environment.

- Since such disclosures are not audited, the lack of regulation allows each company to provide the information in the format it chooses. This makes it more difficult for users to compare how different companies are performing.

THE GLOBAL REPORTING INITIATIVE

The Global Reporting Initiative (GRI) is an organisation set up in 1997, to develop a sustainability reporting framework for businesses. To this end a number of versions of Sustainability Reporting Guidelines have been issued. The GRI Sustainability Reporting Guidelines gives guidance to entities on how to measure and report on managements' approach to the economic, environmental and social aspect that impact on the businesses.

Benefits to Investors

The GRI is a recognised framework and where entities have adopted its guidelines it will provide investors with greater confidence that they are receiving relevant and useful information. Comparability and transparency improves where accepted guidelines exist, as many entities are then following a similar approach to disclosures. Consistent compliance with the GRI guidelines will give investors' confidence that they are receiving complete information rather than just the positive aspects designed to improve reputation. Goals, targets and benchmarks being included will provide a performance measurement which will help investors decide whether they are happy to invest, going forward.

GRI Sustainability Guidelines

The economic aspects are likely to contain information about how the entity impacts on the economic conditions of its shareholders and on the economic systems of both the area in which it operates, and globally. An entity may also include its policies regarding local and global economies and disclose its targets and strategy for meeting those economic targets as well as its performance to date.

The environmental aspect of sustainability provides information about how an entity impacts on the environment. Disclosures are likely to include managements' policies on waste, emissions and pollution. Targets on wastage, pollution, and others are likely to be set, and strategies for achieving these and performance to date could also be included.

The social aspect of sustainability relates to the impact the entity has on the social systems in which it operates. The GRI focuses on performance in the areas of human rights; labour practices; employer-employee relations; occupational health and safety, and equal opportunity.

IFRS PRACTICE STATEMENT MANAGEMENT COMMENTARY

Introduction

IFRS Practice Statement *Management Commentary was published by the IASB in 2010. Management commentary is defined as*:

"It is a narrative report that relates to financial statements that have been prepared in accordance with IFRSs. Management commentary provides users with historical explanations of the amounts presented in the financial statements, specifically the entity's financial position, financial performance and cash flows. It also provides commentary on an entity's prospects and other information not presented in the financial statements. Management commentary also serves as a basis for understanding management's objectives".

Therefore, the objective of the practice statement is to assist management in presenting useful management commentary that relates to financial statements that have been prepared in accordance with International Financial Reporting Standards.

It is aimed at being a narrative report, providing context to the financial statements. It seeks to achieve this aim by interpreting the financial position, performance and cash flows of an entity, as well as explaining its objectives are strategies for the future. Thus, the commentary is both historical and forward-looking in its content.
Many jurisdictions already use similar narrative reports which are sometimes variously called:

• Management's discussion and analysis (MD&A),

• Operating and financial review (OFR),

• Business review, or

• Management's report.

SCOPE

The Practice Statement is applied by entities that present management commentary that relates to financial statements prepared in accordance with IFRSs. It applies only to management commentary and no other information presented in financial statements or broader financial reports.

Expectations are that the practice statement will help achieve comparability across all entities that present management commentary to accompany their IFRS financial statements.

REGULATORY STATUS

The Practice Statement is not an IFRS. Consequently, entities applying IFRSs are not required to comply with the practice Statement, unless specifically required by that jurisdiction.

Non-compliance with the Practice Statement will not prevent entity's financial statements from complying with IFRSs, if they otherwise do so.

However, management cannot assert that their management commentary complies with the Practice Statement unless it is complied with in its entirety. If part of the Practice Statement has been complied with, the commentary should explain the extent of such compliance

Management Commentary meets the definition of 'other financial reporting' described in the *Preface to IFPS* and so the IASB has indicated that management commentary lies within the boundaries of financial reporting. Consequently, the Practice Statement should also be read in the context of the Conceptual Framework.

Content

The Practice Statement allows management itself to decide on the information to include in its management commentary. But in doing so, it must consider the needs of the primary users of financial reports (i.e. the existing and potential investors, lenders and other creditors) as well as any other user group specific to the entity that would be dependent on such information.

But the Practice Statement sets out the principles qualitative characteristics and elements of management commentary that are necessary to provide users of financial reports with information that is useful and relevant.

The Practice Statement established two general principles for the provision of management commentary.

Management commentary should be provided from the management's perspective of the entity's performance, position and progress; and should be generated from the information that management uses in managing the business.

Management commentary should be supplement and complement the information presented in the financial statements, explaining the amounts presented in the financial statements and the conditions and events that helped bring about those amounts.

In its execution, management commentary should provide the users of financial statements with information providing a background to the related financial statements including:

• The entity's resources,

• Any claims against the entity and its resources; and

• The transactions and other events that change them.

Management commentary should incorporate the following principles:

• provide managements view of the entity's performance, position and progress (including forward looking information)

• Supplement and complement information presented in the financial statements and possess the qualitative characteristics described in the *Conceptual Framework for Financial Reporting.* These characteristics are

•Relevance

•Faithful representation

• Comparability

• Verifiability

• Timeliness

• Understand ability

Management commentary should be clear and uncomplicated. It should concentrate on the most pertinent information and:

• Be consistent with its, related financial statements

• Avoid duplication of disclosures made in the notes to the financial statements, where practicable

• Avoid broad and immaterial disclosures

Elements of management commentary

Because the types of activities that are critical to an entity are specific to that particular entity, it is difficult to specify list of disclosures for management commentary (unlike, say, specifying information to be disclosed in the notes to the financial statements).

Management commentary will depend on the facts and circumstances of the entity but it should include information that is essential to an understanding five important elements of the entity:

1. The nature of the business
2. Management's objectives and its strategies for meeting those objectives
3. The entity's most significant resources, risks and relationships
4. The results of operations and prospects
5. The critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives

See appendix 1

APENDIX I

ELEMENT	BENEFIT TO USERS
The nature of the business	The knowledge of the business in which an entity is engaged and the external environment in which it operates.
Management's objectives and its strategies for meeting those objectives	Allows assessment of the strategies adopted by the entity and the likelihood that those strategies will be successful in meeting management's stated objectives
The entity's most significant resources, risks and relationships	Provides a basis for determining: • the resources available to the entity as well as obligations to transfer resources to others • the ability of toe entity to generate long-term, sustainable net inflows of resources; and • the risks to which those resource-generating activities are exposed, both in the near term and in the long term
The results of operations and ***prospects***	Aids understanding whether an entity has delivered results in line with expectations and, consequently, how well management has: • understood the entity's market, •executed its strategy; and • managed the entity resources, risks and relationships

The critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives	The ability to focus on the critical performance measures and indicators that management uses to assess and manage the entity's performance against its stated objectives and strategies.

IAS 1: PRESENTATION OF FINANCIAL STATEMENTS

Objective of IAS 1

The objective of IAS 1 is to prescribe the basis for presentation of general purpose financial statements, to ensure compatibility both with the entity's financial statements of entities IAS 1 sets out the overall framework and responsibilities for the presentation of financial statements, guidelines for their structure and minimum requirements for the content of the financial statements.

Purpose of Financial Statements

The objective of financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful for making economic decisions. The financial statements should also show results of management's stewardship of the resources entrusted to it.

General Features

The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity

Fair presentation requires the faithful representation of the effects of transactions, other events, and condition in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in firm statements that achieve a fair presentation.

IAS 1 requires that an entity whose financial statements comply with IFRSs make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless it complies with all the requirements of IFRSs (including Interpretations).

Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by explanatory material.

IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with a requirement would be so misleading that it would conflict with the objective of financial statements set out in Framework. In such a case, the entity is required to depart from the IFRS requirement, with detailed disclosure nature reasons, and impact of the departure.

Going Concern

An entity preparing IFRS financial Statements is presumed to be a going concern. If management has signified concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed, If management concludes that the entity is not a going concern, the financial statements should not he prepared on a going concern basis, in which case IAS 1 requires a series of disclosures.

Accruals Basis of Accounting

IAS 1 requires that an entity prepare its financial statements, except for cash flow information, using the accrual a of accounting

Consistency of Presentation

The presentation and classification of items in the financial statements shall be retained from one period to the other unless a change is justified either by a change in circumstances or a requirement of a new IFRS

Materiality and Aggregation

Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial.

Materiality has been defined as follows: Omissions or misstatements of items are materials if they could, individually or collectively, influence the economic decisions of users taken on the basis of the Financial Statements. Materiality depends in the size and nature of the omission or misstatement judged in the circumstances. The size or the nature of the item, or a combination of both could be the determining factor.

Offsetting

Assets and liabilities, and income and expenses may not be offset unless required or permitted by a Standard or an Interpretation.

Comparative Information

IAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard requires otherwise. It comparative amounts arc changed or reclassified, various disclosures are required.

Amendments to IAS 1 Presentation of Financial Statements

In June 2011, the IASB published amendments to IAS 1 Presentation of Financial Statements, applicable to annual periods beginning on or after 1 July 2012.

The amendments retain the 'one or two statement' approach at the option of the entity but revise the way other comprehensive income is presented. IAS I now requires separate subtotals for those elements which may be recycled (e.g. cash-flow hedging, foreign currency translations, and those elements that will not (e.g. fair value through DCI items under IFRS 9).

In summary, the amendments:

- Preserve the amendments made to IAS 1 in 2007 that required profit or loss and DC to be presented together (either as *a* single statement or separate profit or loss and a statement of comprehensive income)
- Require entities to group items presented in OCI based on whether they are potentially reclassifiable to profit or loss subsequently. i.e. those that might be reclassified and those that will not be reclassified.
- Require tax associated with items presented before tax to be shown separately for each of the two groups of DCI items (without changing the option to present items of DCI either before tax or net of tax)

Components of Financial Statement

A complete set of financial statements should include

- A statement of financial position at end of period
- A Statement of Profit or Loss and Other Comprehensive Income (SPLOCI) for the period.
- A statement of changes in equity for the period
- A statement of cash flows
- Notes, comprising a summary of significant accounting policies arid other explanatory information, and
- A statement of financial position as at the beginning of the earliest comparative period when an entity
    - Applies an accounting policy retrospectively; or
    - Makes a retrospective restatement of items in its financial statements; or
    - When it reclassifies items in its financial statements

For example, an entity preparing its financial statements, for the year ending 3lst December 2012, applies accounting policy retrospectively. The entity will be required to prepare three statements of financial position, at the following year ends 31st December2012, 2011 and 2010.

<u>Statement of Financial Position</u>

An entity must present a classified statement of financial position, separating current and non-current assets liabilities, only if presentation based on liquidity provides information that is reliable and more relevant may the current/noncurrent split be omitted

Current Assets

An entity shall classify an asset as current when:

i. It expects to realize the asset, or intends to sell or consume it, in its normal operating cycle

ii. It holds the asset primarily for the purpose of trading

iii. It expects to realize the asset within 12 months after the reporting period, or

iv. The asset is a cash or cash equivalent.

All other assets should be classified as non-current.

Current liabilities

An entity shall classify a liability as current when;

i. It expects to settle the liability in its normal operating cycle

ii. It holds the liability primarily for the purpose of trading due to be settled within 12 months after the reporting period

iii. The liabilities are due to be settled within 12 months after the reporting period.

Minimum items to be presented in the statement of financial position

a. Property plant and equipment;
b. Investment property;
c. Intangible assets;
d. Financial assets (excluding amounts shown under (e), (h) and (i));
e. Investments accounted for using the equity method.
f. Biological assets;
g. Inventories;
h. Trade and other receivables;
i. Cash and cash equivalent;
j. Total of assets classified as held for sale, and assets included in disposal groups classified as held for sale in accordance with IFRS 5.
k. Trade and other payables;
l. Provisions;
m. Financial liabilities (excluding amounts shown under (k) and (l));

n. Liabilities and assets for current tax, as defined in IAS 12;

o. Deferred tax liabilities and deferred tax assets, as defined in IAS 12;

p. Liabilities included in disposal groups, classified as held for sale;

q. Non-controlling interests, presented within equity; and

r. Issued capital and reserves attributable to equity holders of the parent.

Additional line items may be needed to fairly present the entity's financial position.

IAS 1 does not formally prescribe the format the statement of financial position. For example, assets can be presented current then noncurrent, or vice versa, and liabilities and equity can be presented current then non-current then equity or vice versa.

In relation to issued share capital and reserves, the following disclosures are required:

- Numbers of shares authorized, issued and fully paid land issued but not fully paid (and issued but not fully paid).
- Par value
- Reconciliation of shares outstanding at the beginning and the end of the period
- Description of rights, preferences, and restrictions
- Treasury shares, including shares held by subsidiaries and associates
- Shares reserved for issuance under options and contracts
- A description of the nature and purpose of each reserve within equity

An example of a Statement of Financial Position is outlined below:

ABC LTD

STATEMENT OF FINANCIAL POSITION AS AT 31ST OCTOBER 2013

Assets	**₦m**	**₦m**
Non-current Assets		
Property	150	
Plant and Equipment	78	
Intangible Assets	22	
Investments	30	

		280
Current Assets		
Inventories	81	
Trade Receivables	76	
Prepayments	4	
Cash and Cash Equivalent	22	
		183
Total Assets		463
Equity and Liabilities		
Shareholders' Equity		
Share capital	100	
Share Premium	20	
Revaluation Reserve	35	
Retained Earnings	97	
Total Equity		252
Non-Current Liabilities		
Long-Term Borrowings	150	
Long-Term Provisions	10	
Total Non-Current Liabilities		160
Current Liabilities		
Trade Payables	35	
Accruals	4	
Income Tax Payable	12	
Total Current Liabilities		51
Total Equity and Liabilities		463

Example: Statement of Financial Position

The following information is available about the balances of ALP, a limited liability company

Balances at 31st May, 2013		₦
Non-Current Assets	- Cost	500,000
	- Accumulated Depreciation	100,000
Cash at Bank		95,000
Issued Share Capital	- Ordinary Shares of ₦1 each	200,000
Inventory		125,000
Trade Payables		82,000
Retained Earnings		292,500
10% Loan Notes		150,000
Trade Receivables		112,000
Loan Note Interest owing		7,500

Requirements

Prepare the Statement of Financial Position of ALP as at 31st May, 2013 using the format IAS 1 – presentation of Financial Statements.

ALP Limited

Statement of Financial Position as at 31st May, 2013

Assets	**₦m**		**₦m**
Non-current Assets			
Cost	500,000		
Less Accumulated Depreciation	(100,000)		
			400,000
Current Assets			
Inventory	125,000		
Trade Receivables	112,000		
Cash at Bank	95,000		
			332,000
Total Assets			732,000
Equity and Liabilities			
Shareholders' Equity			
Share capital	200,000		
Retained Earnings	292,500		
			492,500
Non-Current Liabilities			
10% Loan Notes		150,000	
Current Liabilities			
Trade Payables	82,000		
Accruals	7,500	89,500	
Total Current Liabilities			239,500
Total liabilities			
Total Equity and Liabilities			732,000

Statement of Profit or Loss and Other Comprehensive Income (SPLOCI),

An entity shall present all items of income and expense recognized in a period:

i. Single Statement of Profit or Loss and Other Comprehensive Income, or

ii. In two sentences

- A separate Profit or Loss; and
- A second statement beginning with profit or loss and displaying components of other comprehensive income

Information to be presented in the Statement of Profit or Loss and Other Comprehensive Income:

a. Revenue;

b. Finance costs;

c. Share of the profit or loss of associates and joint ventures accounted for using the equity method;

d. Tax expense;

e. A single amount comprising the total of:

    i. The post-tax profit or loss of discontinued operations and

    ii. The post-tax gain or loss recognized on the disposal of the assets or disposal group(s) constituting the discontinued operation;

f. Profit or loss;

g. Each component of other comprehensive income classified by nature (excluding amounts in (h))

h. Share of the other comprehensive income of associates and joint ventures accounted for using the equity method, and

i. Total comprehensive income

Profit or loss (i.e. if (f) above) and total comprehensive income (i.e. (i) above) should each be analysed as follows n Statement of Profit or Loss and Other Comprehensive income in the case of consolidated accounts:

- Non-controlling interests, and
- Owners of the parent

No items may be presented as extraordinary items,

When items of income or expense are material, an entity shall disclose their nature and amount separately.

Circumstances that would give rise to the separate disclosure of items of income and expense include:

- Write-downs of inventories to net realizable value or of property, plant and equipment to recover amount, as well as reversals of such write-downs;
- Restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring to disposals
- Disposal of items of property, plant and equipment;
- Disposals of investments;

- Discontinuing operations;
- Litigation settlements; and
- Other reversals of provisions.

Expenses should be analysed either by nature (depreciation, purchases of materials, depreciation, etc.) or by function (cost of sales, selling, administrative, etc.).

PQR

Statement of Profit or Loss and Other Comprehensive Income for Year Ended 31st October 2013

	₦'000
Revenue	X
Cost of sales	(X)
Gross profit	X
Distributive cost	X
Administrative expenses	(X)
Profit from operations	X
Finance costs	(X)
Investment income	X
Profit before tax	X
Income tax expenses	(X)
Profit for the year	X
Other Comprehensive Income	
Items that will not be reclassified to profit or loss:	
Gain/Loss on revaluation of PPE	X
Gain/Loss on available for sale investment	X
Items that may subsequently be reclassified to profit or loss:	
Cash-flow hedging gain	X
Total comprehensive income for the year	X

Profit or Loss Plus Statement of Comprehensive income

The recommended pro-forma layout is as follows:

PQR

Profit or Loss for the year ended 31st October, 2013

	₦'000
Revenue	X
Cost of sales	(X)
Gross profit	X
Distributive cost	X
Administrative expenses	(X)
Profit from operations	X
Finance costs	(X)

Investment income	X
Profit before tax	X
Income tax expenses	(X)
Profit for the year	X

A recommended format for the presentation of other comprehensive income is as follows:

PQR

Other Comprehensive Income for the year ended 31st October 2013

	₦'000
Profit for the year	X
Other Comprehensive Income	
Items that will not be reclassified to profit or loss:	
Gain/Loss on revaluation of PPE	X
Gain/Loss on available for sale investment	X
Items that may subsequently be reclassified to profit or loss:	
Cash-flow hedging gain	X
Total comprehensive income for the year	X

Statement of Changes in Equity

An entity shall present a statement of changes in equity showing:

- Total comprehensive income for the period, showing separately the total amounts attributable to owner on the parent and to non-controlling interests
- For each component of equity, the effects of retrospective application or retrospective restatement recommended in accordance with IAS 8
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end the period, separately disclosing changes resulting from:
  - Profit or loss
  - Each item of other comprehensive income, and
  - Transactions with owners in their capacity as owners

An entity shall present, either in the SOCIE or in the notes, the amount of dividends recognized as distributions t owners during the period and the related amount per share.

Example

Essentially the statement of changes in equity presents in a columnar format all the changes which have affected various equity balances of share capital and reserves.

	Share Capital ₦	Share Premium ₦	Revaluation Reserve ₦	Retained Earnings ₦	Total Equity ₦
Balance as at 1.1.13	X	X	X	X	X
Change in accounting policy				(X)	(X)
Restated balance	X	X	X	X	X
Issues of shares	X	X	X	X	X
Revaluation gain			X		X
Transfer			(X)	X	-
Profit for the year				X	X
Dividends				(X)	(X)
	-	-	-	-	
Balance at 31.12.13	X	X	X	X	X
	-	-	-	-	-

IAS 1 also outlines the required content of the Statement of Cash Flows. These statements shall be covered in detail later in this manual.

FINANCIAL REVIEW BY MANAGEMENT

In addition to the Financial Statements identified above, management may present a Financial Review outside of the Financial Statements. The Financial Review explains the main features of the entities financial performance arid financial position as well as the main areas of uncertainty. This Financial Review typically includes:

a. An outline of the main factors affecting performance including changes in the business environment in which the entity operates. How the entity has reacted to those changes and the effect.

b. Entity's policy for investment and its dividend policy.

c. How the entity is financed.

d. Any resources that the entity uses that are not disclosed on the Statement of Financial Position in accordance with IFRS's.

Other reports which may be included are:

a. Environmental Reports — particularly in industries where environmental issues are of significance.

b. Value added Statements.

SUBSTANCE OVER FORM

A. INTRODUCTION

Substance over form is a very important concept in financial accounting. Financial statements must reflect Substance of a transaction (or economic reality) over its legal form. Failure to do so may result in financial statement being misleading.

The treatment of finance leases outlined in IAS 17 is an example of the application of substance over form. Legal finance lease assets remain the property of the lessor but in substance, because the lessee assumes all of the risks rewards, the leased assets are shown in the lessee's statement of financial position, as if legal title belonged to the lessee

IAS 1 requires the application of substance over form in general, but the IASB has yet to issue a specific IFRS decree with the matter.

The IASB however has stated in the past that FRI 5 (in the UK and Irish GAAP) is consistent with the spirit of the Framework and with the IFRSs generally.

Thus, shown below are the main points put forward by FRS 5 *Reporting the Substance of Transactions?* The general principles should be adopted when applying the concept.

The IASB has indicated that it will publish an IFRS on the issue in due course.

B. FRS 5: REPORTING THE SUBSTANCE OF TRANSACTIONS

Reasons for Off Statement of financial position Financing

The main aim of this standard is to ensure that the commercial effect of a business transaction is represented in the financial statements. The real target is off statement of financial position finance. Many companies want to put liabilities off the statement of financial position, for the following reasons:

a. Desire for a low gearing ratio. Companies with high debt are exposed to greater risk, which has an adverse effect on the value of the company. Off statement of financial position finance schemes have been devised which is designed to conceal the amount of debt finance raised by the company.

b. The primary ratio of return on capital employed may be improved if certain assets can be kept off the statement of financial position until they produce the required returns. This may particularly apply in a research development project where the benefits may not be seen until the development stage has been completer would be in the company's interest to keep the assets off the statement of financial position until the income stream comes to fruition.

c. Borrowing capacity of an Organisation is often linked to its existing debt. The lower the debt, the greater the potential of further borrowing

d. Borrowing costs are linked to perceived risk. The higher the existing debt the greater will be the borrowing costs.

e. If a listed company has a high borrowing, the likelihood of a rights issue is perceived to be higher. This adversely affects the company's share price.

f. An organisation effectively controlled by a company, but which fails to fall within the strict definition of subsidiary, may be a loss-making one. It would be in the controlling company's interest to exclude these loans from the group accounts

g. Some finance arrangements may be genuinely undertaken to reduce risks rather than to mislead the reader accounts, such as where a merchant bank may bear the financing risk and the company the operating risk.

What is an Asset?

FRS 5 identifies control and risk as the two key features of an asset.

Control is necessary for an entity to ensure that the future economic benefits accrue to itself and not to others, and it must be in a position to secure its access to those benefits.

There is usually a possibility that the future economic benefits inherent in an asset will vary from those expected. The entity that has access to those benefits will usually be the one to lose or gain under these circumstances Thus, if an entity is exposed to the risk of variations in the benefits it receives, this provides additional evidence to support the treatment of the source of those benefits as an asset. Hence additional evidence that an entity has access to those benefits is given if it is exposed to the risks inherent in those benefits.

What is a Liability?

A liability requires an obligation to transfer economic benefits**.** It is not necessary that these obligations are legally enforceable. An entity may be commercially obliged to adopt a certain course of action that is in its long-term best interests in the widest sense. For example, a company would be foolish not to exercise an option to repurchase stock when it is available at only two-thirds of its market value.

Accounting Treatment per FRS 5

FRS 5 requires that where a transaction results in an asset or liability, that item should be recognised in the statement of financial position if:

a. There is sufficient evidence of the existence of the item (including, where appropriate, evidence that a future inflow or outflow of benefit will occur and

b. The item can be measured as a monetary amount with sufficient reliability.

The standard goes on to consider transactions involving assets that have previously been recognised. Depending upon the nature of the transaction, there are two possibilities:

- Continued recognition or
- Derecognition, i.e. no longer to recognise the asset on the statement of financial position.

The standard states that where a transaction involving a previously recognised asset results in no significant change in:

- The entity's rights or other access to benefits relating to that asset, or
- Its exposure to the risks inherent in those benefits,

The entire asset should continue to be recognised.

Where a transaction involving a previously recognised asset transfers to others:

- All significant rights or other access to benefits relating to that asset, and
- All significant exposure to the risks inherent in those benefits,

The entire asset should cease to be recognised.

Transactions should be accounted for according to their substance

FRS 5 gives five examples of this:

a. Assets and liabilities on a sale and leaseback arrangement should remain in the statement of financial position

  I. The sale is clearly a financing and not a trading transaction.

  ii. There in an option to repurchase, as opposed to a requirement but only if:

    - The option to repurchase is almost certain to be exercised.
    - The seller is given an option to purchase and the buyer an option to sell.
    - Repurchase is linked to the original sale price rather than the market price,

b. **Securitised assets** - this means certain collectable debts, such as a mortgage or credit card accounts, transferred from the originator to a specially formed company (the issuer) which raises money by the issued debentures to pay for these debts. If the originator company retains benefits or risks linked to the security assets, it is considered to be a form of off statement of financial position finance and should be shown financing deal.

c. Factored **debts** - this is a well-established method of finance. In order to determine the appropriate account treatment, it may be necessary to ask:

- Has the seller access to benefits of the factored debtor e.g. future cash flows from payments by debtor
- Has the seller a liability to repay amounts received from the factor because of such reasons as bad debt etc.?

If the answer to either of these questions is yes, then it is probably a financing scheme and the asset and liability should be shown in full in the accounts.

d. **Consignment stock,** which is found particularly in the motor industry. The dealer may take a new car physic onto his premises or a sale on return basis. Here an off statement of financial position scheme could be developed whereby the dealer is borrowing the goods from the supplier to generate benefits to the dealership, necessary to identify whether the dealer has access to the benefits of the stocks and exposure to the inherent in the benefits.

c. **Loan transfers,** which are the rights to receive payments of a loan. Again, much like securitised assets, it necessary to see who receives the benefits and takes the risks to check whether this is a form of off-statement of financial position finance

Linked Presentation

Assets and liabilities should not generally be offset. However, where strict conditions are met, a linked presentation may be permitted. These are:

a. The provider of the finance has no recourse to other assets of the business, or

b. The finance relates to a specific item and the loan is only secured on that item, or

c. The right of offset exists between a debit and credit balance of the same company.

The following is an illustration of "linked presentation" used in FRS 5.

Amalgamated Engineering Plc supplied goods to its customers on extended credit terms of 90 days. As a result, it has suffered cast flow problems and has consequently entered into an agreement to factor its debts with Finance Plc.

The agreement specifies debt transfer subject to a reduction for possible bad debts in return for cash advance of 90% of the amount transferred. In addition, Amalgamated has a right to receive the balance of 10% (less Finance Plc's costs and charges) as and when the debtors eventually pay up.

Finance Plc has a right to recover its advances in the event of default by the debtors but this is subject to an overall maximum sum.

As at 31st December 19.1 the amount factored was ₦8 million less a bad debt provision of 2%. The maximum amount which Finance Plc could recover was ₦500,000 calculated under the agreement.

The Amalgamated Plc statement of financial position at 31st December 19.1 would include the following to ensure compliance with FRS 5 using "linked presentation".

Under current assets

Gross debtors (₦8 million – 2%)		₦7.84 million
Less Non-returnable finance		
(90% x ₦7.84 million)	₦7.056	
Subject to max recourse of	₦0.5	
		₦6.556 million
Net debtors disclosed		₦1.284 million
Cash		₦7.056 million
Under current liabilities:		
Recourse under factored debts		₦0.5 million

Quasi-subsidiaries

A quasi subsidiary is an organisation which, while not being strictly a subsidiary within the legal definition of the term, is nevertheless controlled by the reporting entity. If the reporting company will enjoy benefits from the quasi subsidiary to the same extent as if the organisation was a subsidiary, then such an organisation should be consolidated.

Again the crucial question is whether the controlling company will be exposed to risks and benefits from the organisation. Control may be exercised through a contract, debt or other capital instrument or even by preventing others from exercising control, e.g. in an equal joint venture.

Further Examples — FRS 5

Example 1

A car manufacturer M supplies cars to a car dealer CD or a consignment basis. The terms are as follows:

- Either party can have the car returned or transferred to another dealer.
- CD pays a monthly rental charge of 1% of the cost of the car for the privilege of displaying it.
- CD must arrange insurance for the cars.
- When CD sells a car, or after 3 months, CD has to pay M the lower of:
    i. The factory price of the car when first supplied, or
    ii. The current factory price less all monthly charges paid to date.

Solution 1

The factors which point towards treating the cars as stock of CD are:

- Its obligation to pay for the cars after 3 months and to pay effectively a finance charge in the interim.
- The fact that it cannot be compelled to pay more for the cars than the original factory price at the date of supply
- Its obligation to insure the cars

The main factors which point towards treating the cars as stock of M are its ability to demand return or transfer of cars and the fact that it is deriving rental income in the meantime.

On balance it's likely that this deal would be regarded as a sale and the cars would appear in the statement of financial position of CD.

The balance would be fundamentally affected if the settlement price were changed to become the higher of the elements. CD would then have to pay at least the current factory price for the cars when they were eventually purchased

Example 2

Sale and Repurchase Agreements

A whiskey blending company W has a large store of maturing whiskey in stock. It arranges to sell a certain quantity ₦5 million to a bank and agrees to buy it back one year later for ₦5.5 million. The whiskey remains on its premises.

Solution 2

W has not transferred the risks and rewards of ownership of the whiskey to the bank; it has merely borrowed money on the security of the whiskey. The stock will be shown on its statement of financial position together with a loan ₦5 million. At the end of the accounting period there will be an interest charge in the profit and loss account.

Example 3

Linked Presentation

Company A has debtors totalling ₦500,000. Past experience suggests that bad debts will not exceed 3%. It transfers the title of the debtors to a finance company in exchange for ₦460,000 plus a further sum which varies according to the amounts realised. In addition, Company B has recourse to Company A for the first ₦50,000 of any loss.

Company A's Statement of financial position	₦'000
Debtors	
Gross (after bad debt provisions)	485
Less non-returnable proceeds	(410)
	75

The other ₦50, 000 from Company B will be shown within creditors.

Example 4

Quasi Subsidiary

A hotel group H sells some of its hotels to company B the subsidiary of a bank. B is financed by loans from the bank. H and B enter into a management contract whereby H manages the hotel. It is remunerated by **a** management charge which absorbs all of the profits of B after charging interest.

H has control over the sale of hotels, any gain or loss on such sales reverts to it through an adjustment to the management charge.

Solution 4

It is clear from the circumstances that the banks legal ownership is of little relevance. B will be regarded as a Quasi Subsidiary of H and will be consolidated by it.

The group statement of financial position will show the hotels as an asset and the bank loans as a liability.

Example 5

Partial Sale of an Asset

Z Bank Ltd has made a ₦10 million loan to Company A for 5 years. The loan carries a fixed interest rate of 8%. After a year it sells the right to receive interest payments to the B Bank Ltd for ₦2, 700,000 but retains the right to the repayment of the principal.

Solution 5

The ₦10 million assets in the statement of financial position must be apportioned between the amount sold and the amount retained.

The future amount payable in four years' time remains in the statement of financial position.

This is the present value of this sum of money using a discount rate of 8%, i.e. ₦7, 350,300.

The similarly discounted value of the four annual payments of ₦800, 000 is ₦2, 649,700. This is compared with the proceeds of ₦2, 700,000 to produce a profit of ₦50, 300.

Example 6

(a)
An important aspect of International Accounting Standards is that transactions should be recorded or the basis of substance over their form.

Required:

Explain why it is important that financial statements should reflect the substance of the underlying transactions and describe the features that may indicate that the substance of a transaction may be different from its legal form.

(b)

Chestnut's activities include the production of maturing products which take a long time before they are ready to retail. Details of one such product are that on 1 April 2009 it had a cost of ₦5 million and a fair value of ₦7 million. The product would not be ready for retail sale until 31 March 2012.

On 1 April 2009 Chestnut entered into an agreement to sell the product to Easy finance for ₦6 million. The agreement gave Chestnut the right to repurchase the product at any time up to 31 March 2012 at a fixed price of ₦7,986,000, which date Chestnut expected that product the retail for ₦10 million. The compound interest Chestnut would have to pay on a three-year loan of ₦6 million would be:

	₦
Year 1	600,000
Year 2	660,000
Year 3	726,000

This interest is equivalent to the return required by Easy finance.

Required:

Assuming the above figures prove to be accurate, prepare extracts from the SPLOCI of Chestnut for the three year 31 March 2012 in respect of the above transaction:

i. **Reflecting the legal form of the transaction;**

ii. **Reflecting the substance of the transaction.**

(c)

Comment on the effect the two treatments have on the income statements and the statements of financial position and how this may affect an assessment of Chestnut's performance.

Solution

(a)
For financial statements to be of value to their users they must possess certain characteristics; reliability is one such important characteristic. In order for financial statements to be reliable, they must faithfully represent an entity's underlying transactions and other events. For financial statements to achieve faithful representation, transactions must be accounted for and presented in accordance with their substance and economic reality where this differs from their legal form. For example, if an entity 'sold' an asset to a third party, but continued to enjoy the future benefits embodied in that asset, then this transaction would not be represented faithfully by recording it as a sale (in all probability this would be a financing transaction).

The features that may indicate that the substance of a transaction is different from its legal form are:

- Where the control of an asset differs from the ownership of the asset
- Where assets are 'sold' at prices that are greater or less than their fair values
- The use of options as part of an agreement
- Where there are a series of 'linked' transactions.

It should be noted that none of the above necessarily mean there is a difference between substance and legal form.

Extracts from the SPLOCI

b i. Reflecting the legal form

	Year ended:			
	31 March 2010	**31 March 2011**	**31 March 2012**	**Total**
	₦'000	**₦'000**	**₦'000**	**₦'000**
Revenue	6,000	Nil	10,000	16,000
Cost of sales	(5,000)	Nil	(7,986)	(12,986)
Gross profit	1,000	Nil	2,014	3,014
Finance cost	Nil	Nil	Nil	Nil
Net profit	1,000	Nil	2,014	3,014

b ii. **Reflecting the substance**

	Year ended:			
	31 March 2010	**31 March 2011**	**31 March 2012**	**Total**
	₦'000	**₦'000**	**₦'000**	**₦'000**
Revenue	Nil	Nil	10,000	10,000
Cost of sales	Nil	Nil	(5,000)	(5,000)
Gross profit	1,000	Nil	5,000	5,000
Finance costs	(600)	(660)	(726)	(1,986)
Net profit	(600)	(660)	4,274	3,014

c.

It can be seen from the above that the two treatments have no effect on the total net profit reported in SPLOCI, however, the profit reported in different periods and classification of costs is different. In effect the legal form creates some element of profit smoothing and completely hides the financing cost. Although not shown, the effect the statements of financial position is that recording the legal form of the transaction does not show the inventory, does it show the in-substance loan. Thus recording the legal form would be an example of off balance sheet (statement of financial position) financing. The effect on an assessment of Chestnut using ratio analysis may be that recording the legal form rather than the substance of the transaction would be that interest cover and inventory turnover would be higher and gearing lower. All of which may be considered as reporting a more favourable performance

MORE EXAMPLES

EXAMPLE 1

BANTAM is a car dealership and prepares its financial statements to 30 June. In the year to 30 June 2013, it held a number of vehicles at a number of different sites. The vehicles were supplied by WELTER, a car manufacturer, which is BANTAM's main supplier. Under the trading terms agreed with WELTER, BANTAM is entitled to hold up to a maximum of 1,000 vehicles although legal title remains with WELTER until the vehicle is sold to a third party. BANTAM is able use the cars for demonstration purposes and can relocate the vehicles between sites, provided the mileage on any individual vehicle does not exceed 1,500 miles.

Breach of this mileage limit would result in BANTAM incurring a penalty. BANTAM has the right to return vehicles at any time within six months of delivery, with no charge. BANTAM is responsible for insuring all the vehicles on its premises.

Required:

Discuss the economic substance of BANTAM's trading agreement with WELTER in respect of the vehicles, concluding which entity should recognise the vehicles as inventory for the period that they are held by BANTAM.

Recognition of inventories

The economic substance of the arrangement is determined by analysing which party holds the significant risks and benefits of ownership of the vehicles.

Factors indicating that the risks and benefits of ownership are with BANTAM:

- BANTAM is responsible for insuring the vehicles whilst at their premises.
- BANTAM is able to use the vehicles for demonstration purposes and to move them between sites freely.

However, this is slightly mitigated by the fact that there is a mileage limit (see below).

Factors indicating that the risks and benefits of ownership are with WELTER:

- BANTAM is free to return any vehicle free of charge within six months. This means that the most significant risk of obsolescence rests with WELTER.
- WELTER, by setting a mileage limit, is still effectively in control of the vehicles.
- Legal title remains with WELTER, hence should a dispute arise; WELTER should the able to recover the vehicle.

BANTAM does hold some of the risks and rewards of ownership associated with the vehicles. However, the significant risk of obsolescence is held by WELTER. BANTAM can return the vehicles at any time without penalty and, as noted above would indicate that the risk of obsolescence is in fact with WELTER. As this is seen as the most significant risk, WELTER should continue to recognise the goods within its inventories.

Example 2

On September 2013 TROUT sold land to SALMON, an entity that provides TROUT with long term finance. The sale price was ₦1,600,000 and the carrying value of the land on the date of the sale was ₦1,310,000 (the Original cost of the asset).

Under the terms of the sale agreement TROUT has the option to repurchase the land within the next four years for between ₦1,660,000 and ₦1,800,000 depending on the date of repurchase. SALMON cannot use the land for any purpose without the prior consent of

TROUT. The land must be repurchased for ₦1,800,000 at the end of the four year period if the option is not exercised before that time.

TROUT has derecognised the land and recorded the subsequent gain within profit for the year ended 31 September 2013.

Required:

Discuss how the sale of the land should be accounted for in accordance with the principles of IAS 18 Revenue and the Framework for Preparation and Presentation of Financial Statements and prepare any accounting adjustments required to TROUT's financial statements for the year to 31 September 2013.

<u>Sale of land</u>

This is a form of sale and repurchase agreement and therefore under both IAS 18 and the Framework we need to consider the substance of the transaction and ultimately who holds the majority of the risks and rewards of the ownership of the land.

The substance of this transaction would appear to be a financing arrangement, especially as SALMON is already a provider of long term finance to TROUT, with the land acting as security. The risks and rewards associated with the land have not actually been transferred to SALMON. TROUT continues to be subject to the principal risk of the asset, which is a fall in its value, as it would be forced to repurchase the land in 4 years' time at ₦1.8 million. TROUT could, however, gain from the agreement if the value of the land increased beyond the agreed repurchase terms. In addition, TROUT continues to determine how the land can be used.

The asset should not be derecognised by TROUT and the gain on sale should be eliminated. The proceeds received represent a loan received and therefore a corresponding liability should be recognised in TROUT's financial statements at 31 September 2013. In subsequent years the liability will be adjusted to include interest (which arises because the repurchase price is higher than the original "sale" price). However, no interest on this financing is recognised in the year to 31 September 2013 as the transaction occurred at the year-end date.

The correcting entry is:

	Property, plant and equipment	₦1,310,000
Dr		
Dr	Gain on sale – P/L	₦290,000
Cr	Liability	N1,600,000

EXAM FOCUS

In the Educators briefing for 2012, the following query and response was highlighted. At the time of going to print for this manual, it is assumed to apply to 2014 also, unless the examiner subsequently indicates otherwise

Query: In relation to P2 Advanced Corporate Reporting, current developments and in particular IFRS 13 Fair Value Measurement were a question to appear on this area, would it be a discursive question, or could it include computational aspect also?

Response: Questions on topical issues/current developments would generally be discursive in nature

FAIR VALUE MEASUREMENT

INTRODUCTION

In 2011, the International Accounting Standards Board (IASB) issued IFRS 13 *Fair Value Measurement*

This was the conclusion of a convergence project undertaken with the U.S. Financial Accounting Standards Board (FASB), which took number of years and involved significant consultation with numerous interested parties. The FASB and the IASB have achieved the goal of establishing a single set of global accounting standards to measure fair value; this means that IFRS 13 is virtually identical to the American standard on Fair Value Measurement.

IFRS 13 becomes effective for annual reporting periods beginning on or after January 1, 2013, although early adoption is permitted.

The standard's objectives are to.

1. Clarify the definition of fair value
2. Provide a single source of guidance for all fair value measurements, and
3. Enhance disclosures about reported fair value estimates.

Historically, fair value guidance was spread across various standards and it was incomplete in certain places, while silent in other situations.

This created the potential for inconsistency and differences in interpretation when arriving at an estimate of fair value.

In providing a single source of guidance and a precise definition of fair value, the standard:

- Assists in improving consistency and comparability,
- Helps preparers and auditors in fulfilling their role, and
- Contributes to users' understanding of what fair value represents.

A key point to emphasise is that the standard addresses ***how*** to measure fair value, not ***when*** to measure it. In practice, this means an increase in items reported as fair value is not expected, but the newly introduced framework may result in changes to *how* fair value has been historically measured and disclosed.

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except for:

- Share-based payment transactions within the scope of IFRS 2 *Share-based Payment*
- Leasing transactions within the scope of IAS l7 *Leases*
- Measurements that have some similarities to fair value but that are not fair value, such as net realisable value in IAS 2 *Inventories* or value in use in IAS 36 *Impairment of Assets*

The new fair value definition emphasises that it is a *market-based* measurement.

Key definitions:

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date *(Sometimes referred to as an* ***exit price****).*

Active market: A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

Exit price: The price that would be received to sell an asset or paid to transfer a liability.

Highest and best use: The use of a non-financial asset by market participants that would maximise the value of the asses or the group of assets and liabilities (e.g. a business) within which the asset would be used.

Most advantageous Market: The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

Principal market: The market with the greatest volume and level of activity for the asset or liability

Measurement of fair value

Overview of fair value measurement approach

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset o to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all of the following:

1. The asset or liability being measured.
2. The principal or most advantageous market in which an orderly transaction would take place for the asset or liability.
3. For a non-financial asset, the highest and best use and whether the asset is used in combination with other assets or on a stand-alone basis.
4. Those assumptions that market participants would use when pricing the asset or liability:
    - Principal or most advantageous market
    - Principal market is **the** market with the greatest volume or level of activity for that asset or liability
    - If no principal market, use the most advantageous market, the market in which the entity could achieve the most beneficial price.
5. The valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the "fair value hierarchy" within which the inputs are categorised.

Guidance on Measurement

IFRS 13 provides the guidance on the measurement of fan value, including the following

- An entity takes into account the characteristics of the asset of liability being measured that a market participant would take into account when pricing the asset or liability at measurement date (e.g. the condition and location of the asset and any restrictions on the sale and use of the asset).
- Fair value measurement assumes an orderly transaction between market participants at the measurement date under current market conditions.
- Fair value measurement assumes a transaction taking place in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability
- A fair value measurement of a non-financial asset takes into account its *highest and best use.* This means the entity must contemplate whether the use of the asset is physically possible, legally permissible and financially feasible (usually entities current use). If asset held defensively to prevent others from using it, IFRS 13 requires the asset to be measured based on highest and best use, with disclosure.
- A fair value measurement of a financial or non-financial liability or an entity's own equity instruments assuming it is transferred to a market participant at

the measurement date, rather than settled, extinguished or cancelled at the measurement date

- The fair value of a liability reflects non-performance risk (the risk the entity will not fulfil an obligation), including an entity's own credit risk and assuming the same non-performance risk before and after the transfer of the liability
- An optional exception applies for certain financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk, provided conditions are met (additional disclosure is required).

Valuation techniques

An entity uses valuation techniques appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants and the measurement date under current market conditions. Three widely used valuation techniques are:

1. **Market approach**— uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities (e.g. a business).
2. **Cost approach** — reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost)
3. **Income approach** —converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts.

In some cases, a single valuation technique will be appropriate, whereas in others multiple valuation techniques will be appropriate.

Fair value hierarchy

Overview
the standard introduces the concept of a fair Value hierarchy based on the observability of the inputs used to measure fair value (similar to concepts first introduced by IFRS 7 *Financial Instruments Disclosures).* Inputs to fair value measurements should be used in the following order of priority:

Level 1 Inputs

Level 1 input are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.

A quoted market price in an active market provides the most reliable evidence of fair value and is-used without adjustment to measure fair value whenever available, with limited exceptions.

If an entity has an asset or liability that is traded in an active market, the fair value of the asset or liability is measured within Level 1 as

- The quoted price for the individual asset or liability multiplied by the quantity held by the entity, *(even if the market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price).*

Level 2 inputs

Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Examples of level 2 inputs include:

- Quoted prices for identical assets or liabilities in *inactive* markers;
- Quoted prices for similar assets or liabilities in active or inactive markets;
- Observable inputs other than quoted prices (interest rates and yield curves, for example); or
- Inputs that are corroborated by market data.

Level 3 inputs

Level 3 Inputs are unobservable inputs for the asset or liability. Unobservable inputs should be developed using the best information available in the circumstances, which might include the entity's own data, taking into account all Information about market participant assumptions that is reasonably available.

Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

Disclosure

IFRS 13 enhances the disclosures about fair value measurements; including disclosure around the valuation method and inputs uses as well the information used to develop those inputs. Additional quantitative and descriptive disclosures are required where Level 3 unobservable inputs are used, with the intention of helping financial statement readers understand the sensitivity of the analysis to key significant inputs.

The objective of the disclosures is to require she entity to disclose information that helps users of its financial statement assess both of the following:

- For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques arid inputs used to develop those measurements
- For fair value measurements using significant unobservable inputs (i.e. level 3), the effect of the measurement on profit or loss or other comprehensive income for the period.

COMPREHENSIVE EXAMPLE

A.

The International Accounting Standards Board has recently completed a joint project with the Financial Accounting Standards Board (FASB) on fair Value measurement by issuing IFRS 13 ***Fair Value Measurement.*** IFRS 13 defines fair value, establishes a framework for measuring fair value and requires significant disclosures relating to fair value measurement.

The IASB wanted to enhance the guidance available for assessing fair value in order that users could better gauge the valuation techniques and inputs used to measure fair value. There are no new requirements as to when fair value accounting is required, but the IFRS gives guidance regarding fair value measurements in existing standards. Fair value measurements are categorised into a three level hierarchy, based on the type of inputs to the valuation techniques used. However, the guidance in IFRS 13 does not apply to transactions dealt with by certain specific standards.

Required:

i. Discuss the main principles of fair value measurement as set out in IFRS 13.

ii. Describe the three level hierarchy for fair value measurements used in IFRS 13.

B.

Epsilon Ltd, a public limited company, is reviewing the fair valuation of certain assets and liabilities in light of the introduction of IFRS 13.

It carries an asset that is traded in different markets and is uncertain as to which valuation to use. The asset has to be valued at fair value under International Financial Reporting Standards. Epsilon Ltd currently only buys and sells the asset in the Australasian marker. The data relating to the asset are set out below:

Year to 30 November 2012

	Asian Market	European Market	Australasian Market
Volume of market – units	4 million	2 million	1 million
Price	₦19	₦16	₦22
Costs of entering the market	₦2	₦2	₦3
Transaction costs	₦1	₦2	₦2

Additionally Epsilon Ltd had acquired an entity on 30 November 2012 and is required to fair value a decommissioning liability. The entity has to decommission a mine at the end of its useful life, which is in three years' time. Epsilon Ltd has determined that it will use a valuation technique to measure the fair value of the liability. If Epsilon Ltd were allowed to transfer the liability to another marker participant, then the following data would be used:

Input	Amount
Labour and material cost	₦2 million
Overhead	30% of labour and material cost
Third party mark-up-industry average	20%
Annual inflation rate	5%
Risk adjustment – uncertainty relating to cash flows	6%
Risk-free rate of government bonds	4%
Entity's non-performance risk	2%

Epilson Ltd needs advice on how to fair value the liability.

Required

Discuss, with relevant computations, how Epsilon Ltd should fair value the above asset and liability under IFRS 13.

a. (i)

Fair value has had a different meaning depending on the context and usage. The IASB's definition is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants and the measurement date. Basically it is an exit price. Fair value is focused on the assumptions of the market place and is not entity specific. It therefore takes into account any assumptions about risk. Fair value is measured using the same assumptions arid taking into account the same characteristics of the asset or liability as market participants would.

Such conditions would include the condition arid location of the asset and any restrictions on its sale or use. Further, it is not relevant if the entity insists that prices are too low relative no its own valuation of the asset and that it would be unwilling to sell at low prices. Prices to be used are those in ‘an orderly transaction’. An orderly transaction is one that assumes exposure to the market for a period before the dare of measurement to allow for normal marketing activities and to ensure that it is not a forced transaction. If the transaction is not ‘orderly’, then there will not have been enough time to create competition arid potential buyers may reduce the price that they are willing to pay. Similarly, if a seller is forced to accept a price in a short period of time, the price may not be representative. It does not follow that a market in which there are few transactions is not orderly. If there has been competitive tension, sufficient time and information about the asset, then this may result in a fair value for the asset.

IFRS 13 does not specify the unit of account for measuring fair value. This means that it is left to the individual standard to determine the unit of account for fair value measurement. A unit of account is the single asset or liability or group of assets or liabilities. The characteristic of an asset or liability must be distinguished from a characteristic arising from the holding of an asset or liability by an entity. An example of this is that if an entity sold a large block of shares it may have to do so at a discount to the market price. This is a characteristic of holding the asset rather than the asset itself and should not be taken into account when fair valuing the asset.

Fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The principal market is the one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

The most advantageous market is the one which maximises the amount that would be received for the asset or minimises the amount that would be paid to transfer the liability after transport and transaction costs. An entity does not have to carry out an exhaustive search to identify either market but should take into account all available information. Although transaction costs are taken into account when identifying the most advantageous market, the fair value is not after adjustment for transaction costs because these costs are characteristics of the transaction and not the asset or liability. If location is a factor, then the market price is adjusted for the costs incurred to transport the asset to that market. Market participants must be independent of each other and knowledgeable, and able and willing to enter into transactions.

IFRS 13 sets out a valuation approach, which refers to a broad range of techniques, can be used. These techniques are threefold. The market, income and cost approaches

ii.When measuring fair value, the entity is required to maximise the use of observable inputs and minimise the use of unobservable inputs. To this end, the standard introduces a fair value hierarch, which prioritises the inputs into the fair value measurement process.

Level 1 inputs are quoted prices (unadjusted) in active markets for items identical to the asset or liability being measured. As with current IFRS, if there is a quoted price in an active market, an entity uses that price without adjustment when, measuring fair value. An example of this would be prices quoted on a stock exchange. The entity needs to be able to access the market at the measurement date Active markets are ones where transactions take place with sufficient frequency and volume for pricing information to be provided. An alternative method may be used where it is expedient. The standard sets out certain criteria where this may be applicable. For example, where the primary quoted in an active market does not represent fair value at the measurement date. An example of this may be where a significant event takes place after the close of the market such as a business reorganisation or combination.

The determination of whether a fair value measurement is level 2 or level 3 inputs depends on whether the inputs are observable inputs or Unobservable inputs and their significance.

Level 2 inputs are inputs other than the quoted prices in level 1 that are directly or indirectly observable for that asset or liability They are quoted assets or liabilities for similar items in active markets or supported by market data. For example, interest rates, credit spreads or yield curves Adjustments may be needed to level 2 inputs and if this adjustment is significant, then it may require the fair value to be classified as level 3.

Level 3 inputs are unobservable inputs. The use of these inputs should be kept to a minimum. However, situations may occur where relevant inputs are not observable and therefore these inputs must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability. The entity should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The general principle of using an exit price remains and IFRS 13 does not preclude an entity from using its own data. For example, cash flow forecasts may be used to value an entity that is not listed. Each fair value measurement is categorised based on the lowest level input that is significant to it.

B.

Year to 31 December 2012	**Asian Market**	**European Market**	**Australasian Market**
Volume of market – units	4 million	2 million	1 million
Price	₦19	₦16	₦22
Costs of entering the market	(₦2)	(₦2)	(n/a) see note
Potential fair value	₦7	₦14	₦22
Transaction costs	(₦1)	(₦2)	(₦2)
Net profit	₦16	₦12	₦20

Note: As Epsilon Ltd buys and sells in Australasia, the costs of entering the market are not relevant as these would not be incurred

Further transaction costs are not considered as these are not included as part of the valuation.

The principal market for the asset is the Asian market because of the fact that it has the highest level of activity due to the highest volume of units sold. The most advantageous market is the Australasian market because it returns the best profit per unit. If the information about the markets is reasonably available, then Epsilon Ltd should base its fair value. On prices in the Asian market due to it being the principal market, assuming that Epsilon Ltd can access the market. The pricing is taken from this market even though the entity does not currently transact in the market and is not the most advantageous. The fair value would be ₦17, as transport costs would be taken into account but not transaction costs.

If the entity cannot access the Asian or European market, or reliable information about the markets is not available, Epsilon Ltd would use the data from the Australasian market and the fair value would be ₦22. The principal market is not always the market in which the entity transacts. Market participants must be independent of each other and Knowledgeable and able and willing to enter into transactions.

Input		**Amount (₦'000)**
Labour and material cost		2,000
Overhead (30%)		600
Third party mark-up-industry average (20% of 2,600)		520
	Total	3,120
Annual inflation rate (3,120 x 5% compounded for three years)		492
	Total	3,612
Risk adjustment (6%)		217
	Total	3,829
Discounted at risk free rate of government bonds plus entity's non-performance risk (6%)		3,215

The fair value of a liability assumes that it is transferred to a market participant at the measurement date. In many cases there is no observable market to provide pricing information. In this case; the fair value is based on the perspective of a market participant who holds the identical instrument as an asset. If there is no corresponding asset, then a valuation technique is used. This would be the case with the decommissioning activity. The fair value of a liability reflects any compensation for risk and profit margin that a market participant might require to undertake the activity plus the non-performance risk based on the entity's own credit standing. Thus the fair value of the decommissioning liability would be ₦3, 215,000.

INTRODUCTION

The standard indicates that the main issues to be dealt with are

1. Recognition of assets
2. Determination of their carrying amount
3. Depreciation and impairment losses
4. Disclosure requirement

The standard does not apply to:

a. Property, plant and equipment classified as "held for sale" under IFRS 5
b. Mineral rights and reserves
c. Biological assets

Related Standards

1. IAS 23 Capitalisation of Borrowing Costs
2. IAS 40 investment Property
3. IFRS 5 Non-Current assets "Held for Sale" and discontinued operations
4. IAS 17 Leased Assets

Definition of PPE

The conceptual Framework defines an asset as:

1. A resource controlled by the entity
2. As a result of pact events
3. From which future economic benefits are expected to flow to the entity

IAS 16 states that PPE are tangible items that are held for use:

- In the production or supply of goods and services,
- For administration purposes; or
- For rent to others

And are expected to be used during more than one period

Recognition Criteria

The cost of an item of PPE should be recognised as an asset when:

1. It is probable that future economic benefits associated with the item will flow to the entity; and

2. The cost of the asset can be measured reliably

The evaluation is applied when expenditure is incurred. It cannot be applied retrospectively.

Some items may not directly increase the future economic benefits of any particular existing item of property, plant and equipment, but may be necessary for an entity to obtain the future economic benefits from its other assets. An example of such an item is fire safety equipment, which should be recognised as an addition to property, plant and equipment

Initial Measurement

PPE should be initially measured at **COST.** Cost of an item includes the costs of installation and its ultimate removal/decommissioning at the end of its useful life. Cost only includes direct costs incurred bringing the asset into working condition and its ultimate disposal (note that this is different to costs for inventories whore indirect production overheads are included).

Direct Costs: are costs that would not have been incurred if the activity had not taken place. Capitalisation of directly attributable costs should *cease* when substantially all the activities that are necessary to get the asset ready for use are complete, even if the asset has not yet been brought into use**.**

Costs to be capitalised as part of the cost of the asset:

- Duties & Taxes
- Professional Fees (architects, surveyors, legal fees)
- Cost of Site preparation (levelling a site, services etc.)
- Installation Costs
- Commissioning/Testing Costs
- Dismantling costs where obligation exists
- Interest costs, in accordance with IAS 23

Costs that should NEVER be capitalised:

- Indirect Costs
- Fixed costs
- Administration and general overheads
- Abnormal costs (excess wastage or idle time)
- Costs incurred AFTER the asset is physically ready for use

- Costs incurred in the initial operating period, e.g. initial operating losses and any further costs incurred before a machine is used at its full capacity
- Marketing or advertising costs
- Training Costs for new equipment
- Feasibility Studies

EXAMPLE 1

Kerr Pink limited has recently acquired an item of plant. The details of this acquisition are

	₦	₦
List price of plant		240,000
Trade discount applicable to Kerr Pink		12.5%
Ancillary costs		
Shipping and handling costs		2,750
Pre-production testing		12,500
Maintenance contract for three years		24,000
Electrical cable installation	14,000	
Concrete reinforcement	4,500	
Own labour costs	7,500	
		26,000

Kerr Pink paid for the plant (excluding the ancillary costs) within four weeks and thus received a 3% early settlement discount. An error was made in installing the electrical cable. This error cost ₦6, 000 to rectify and is included in ₦14, 000 figures. The plant is expected to last for 10 years. At the end of this period, there will be compulsory cost ₦18, 000 to dismantle the plant and restore the site. (Ignore discounting).

	₦	₦
List price of plant		240,000
Less trade discount (12.5%)		(30,000)
		210,000
Shipping and handling costs		2,750
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		18,000
Initial cost of plant		**263,250**

NOTE

- Early settlement discount is a revenue item
- Maintenance cost is also a revenue item.
- The electrical error must be charged to the Profit or Loss.

Deferred payment

If payment is deferred beyond normal credit terms, the difference between the total payment and the cash price equivalent must be recognised as interest over the credit period, unless such interest is capitalised in accordance with IAS 23.

Example 2

Queens Limited purchased goods on 31st March 2010. The purchase cost was ₦25, 000, and this was payable on 31st March 2011. Normal credit terms are 3 months, and the normal cash price is ₦22, 000.

		₦	₦
Debit	Purchases	22,000	
Credit	Trade payables		22,000

(Being cost of goods at cash equivalent)

		₦	₦
Debit	Interest cost – P/L	3,000	
Credit	Trade payables		3,000

(Being interest cost for the year)

An asset exchanged for another asset

If an asset is acquired in exchange for another asset (whether similar or dissimilar in nature) the cost of the asset acquired will be measured at fair value unless:

- the transaction lacks commercial substance; or
- the fair value of neither the asset received nor the asset given up is reliably measurable

Example 3

Rooster Limited has agreed to exchange a land site, which it owns, for a building which has a fair value of ₦250, 000. The carrying value of the land site in the financial statements is ₦200, 000.

		₦	₦
Debit	Building	250	
Credit	Land		200
Credit	Profit on disposal of land – P/L		50

If the acquired item **is** not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Subsequent Expenditure

Subsequent expenditure on existing PPE should only be capitalised if it clearly enhances the economic benefits of the asset.

An entity should not recognise the costs of da-to-day servicing of an item as being property, plant and equipment. These costs should be recognised in profit or loss as they are incurred. An example would be the regular servicing of a furnace.

Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. A condition of continuing to operate an item of property, plant and equipment (e.g. a furnace) may be performing regular major inspections for faults. When each major inspection is performed, its cost is recognised in the carrying amount of property, plant and equipment if the recognition criteria (future economic benefits and measurement reliability) are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

Replacement Expenditure

IAS 16 states that parts of some items of property, plant and equipment may require replacement at regular intervals (e.g. the engine of a vehicle). Such parts will be included in property, plant and equipment when the cost is incurred, if the recognition criteria (future benefits and measurement reliability) are met.

The carrying amount of those parts that are replaced is derecognised in accordance with the de-recognition provision of IAS 16

Example 4

On 1st July 2009, Maris Piper Limited replaced a lift in one of its factory buildings. The cost of the new lift was ₦150, 000, and the carrying amount of the old lift was ₦36, 000. The old lift had a zero disposal value, and decommissioning of the new lift is estimated to be ₦10,000.

In accordance with IAS 16, the costs of the replacement lift are included in property, plant and equipment. The estimate of the costs of decommissioning the new lift should also be included in the asset's cost. The pair or loss arising from the de-recognition of the old lift is included in the Profit or Loss, in accordance with IAS 16, and is not included in revenue

		₦'000	₦'000
Debit	Buildings (150 + 10k)	160	
Credit	Bank		150
Credit	Provision for dismantling – SOFP		10

(Being cost of new lift)

		₦'000	₦'000
Debit	Loss on de-recognition of old lift – P/L	36	
Credit	Buildings		36

(Being loss on disposal of old lift – disclose separately, in accordance with IAS 1, subject to materiality)

Subsequent Measurement of PPE

PPE can be measured at period-end using either:

1. Cost model

   After recognition the asset should be carried in the SOFP at:

   Cost

   Less Accumulated Depreciation

   Less Accumulated Impairment Losses

2. Revaluation Model

   After recognition, an asset whose fair value can be measured reliably should be carried at a revalued amount, i.e.

   Fair value of the asset at the date of revaluation

Less subsequent accumulated depreciation

Less subsequent impairment losses

IAS 16 -Revaluation model

Tangible non-current assets are initially measured at Cost and then re-valued at Fair Value, if fair value can be measured reliably.

Fair Value is normally determined from Market based evidence by appraisal, normally undertaken by professionally qualified valuer.

IFRS 13 FAIR VALUE

Fair Value is determined as the price that would be received to sell an asset (or paid to transfer a liability) in an orderly transaction between market participants at the measurement date (IFRS 13).

Fair Value is based on the highest and best use of that asset that would maximise its value based on uses that are physically possible, legally permissible and financially feasible. Fair value is considered from the perspective of market participants (buyers and sellers), even if they may use the asset differently.

Current use of a non-financial asset is presumed to be its highest and best use, unless there are factors that would suggest otherwise.

EXAMPLE

A company has land currently developed for industrial use as a site for a factory.

Alternatively, the site could be developed into a block of residential flats which, based on evidence relating to adjoining plots of similar size, appears to be a practical use of the site.

The highest and best use of the land is determined by taking the higher measurement from the two possible outcomes i.e.

1. Value of the land as currently developed for industrial use
2. Value of the land as a vacant site for residential use taking into account the costs of demolishing the factory and other costs (including the uncertainty over legal and planning issues) necessary to convert the land to a vacant site (i.e. the land is to be used by market participants on a stand-alone basis).

Depreciated Replacement cost can be used if there is no market based evidence of Fair Value because of the specialised nature of the asset.

Revaluation Rules

1. Revaluations must be carried out with sufficient regularity to ensure that the carrying value does not differ materially from fair value at the reporting date.

2. The Revaluation model must be applied to the entire class of PPE.

Gain or Loss on Revaluation

If a revaluation increase the value of the asset, the surplus should be disclosed as other comprehensive income” the SPLOCI and credited to Revaluation Surplus, unless it reverses a previous deficit which was originally charged to profit and loss.

If the revaluation decreases the value of the asset, the deficit should be written off to Profit and Loss unless there is a previous surplus on the same asset.

Example 5

Company X has land in its books with a carrying value of ₦14m. Two years ago, the land was worth ₦16m. The loss was recorded in the Profit or Lost. This year the land has been valued at ₦20m.

		₦m	₦m
Debit	Land	6	
Credit	Profit of loss		2
Credit	Revaluation surplus		4

Example 6

Company Y Ltd has land in its books with a carrying value of ₦20m. Two years ago, the land was worth ₦15m. The gain was credited to the Revaluation surplus. This year, the land has been revalued to ₦13m.

		₦m	₦m
Debit	Revaluation surplus	5	
Debit	Profit or loss	2	
Credit	Land		7

Example 7

Company had the following in its SOFP at 32 December 2012;

Buildings	**₦**
Cost	5,000,000
Accumulated depreciation	1,000,000
Carrying amount	4,000,000

Depreciation has been charged at 2% per annum. The building is revalued to N5, 925,000 on the 30th June, no charge in expected useful life.

Depreciation charge for 2013		₦
₦5,000,000 x 2% x 6/12	=	50,000
+		
₦5,925,00 x 6/12 39.5years	=	75,000 125,000

The asset is depreciated as normal up to the revaluation. After that, the revalue amount is written off over the remaining life of the asset

At the rate of the revaluation

	₦
Carrying amount	3,950,000
Revalued amount	5,925,000
Revaluation surplus	1,975,000

From 2014, the annual depreciation charge would be ₦150, 000

2013 Profit or Loss

	₦
Depreciation	125,000
2013 SOFP	
Valuation at 30th June	5,925,000
Depreciation	75,000
Carrying amount	5,850,000
Revaluation surplus	1,950,000

Revaluation Reserve:

- The Revaluation Surplus may be transferred directly to Retained Earnings when the assist is derecognized.
- Some of the surplus may be transferred as the asset is used by the entity. This amount should be equal to the excess of the revised depreciation charge over the Historic Cost depreciation charge.
- Transfers are not made through the Profit & Loss

Therefore, in the previous example:

The following can be released to accumulated reserves as follows:

$$\frac{1{,}975{,}00}{39.5\ year} = ₦50{,}000\ per\ annum$$

$$In\ 2013\ ₦50{,}000 \times \frac{6}{12} = ₦25{,}000\ can\ be\ released$$

Disclosure Notes relevant to Revaluation

1. Effective date of valuation
2. Whether an independent Valuer was involved.
3. The methods and significant assumptions applied in estimating items fair values.
4. The extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques.

Depreciation

- All non-current assets of a finite life must be depreciated over their estimated useful economic life
- Depreciation allocates the "cost or valuation less the estimated residual value" over its estimated useful life and the asset.
- The depreciation charge for each period should be charged to the Profit or Loss, unless it is included in the carrying amount of another asset. The latter would apply, for example, in respect of depreciation of plant use for development activities which may be included in the cost of an intangible asset, recognised in accordance with IAS 38

Example
Golden Wonder Limited purchased plant for ₦200, 000 on 1st January 2010, which is being utilised for qualifying development expenditure. The plant has a useful life of 10 years and an estimated residual value of ₦20,000.

		₦'000	₦'000
Debit	Development costs – SOEP	18	
Credit	Accumulated depreciation		18

Useful life

1. Useful Life is the period over which an asset is expected to be available for use by an entity; or
2. The number of production or similar units expected to be obtained from the asset by an entity.

Depreciation begins when the asset is available for use and continues even though the asses may be idle.

Depreciation calculation

1. Depreciation is always based on the carrying value, which is Cost or Fair Value.
2. Residual value is based on current prices excluding the effects of inflation or deflation of the asset at the end of its useful life.

Depreciation is recognized as long as the residual value does not exceed the carrying amount

Depreciation — Review of useful life & residual value

The useful life and residual value should be reviewed at least annually, and revised it necessary.

Any adjustments are accounted for as a change in estimate (rather than a change in accounting policy).

Different Component of PPE

Different depreciation rates can be used for different component parts of one large asset (a complex asset) Where individual material component parts or the asset have different useful lives, then these components must be depreciated using different estimates of useful lives, e.g. Aeroplanes (body and engine), Building (land & building)
De-recognition of Non-current asset

Assets are de-recognised or disposal o where there are no longer any future economic benefits expected from its use. That is when they are

- Sold
- Scrapped
- Withdrawn from use

A gain or loss arising on disposal must be calculated when the assets are de-recognised. The gain or loss is based on the carrying value of the asset in the accounts and in computed as follows:

Sales proceeds

Less: Carrying Value at the date of disposal

On disposal, any surplus in the revaluation reserve in respect of the disposed asset may be transferred to retained earnings, but cannot be recognised in comprehensive Income for that period (it would have already been recognised when the revaluation was carried out)

The gain or ass / disposal proceeds are not recognised as "revenue" in the Profit or Loss.
Transfer from Inventory to PPE

On occasion, a company may decide to keep a current asset for its own use. The current asset becomes a non-current Asset**.**

On transfer:

• The amount capitalised should be the ***lower*** of the asset's cost and fair value.

• If the fair value is less than the previous carrying value, the write off should be recognised in the Profit or Loss

Disclosure
For each class of PPE

a. Measurement bases for calculating the gross carrying amount
b. Depreciation method
c. Useful lives of depreciation rates used

d. Gross carrying amount aid accumulated at the beginning of the period

e. Reconciliation of carrying amount at beginning and end of period, showing

    i. Additions

    ii. Assets held for sale (IFRS 5)

    iii. Acquisitions through business combinations

    iv. Revaluations

    v. Impairment losses and reversals of losses

    vi. Depreciation

    vii. Other changes, e.g. foreign currency exchange differences

If they arise, disclose

a. Restrictions on title and whether assets have been pledged as security and for now much

b. Amount recognized in this course of assets construction

c. Contractual commitments to acquire PPE

d. Amount of compensation from third parties for assets that were impaired, lost or given up included in the profit or loss

If assets have been revalued, disclose

a. Date of revaluation

b. Whether independent Valuer was used

c. Methods and assumptions made

d. Extent to which estimates were based on active markets or other technique

e. Carrying amount of asset if cost model had been used

f. Revaluation surplus

IAS 16 ***encourages*** disclosure of

a. Carrying amount of idle PPE

b. Gross carrying amount of fully depreciated assets still in use

c. Carrying amount of assets retired from active use and not classified as held for sale

d. If the cost model is used, then disclose the Fair Value, if materially different

QUESTION BANK - PPE

EXAMPLE 1

NODDY LTD acquired a 12 year lease or a property on 1 October 2011 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 30th September 2012 and 2013 were ₦231, 000 and ₦175, 000 respectively. The existing balance on the revaluation reserve at l October 2011 was ₦50, 000. This related to some non-depreciable land whose value had not changed significantly since 1st October 2011.

Requirement:
Prepare extracts of the financial statements of NODDY LTD (including the movement on** the **revaluation reserve) for the years ended** **30th** **September 2012 and 2013 in respect of the leasehold property.

<u>Solution</u>

1st October 2012	Cost	240,000	
	Depreciation (240/12 years)	20,000	
30th September 2012	Carrying Value	220,000	
	Revalue to	231,000	
	Gain	11,000	
	Debit – PPE	11,000	
	Credit – Revaluation Reserve/OCI		11,000
1st October 2012	Valuation	231,000	
	Depreciation (231/11 years)	21,000	
30th September 2013	Carrying value	210,000	
	Revalue to	175,000	
	Loss	35,000	
	Debit – revaluation Reserve	11,000	
	Debit – Income Statement	24,000	
	Credit – PPE		35,000

Extract from the profit or loss for the year ended 30th September

	2012	2013
	₦	₦
Depreciation	20,000	21,000
Revaluation Loss		24,000

Extract from SOFP at 30th September

	2012	2013
	₦	₦
Non-current Assets		
PPE	231,000	175,000
Equity		
Revaluation reserve	61,000	50,000

EXAMPLE 2

Epsilon is a listed entity. You are the financial controller of the entry and its consolidated financial statements for the year ended 31st March 2015 are using prepared. Your assistant, who has prepared the first draft of the statements, is unsure about the correct treatment or the transaction below and has asked for your advice. Details of the transaction are:

On 1st April, 2010 Epsilon began to extract minerals from a large site that it had recently constructed. The direct costs constructing the site totalled ₦25 million. The directors of Epsilon estimate that an appropriate allocation of general administrative costs to this project would be ₦2.5 million. The site has an expected useful economic life of 10 years at the end of that period the cost of rectifying the damage to the environment caused by the construction of the site estimated at ₦6 million.

Epsilon is under no legal obligation to rectify this damage but its published policies indicate that rectification is it's practice. i.e. practice in such circumstances. Your assistant has included ₦27.5 million in property, plant and equipment and char ₦2.75 million depreciation in the SPLOCI.

He has not included any provision for the cost of rectifying the environmental damage because Epsilon has no legal obligation to rectify it arid could therefore choose not to.

The relevant discount rate to be used in any calculations is 8% per annum and the present value of ₦1 receivable at end of 10 years at this rate is 46.32 Naira.

Explain and quantify the appropriate accounting treatment of the three transactions in the financial statement the year ended 31 March 2013.

Solution

The assistant should initially have included ₦25 million, rather than ₦27.5 million in property, plant and equipment (PPE). IAS 16 *Property, Plant and Equipment* states that only the direct costs of getting an asset ready for use should be capitalise

The treatment of the damage caused by construction and rectification is also incorrect. Under the provisions of IAS: *Provisions, Contingent, Liabilities and Contingent Assets,* Epsilon can have an obligation in respect of these costs as obligations do not need to be legally enforceable. Where an entity has indicated by its published policies and by an established pattern of past practice that it accepts certain responsibilities in certain situations, then IAS 37 indicates that it has a *constructive* obligation where those situations arise.

Because the event giving rise to the obligation has already occurred by the reporting date, Epsilon reeds to provide the whole of the rectification cost, ₦6 million in this case.

However, IAS 37 also states that where the effect of discounting is material, the provision should be discounted to its present value. In this case the required provision at 1 April 2010 (in ₦'000) will be ₦6,000 x 0.4632 = ₦2,779.

As time passes and the discount unwinds, the provision increases and this increase are shown as a finance cost. The finance cost for the year ended 31 March 2013 will be ₦222 (₦2, 779 x 0.08) and the provision at 31 March 2013 ₦3, 0 (₦2, 779 + ₦222).

When the initial provision is made the debit entry is to PPE as this is part of the cost of gaining access to the economic benefits from the site Therefore the total cost should be ₦27,779 (₦25,000 + ₦2,779) and the depreciation for the year ended 31st March, 2013 ₦2,778 (₦27,779 X 1/10).

The carrying amount of PPE at 31 March 2013 will be ₦25, 001 (₦27, 779 – ₦2, 778)

EXAMPLE 3

On 1 April 2011 Omega purchased ten new machines for ₦12 million each. Each machine had an overall estimated useful economic life of 10 years. The estimated residual value of each machine was zero. Each machine will require a substantial overhaul after five years in order to maintain its operating capacity and the cost of such an overhaul at 1 April 2011 prices was ₦3 million per machine.

In the year ended 21 March 2012 Omega charged total depreciation of ₦12 million on the machines but the directors *have* subsequently realised that this may have been an error that could have a material impact on the financial statement.

Produce extracts, with supporting explanations, from the statements of profit or loss** arid **other comprehensive income for the year's ended 31 March 2012 and2013 and from the statement of changes in equity for the year ended 31 March 2013 that show how the transaction will be reflected in the financial statements of Omega.

SOLUTION

IAS 16 — Property, plant and equipment — recognises that certain assets need a major inspection or overhaul in order to continue to be used. The cost of the overhaul is capitalised separately from the rest of the asset and depreciated over the period to the next overhaul.

Therefore, the asset of ₦120 million should be split into two parts for depreciation purposes. ₦30 million of the total cost should be depreciated over five years and the remaining balance of ₦90 million (120m - 30m) depreciated over 10 years.

Last year Omega should have applied component depreciation to this asset and charged depreciation of N15 million **(**30m x 1/5 +. 90m x 1/10). They only charged N12 million and so undercharged depreciation by N3 million. The impact of this error will not affect the SPLOCI for the year ended 31 March 2013.

It will instead be included in the statement of changes in equity as a retrospective adjustment to opening retained earnings. The depreciation charge in the statement of comprehensive income for the year ended 31 March 2013 will be N15 million.

EXAMPLE 4

Omega prepares financial statements financial statements under International Financial Reporting standards (IFRS). On 1 October 2011 Omega began the construction or a new factory. Cost relating to the factory was as follows:

Details	Amount
	₦'000
Purchase of land on which to build the factory	20,000
Cost of levelling the land prior to bringing construction	850
Cost of materials needed to construct the factory (Note 1)	8,000
Monthly employment costs of the construction (Note 1)	500
Monthly amount of other overheads directly related to the construction (Note 1)	200
Payments to external advisors relating to the construction	500
Income from temporary use of part of the site as a car park during the construction period	(250)
Costs of relocating staff to work in the new factory	400

Costs relating to the public of the factory (Note 2)	200

Note 1

In December 2011 a fire destroyed materials costing ₦500, 000. The cost of these materials is included in the material figure that is given above. Construction work was suspended for two weeks because of the fire. The construction workers continued to be paid during this two-week period and other additional overheads of ₦40, 000 were incurred in this period. These related to keeping the construction site secure during the temporary cessation construction.

Note 2

Construction of the factory was completed on 28 February 2012 and the construction workers transferred to other projects from the date. The factory was riot available for use until 31 March 2012, when the factory was inspected by local government officials (as required by local legal regulations) and certified as safe for use. The factor was not actually brought into use until 31 May 2012, following a public opening ceremony.

Note 3

The costs of construction were mainly financed by a loan of ₦30 million that was arranged during September 2011. The effective annual interest rate on the loan was 8%. The proceeds were invested prior to being needed to finance the construction cost and in the period ended 31 March 2012 the temporary investment produced income or ₦300, 000.

Note 4

The depreciable element of the factory comprises the building costs. The majority of these costs have an estimated useful economic life of 40 years. However, the factory roof will need to be replaced after 20 years. The estimated cc of replacing toe roof at current prices is ₦24 million.

Note 5

Omega computes its depreciation charge on a monthly basis and measures property, plant and equipment using the cost mood

Note 6

No impairment of the factory had occurred by 31 March 2013

Required:

Compute the carrying value of the factory in the statement of financial position of Omega at 31 March 2013.

You should support your computations with appropriate explanations or the amount you have included for the cost of the factory and for its ***subsequent depreciation.***

Solution 4

Details	**₦'000**	**Explanation**
Purchase of land	20,000	Direct cost of construction
Levelling of land	850	Direct cost of construction
Purchase of materials	7,500	Not including cost of material lost in fire
Cost of construction workers	2,250	Construction period five months, less idle two weeks
Other construction overheads	900	Construction period as above. Ignore overheads incurred after construction complete
Consultants fees	500	Direct cost of construction
Income from car park	Nil	Income from operations incidental to the construction taken to the SOCI
Relocation costs	Nil	Not a direct cost of construction
Costs of opening factory	Nil	Not a direct cost of construction
	32,000	
Capitalised finance costs	800	Five and a half months interest on ₦30m less temporary investment of surplus funds
Total cost	32,800	

Computation of depreciation charged to 31 March, 2013

Depreciate from 1 April 2012 (the date available for use)

The depreciable amount: 12,300 (32,000 – 20,000 land + (800 x 12/32)*)

The depreciation for the year: 368 (2,400 x 1/20 + (12,300 – 2,400) x 1/40)

*Land is not subject to deprecation and so is excluded from the depreciable amount. Likewise, the finance cost of 800 ***is*** allocated land and buildings on a pro-rata basis. Thus, since land represents 20,000 of the 32,000 initial costs, the finance cost allocated to land are not depreciated either. Thus, only 12/32nd of the finance cost is subject to depreciation.

Computation of carrying value at 31 March 2013

Cost	32,800
Depreciation	(368)
Carrying value	32,432

Tutorial Note

The need to replace the roof in 20 years' time is recognised through component depreciation rather than by recognising a Provision.

EXAMPLES 5

Ross Ltd had spent several years trying to find alternative premises for the company without success. In the end, I paid, Mark Tweedy who is a qualified Valuer, the sum of ₦30, 000 to assist in selecting an appropriate site for building purpose-built showroom and workshop. The site was eventually purchased in January 2013 and the building was completed on 1st November 2013

The following costs have been capitalised in the accounts for year ended 31st December 2013:

	₦
Site selector (as described above)	30,000
Architect fees	20,000
Lost revenue during two weeks closure to facilitate move	100,000
Purchase of land	980,000
Legal fees (purchase of land)	50,000
Building costs	500,000
Total costs	1,680,000

The book-keeper has charged 2 months' depreciation on the total costs capitalised in the accounts. The depreciation policy for buildings in Ross Ltd is to charge a full year's depreciation in the year of acquisition at 2% straight line and none in the year of disposal.

On 31st December 2013, Mr. Tweedy advised Ross Ltd that the showroom and workshop were worth ₦1, 700,000, its current purpose. However, due to new planning developments within the last year, the site is now worth well in excess of this amount if developed for residential property. The current value on the open market for residential purposes would be around ₦1, 900,000.

Ross Ltd is keen to strengthen the Statement of Financial Position and would like your advice on how to incorporate these valuations in the financial statements.

Requirement

i. Set out the costs that may be capitalised in the accounts in relation to the new building, and any relevance adjusting.

ii. Set out the journals required to incorporate the correct valuation into the financial statements, together with any relevant disclosures and requirements.

Solution

i. IAS 16 Property, Plant and Equipment outline the principles for initial measurement of property, plant and equipment, i.e. at cost. Paragraph 16 identifies three components of cost:

- Purchase price;
- Directly attributable costs;
- Initial estimate of the cost of dismantling and removing the item.

The standard states that the key feature of directly attributable costs is that they are necessary to bring the asset to the location and condition necessary it to be capable of operating in the manner intended by management. Such costs include professional fees and many be incurred prior to the use of the asset. However, the key word in the definition is necessary.

There may be costs incurred that are not necessary. IAS 16 provides examples of directly attributable costs, while also containing examples of costs that should not be included.

With respect to loss, the cost of the site selection should be excluded as it is difficult to justify this as being a necessary cost of bringing the asses to the location and condition necessary for it to be capable of operating in the manner intended by management. Furthermore, the lost revenue should also be excluded as this arose because of management's decision regarding the timing of operations rather than being attributable to getting the asset in a position for operation.

Journal Required:

Debit	SPLOCI – lost revenue	100,000
Debit	SPLOCI – professional fees	30,000
Credit	SOFP – premises	130,000

Being reversal of amounts capitalised

Depreciation has not been charged on a correct basis by the book-keeper, who has only charged two months depreciation on the total costs capitalised (i.e. ₦1,680,000 x 2/12 x 2% = ₦5,600). The correct charge is a full year's depreciation at 2% based on the correct capitalised figure of ₦1, 550,000 less the land of ₦1, 030,000. This amounts to ₦10, 400.

Journal Required:

Debit	SPLOCI – depreciation	4,800
Credit	SOFP – accumulated depreciation	4,800

Being correction of depreciation charge on new premises for the year to 31st Dec 2013

ii. Valuation of premises

IAS 16 Property, Plant and Equipment states that an entity should choose either the cost model or the revaluation model as its accounting policy and should apply that policy to an entire class of property, plant and equipment.

If the revaluation model is selected, the asset should be carried at its revalued amount, which is the fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from the assets' fair value at the balance sheet date. The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by a professionally qualified Valuer.

IAS 16 stales that the fair value is the amount for which an asset could be exchanged between knowledgeable, willing Parties in at arms-length transaction. IAS 16 does not state that assets should be valued on an existing use basis (₦1, 700,000) and therefore the premises may be valued at their market value (₦1, 900,000).

Journal required:

Debit	SOFP – premises	350,000
Debit	SOFP – accumulated depreciation	10,400
Credit	SOFP – revaluation reserve	360,400

-

being revaluation of premises on a market value basis

The effects of taxes on income, if any, resulting from the revaluation should be recognised in accordance with IAS 1 *Income Taxes.* Ross should disclose the following information in accordance with IAS 16, if assets are stated at revaluated amounts:

- Effective date of valuation;
- Whether an independent Valuer was involved;
- Methods and assumptions applied in estimation fair value;
- Extent to which fair value was determined with reference to observable prices in an active market using other valuation techniques;

- The carrying amount that would have been recognised under the cost model.

- The revaluation surplus, including the change for the period, and any restrictions on the distribution of the balance to shareholders.

EXAMPLE 6

Delta is an entity that prepares financial statements to 31 March each year. During the year ended 31 March 2012 the following events occurred:

On 1 April 2011 Delta purchased some land for ₦10 million. Delta purchased the land in order to extract minerals from it. During the six months from 1 April 2011 to 30 September 2011, Delta incurred costs totalling ₦3.5 million in preparing the land and erecting extraction equipment. This process caused some damage to the land.

Delta began extracting the minerals on 1 October 2011 and the directors estimate that there are sufficient minerals to enable the site to have a useful economic life of 10 years from that date. Further damage to the land is caused as the minerals are extracted.

Delta is legally obliged to rectify the damage caused by the preparation and mineral extraction. The directors estimate that the costs of this rectification on 30 September 2021 will be as follows:

- ₦3 million to rectify the damage caused by the preparation of the land.

- ₦200, 000 for each year of the extraction process to rectify damage caused by the extraction process itself.

Following this rectification work the land could potentially be sold to a third party for no less than its original cost of ₦20 million.

An annual discount rate appropriate for this project is 12%. The present value of ₦1 payable in 10 years' time with an annual discount rate of 12% is 32.2 Naira. The present value of ₦1 payable in $9\frac{1}{2}$ years' time with an annual discount rate of 12% is 34.1 Naira.

Solution

Under the principles of IAS 16 Property, Plant and Equipment, costs of ₦13.5 million (₦10 million + ₦3.5 million) will be debited to property plant and equipment in respect of the cost of acquiring the extraction facility.

The costs of erecting the extraction facility (excluding the land) will be depreciated over a 10-year period giving a charge in the current period of ₦175, 000 (₦3.5 million x 1/10 x 6/12).

From 1 October 2011, an obligation exists to rectify the damage caused by the erection of the extraction facility and this *obligation* should be provided for.

The amount provided is the present value of the expected future payment, which is ₦956, 000 (₦3 million x 0.322).

The amount provided is debited to property, plant and equipment and credited to provisions to October 2011.

The debit to property, plant and Equipment creates additional depreciation of ₦48, 300 in the current year (₦966, 000 X 1/10 X 6/12).

The closing balance in property, plant and equipment is ₦14, 242,700 (₦13.5 million -₦175, 000 **+** ₦966, 000 - ₦48, 300).

As the date of settlement of the liability draws closer the discount unwinds.

The unwinding of the discount in the current year is ₦57, 960 (₦9156000 X 12% X 6/12).

The extraction process itself creates an additional liability based on the damage caused by the reporting date.

The additional amount provided is ₦34, 100 (₦200, 000 x 67.12 x 0341).

This additional provision causes an extra charge to the statement of comprehensive income.

The carrying amount of the provision at the year-end is ₦1, 058,060 (₦966, 000 **+** ₦57, 960 **+** ₦34, 100).

1.07 Review Questions

1. The methods by which Accounting Standards are developed differ considerably throughout the world. It is often argued that there are two main systems of regulation that determine the nature of Accounting Standards: a rules-based and a principles-based system. Briefly explain the difference between the two systems, and state which system you believe is more descriptive of International Financial Reporting Standards (IFRS).

2. Sycamore is a public listed company that currently uses Irish Accounting Standards for its financial reporting. The board of directors of Sycamore is considering the adoption of International Financial Reporting Standards (IFRS) in the near future. The company has ambitious growth plans which involve extensive trading with many foreign companies and the possibility of acquiring at least one of its trading partners as a subsidiary in the near future. Identify the advantages that Sycamore could gain by adopting IFRS for its financial reporting purposes.

3. The directors of Alpha are involved in takeover talks with another entity. In the discussions, one of the directors stated that there was no point in an accountant studying ethics because every accountant already has a set of moral beliefs that are followed, and these are created by simply following general accepted accounting practice. He further stated that in adopting a defensive approach to the takeover, there was no ethical issue in falsely declaring Alpha's profits in the financial

statements used for the discussions because, in his opinion, the takeover did not benefit the company, its executives or society as a whole. Discuss the above views of the director regarding the fact that there is no point in an accountant studying ethics, and that there was no ethical issue in the false disclosure of accounting profits.

4. OMEGA is a large international manufacturing entity. While its main manufacturing place is situated in the country Ireland, it has divisions and staff operating worldwide. OMEGA has the reputation of keeping its key stakeholders well-informed and producing voluntary additional disclosures within its annual report.

    a) Discuss the social **and** environmental issues which are likely to be most important to the investors in OMEGA.

    b) Discuss the limitations that investors should consider when relying on voluntary information provided by entities in their annual reports.

MODULE 2

2.00 PREPARATION OF FINANCIAL STATEMENTS (INCLUDING CONSOLIDATED FINANCIAL STATEMENTS)

2.01 Learning Outcomes

On successful completion of this Module, Students should be able to:

i. Present and explain those basic statutory requirements for acceptable financial statements.
ii. Distinguish between statutory and non-statutory financial statements.
iii. Explain the procedure for the preparation of consolidated financial statements.

2.02 Statutory Financial Statements for Incorporated Entities

Financial instruments represent a complex area of corporate reporting and are governed by the following four standards:

1. IAS 32 Financial instruments: Presentation
2. IAS 39 Financial instruments: Recognition and Measurement (*Superseded by IFRS 9 Effective 1 January 2015)*
3. IFRS 7 Financial Instruments: Disclosures
4. IFRS 9: Financial Instruments
5. IAS 27: Consolidated and Separate Financial Statements
6. IAS 28: Investment in Associated Companies

IAS 32 Financial Instruments: Presentation outlines the accounting requirements for the presentation of financial instruments, particularly as to the classification of such instruments into:

1. Financial assets
2. Financial liabilities and
3. Equity instrument.

The standard also provides guidance on the classification of related interest, dividends and gains losses and when financial assets and financial liabilities can be offset.

The standard should be applied to the presentation of all types of financial instruments, whether recognized or unrecognized.
The standard does not apply to a number of investments, notably

- Subsidiaries
- Associates
- Joint ventures and

OBJECTIVE OF IAS 32

The objective of IAS 32 is to establish principles for presenting financial instruments at liabilities or equity and for offsetting financial assets and liabilities. In doing so, it seeks to enhance financial statement users' understanding of the significance of on-balance sheet

and off-balance sheet financial instruments to an entities financial position performance and cash-flows:
IAS 32 attempts to achieve this objective as follows:

- Clarifying the classification of a financial instrument issued by an entities
- Prescribing the accounting for treasury shares (an entity's own repurchased shares)
- Prescribing strict conditions under which assets and liabilities may be offset in the SOFP

IAS 32 is a companion to IAS 39 Financial instruments: Recognition and Measurement and IFRS 9 Financial instruments

IAS 39 deals with, among other things, initial recognition of financial assets and liabilities, measurement subsequent to initial recognition, impairment, de-recognition, and hedge accounting IAS 39 is progressively being replaced by IFRS 9 as the IASB completes the various phases of its financial instruments project.

SCOPE

IAS 32 applies impregnating and disclosing information about all types of financial instruments with the following exception.

- 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 32 interests in joint ventures
* Employers rights and obligation under employee benefit plans (IAS 19 Employee Benefits)
* Insurance contracts (IFRS 4 Insurance Contracts)
* Contracts and obligations under share based payment transactions (see IFRS 2-based payment) with the some exceptions, for example when accounting for treasury shares purchased, sold, issued or cancelled by employee share option plans or similar arrangements.

IAS 32 applies to 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.

KEY 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:
- Cash
- An equity instrument of another entity
- A contractual right

1. To receive cash or another financial asset from another entity; or
2. 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:
1. A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments.
2. 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.
3. Puttable instruments classified as equity or certain liabilities arising on liquidation classified by IAS 32 as equity instruments.

Financial liability: any liability that is:

1. a contractual obligation to deliver cash or another financial asset to another entity; or
2. to exchanges 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 and is:
1. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments or
2. 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 instrument; puttable/?? Instruments classified as equity or certain liabilities arising on liquidation classified by IAS 32 as 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: This is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

CLASSIFICATION AS EQUITY OR LIABILITY
Financial instruments should be presented according to their substance and not merely their legal form Entities that issue financial instruments should classify them as either equity or financial liabilities.

The classification depends on the following
- The substance of the contractual arrangement on initial recognition
- The definition of a financial liability and an equity instrument

The main difference between an equity instrument is the fact that an equity instrument has no obligation to transfer economic benefits.

EXAMPLES

1. Preference shares
If an entity issues preference shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and therefore, should be recognized as a liability. In contract, preference shares that do not have a fixed maturity and where the issuer does not have a contractual obligation to make any payment are equity.

In this example even though both instruments are legally termed preference shares they have different contractual items and one is a financial liability while the other is equity.

2. Issuance of fixed monetary amount of equity instruments
A contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the fixed monetary amount of the contractual right or obligation is a financial liability.

3. One party that a choice over how an instrument is settled
When a derivative financial instrument gives one party a choice over how it is settled (for instance the issuer or the holder can choose settlement net in cash or by exchanging shares for cash). It is financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

Classifications of rights issues
In October 2009, the IASB issued an amendment to IAS 32 on the classification of rights issues. For rights issues offered for a fixed amount of foreign currency current practice appears to require such issues to be accounted for as derivative liabilities. The amendment states that if such rights are issued pro rata to in entity's all existing shareholders in the same class for a fixed amount of currency; they should be classified as equity regardless of the currency in which the exercise price is denominated.

INTEREST, DIVIDENDS, LOSSES AND GAINS
IAS 32 also considers how financial instruments affect the profit or loss. The effect depends on whether interest, dividends, losses or gains relate to the instrument.

a. Interest, dividends, losses or gains relating to a financial instrument classified as a financial liability should be recognized as income or expense in profit and loss.
b. Distribution 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 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).

OFF SETTING
IAS 32 also prescribes rules for the offsetting of financial liabilities. It specifies that a financial asset and a financial liability should be offset and the net amount reported when, and only when, an entity.

- Has a legally enforceable right to set off the amounts and
- Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

Example
The directors of QWERTY want to avoid increasing the gearing of the entity. They plan to issue 10 million 8% cumulative redeemable 51 preference shares in 2013.

Required:
Explain how the preference shares would be classified in accordance with IAS 32 Financial Instruments: Presentation and the impact that this issue will have on the gearing of QWERTY.

The substance of the instrument is a debit instrument. IAS 32 requires that any instrument that contains an obligation to transfer economic benefit be classified as a liability. The cumulative nature of the returns on the preference shares means that the outflow of benefit is inevitable. The preference shares would then be classified as debt and would in fact increase the gearing of the entity.

IFRS 9: Financial instrument is part of the project completed to data to replace IAS 39, financial instruments Recognition and Measurement. This project was undertaken by the international Accounting Standard Board (IASB) conjunction with the Financial Accounting Standard Board (FASB) in the US with the mission to improve and convent financial reporting standards.

IFRS 9 was originally issued in November 2009, reissued in October 2010 and applies to annual periods beginning on or after 1 January, 2015.
IFRS 9 is effective for accounting periods commencing on or after 1st January 2015, with earlier application permissible. Further development dealing with impairment, derivatives and hedging are currently in progress. Therefore, IAS 39 continues to apply to these issues trial IFRS 9, in its current form, does not yet deal with it should be noted however, that it is proving to be quite difficult to get consensus with the US FASB on these issues.

IFRS 9 has (arguably) simplified and improved accounting for financial assets in comparison with its predecessor, IAS 39. The number of classifications has been reduced from four to three, as the available for sale 9AFS) classification has not been retained within IFRS 9. As a result, the requirement to recycle gains losses previously taken to equity upon the de-recognition of the financial asset has been eliminated. This, in turn, has simplified the financial reporting information.

Greater emphasis has been placed on fair value accounting and reporting while at the same time, IFRS 9 has also reduced the degree of discretion for classification and accounting treatment of financial assets, which should support consistent reporting of financial information relating to financial assets and enhance understanding and comparability of that information.

EQUITY INSTRUMENT

Equity instruments are initially measured at fair value less any issue costs.

In many legal jurisdiction when equality shares are issued they are recorded at a nominal value, with the excess consideration received recorded in a share premium account and the issue costs being written off against this premium.

Example: Accounting for the issue of equity

Canning Ltd issues 100,000 ₦1 ordinary shares for cash consideration of ₦1.50 each. Issue costs are ₦1,000.

Required:

Explain and illustrate how the issue of shares is accounted for in the financial statements of Canning Ltd.

Solution

The entity has raised finance (that is, it received cash) by issuing financial instruments.

Ordinary shares have been issued. These are irredeemable and so, Canning has no obligation to repay the cash received instead, and it has increased the ownership interest in its net assets. As a result, the issue of ordinary share capital creates equity instruments. The issue costs are written off against share premium. The issue of ordinary share can be summarized in the following journal entry.

DEBIT:	Cash	₦149,000 (100,000 shares x ₦1.50 less ₦1,000)
CREDIT:	Equity Share Capital	₦100,000
CREDIT:	Share premium	₦49,000

Equity instruments are not remeasured. Any change in the fair value of the shares is not recognized by the entity, as the gain or loss is experienced by the investor, the owner of the shares. Equity dividends are paid at the discretion of the entity and are accounted for as reduction in the retained earnings, so have no effect on the carrying value of the equity instruments.

If the shares being issued were redeemable, then the shares would be classified as financial liabilities (debt, as the issuer would be obliged to repay at some point in the future).

FINANCIAL ASSETS
An entity should recognize a financial asset on its Statement of financial position when, and only when the entity becomes party to the contractual provisions of the instrument. At initial recognition, all financial assets are measured at fair value. Fair value is normally the cost incurred and this will exclude transactions costs (which will be charged to profit or loss as incurred).

Subsequent measurement at the period end will depend on whether the financial asset is a debt instrument or an equity instrument. Financial assets are subsequently measured at:

- Fair Value, with changes in value normally recognized in profit or loss or
- Amortised cost, with interest recognized in profit or loss.

IFRS now classifies financial assets under three headings as follows:

1. Financial assets at Fair Value through Profit or Loss (FVTPL)
Financial assets will normally be classified as being Fair Value through Profit or Loss unless they are designated to be measured and accounted for in any other way. This classification includes:

- Any financial assets held for trading purposes and
- Derivatives, unless they are part of a properly designated hedging arrangement.

Re-measurement to fair value takes place at each reporting date, with any movement in fair value taken to profit or loss for the year which effectively incorporates an annual impairment review. Fair Value is established by reference to either the market price (where the instrument is quoted) or by valuation techniques (if the instrument is unquoted) IFRS 9 also states that in some cases, cost may be the best estimate of fair value.

2. Financial assets at fair value through other comprehensive income (FVTOCI)
This classification applies to equity instruments only and must be designated upon initial recognition. It will typically be applicable for equity interests that an entity intends to retain ownership of on a continuing basis. That is, an equity instrument not held for trading initial recognition at fair value would normally include the associated transaction costs of purchase. The accounting treatment automatically incorporates an impairment review and the entity makes an irrevocable election to recognize any changes in fair value in Other Comprehensive Income (OCI) in the year.

Example
Forfar Ltd purchased shares in another company, East Fife Ltd, with the intention of holding it in the long term. The investment cost ₦450,000. At year end, the market price of the investment was ₦525,000. How should the asset be initially and subsequently measured? Forfar Ltd has elected to recognize changes in Other Comprehensive Income.

a. The financial asset is initially recognized at the fair value of the consideration given, i.e. ₦450,000.
b. At the year end, it is remeasured to ₦25,000
c. A gain of ₦75,000 is recognized in other Comprehensive Income.

Should the financial asset be disposed of, then upon de-recognition, any gain or loss is based upon the carrying value at the date of disposal. One important point is that there is no recycling of any amounts previously taken to equity in earlier accounting periods. Instead, at de-recognition, an entity may choose to make an equity transfer from other components of equity to retained earnings as any amounts previously taken to equity can now be regarded as having been realized:

3. Financial assets measured at amortised cost

The classification can apply only to debt instruments and <u>must</u> be designated upon initial recognition. For the designation to be effective, the financial asset must pass two tests: as follows:

1. <u>The business model test:</u>
   To pass this test; the entity must be holding the financial asset to collect in the contractual cash follows associated with that financial asset. If this is not the case, such as the financial asset being held and then traded to take advantage of changes in fair value, then the test is failed and the financial asset reverts to the default classification to be measured at FVTPL.
   Where the entity changes its business model, it may be required to classify its financial assets as a consequence, but this is expected to be an infrequent occurrence. If reclassification does occur, it is accounted for from the first day of the accounting period in which the reclassification takes place.

2. <u>The contractual cash flow characteristics test</u>
   To pass this test, the contractual cash flows collected must consist solely of principal and interest based on the principal amount outstanding.
   If this is not the case, the test is failed and the financial asset reverts to the default classification to best measured at FVTPL.

One example of a financial asset that would fair this test is a convertible bond. While there is receipt at the nominal rate of interest payable by the bond issuer and the bond will be converted into shares or cash at a later date, the cash flows are affected by the fact that the bond holder has a choice to make at some later date – either to receive shares or cash at the time the bond is redeemed. The nominal rate of interest received will be lower than for an equivalent financial asset without conversion rights to reflect the right of choice the bondholder will make at some later date. The bond would therefore fall the test and must be accounted for as fair value through Profit or Loss. (This would imply that the requirement under IAS 32 of dealing with a compound financial instrument is no longer permissible under IFRS 9).

Therefore in summary for a debit instrument to be measured of amortised cost, it will required that

- The asset is held within a business model whose objective is to hold the assets to collect the contractual cash flows and
- The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding.

This classification of financial asset requires an annual review for evidence of possible impairment and, if there is such evidence, there must be an impairment review. Any impairment identified must be charged to profit or loss in full immediately.

One problem that may arise in relation to financial assets measured at fair value is whether a reliable fair value can be determined at the reporting date. For quoted financial assets, such as equity shares in a listed entity, this may be a relatively straightforward process.
If, however, the financial assets in question are not traded on an exchange, there may be no definitive method to determine fair value at a particular date. This could result in the exercise of judgment or discretion, which could undermine the reliability or relevance of any amounts accounted for as a fair value.

Example
Caledonia the purchased a five-year bond on 2nd January 2013 at a cost of €1m with annual interest of 4%, which is also the effective rate, payable on 31st December annually. At the reporting date of 31st December 2013 interest has been received as expected and the market rate of interest is now 6%.

Required:
Account for the financial asset at 31 December 2013 on the basis that:
(i) It is classified as FVTPL and
(ii) It is classified to be measured at amortised cost, on the assumption it passes the necessary tests and has been properly designated at initial recognition.

Solution

(i) It classified as FVTPL

This requires that the fair value of the bond is measured, based upon expected future cash flows (i.e. ₦1m x 4% = ₦40,000 discounted at the current to market rate of interest of 6% as follows

Year	Expected cash flow	4%	Present Value(₦m)
31st December 2014	40,000	0.9615	38,460
31st December 2015	40,000	0.9245	36,980
31st December 2016	40,000	0.8892	35,568
31st December 2017	1,040,000	0.8548	888,992
			1,000,000

Therefore, at the reporting date of 31 December 2013, the financial asset will be stated at a fair value of ₦930,704, with the fall in fair value amounting to ₦69,296 taken to profit or loss in the year. Interest received will be taken to profit or loss for the year amounting to ₦40,000.

(ii) If classified to be measured at amortised cost:

The requires that the fair value of the bond is measured based upon expected future cash flows discounted at the original effective rate of 4%. This will continue to be at €1m as the following calculation confirms.

Year	Expected cash flow	6%	Present Value(₦m)
31st December 2014	40,000	0.9434	37,736
31st December 2015	40,000	0.8900	35,600
31st December 2016	40,000	0.8396	33,584
31st December 2017	1,040,000	0.7921	823,784
			930,704

In addition, interest received during the year of €40,000 will be taken to profit or loss for the year.

Under IFRS 9, the treatment of financial assets that are measured at fair value effectively incorporates an impairment review, as any fall in fair value is taken to profit or loss or other comprehensive income for the year depending upon the classification of the financial asset.

For financial assets designated to be measured at amortised cost, an entity must make an assessment at each reporting date whether there is evidence of possible impairment. If this is deemed to be the case, then an impairment review should be performed. If an impairment loss is identified. It is charged to profit or loss immediately.

The recoverable amount would normally be based upon the present value of the expected future cash flows estimated at the date of the impairment review and discounted to their present value terms based on the original effective rate of return at the date the financial asset was issued.

Example
Using the information contained in the previous example (where the carrying value of the financial asset at 31st December 2013 was ₦1m), if, in early 2014. It was identified that the bond issuer was beginning to experience significant financial difficulties, and there was no doubt concerning the full recovery off the amounts due to Caledonia, an impairment review would be required. The expected future cash flows now expected by Suarez from the bond issuer are as follows:

Year	Expected cash flows
31 December 2014	₦20,000
31 December 2015	₦20,000
31 December 2016	₦20,000
31 December 2017	₦20,000 + ₦800,000

Required:
Calculate the extent of impairment of the financial asset to be included in the financial statements of Suarez for the year ending 31 December 2014.

Solution

The future cash flows now expected are discounted to present value based on the original effective rate associated with the financial asset of 5% as follows:

Year	Expected cash flow	4%	Present Value(₦m)
31st December 2014	20,000	0.9615	19,230
31st December 2015	20,000	0.9245	18,490
31st December 2016	20,000	0.8892	17,784
31st December 2017	820,000	0.8548	700,936
			756,440

Therefore, impairment amounting to the change in carrying value of (₦1,000,000-₦756,440) ₦43,560 will be recognized as an impairment charge in the year to 31 December 2014.

Additionally, there will also be recognition of interest receivable in the statement of comprehensive income for the year amounting to (₦756,440 x 4%) ₦30,258. This is the "unwinding of the discount" in the period Both the IASB in the US continue their work on accounting for impairment of financial assets with a reporting standard expected before the end of 2011.

Reversal of an impairment Loss:
A reversal of an impairment loss is only permitted as a result of an event occurring after the impairment loss has been recognized. For example, a customer's credit rating been revised upwards by a credit rating agency.

Reversal of an impairment losses in respect of financial assets measured at amortised cost are recognized in profit or loss.

Exposure Draft on Impairment

In November 2009, The IASB published an exposure draft on the subject of impairment. Under the suggested new requirements of IFRS 9, financial instruments, only financial assets measured at amortised cost will be subject to impairment reviews. It is also proposed that an "expected loss model" towards impairment reviews be introduced when reviewing these financial assets.
The expected loss model requires as that entities determine and account for expected credit losses when the asset is originated or acquired rather than wait for an actual default. This is achieved by making an allowance for the initial expected losses over the life of the asset by considering a reduction in the interest revenue.

Example

Sean of Shefflin holds a portfolio of financial assets that are debt instruments (i.e. he is a leader). These assets are initially recognized at ₦1,000,000 and accounted for at amortised cost, as they meet both the business model and cash flow tests. Both the coupon rate and the effective rate of each loan is 7% in the current period no loans have actually defaulted, however, it is anticipated that a proportion of loans will default over the loan period and, thus, in the long run the rate of return from the portfolio will be approximately 5%.

Discuss the impairment review of these assets in the first accounting period using the Expected Loss Model.

Solution

The gross interest income that is initially recognition in income is ₦70,000 (as calculated using the effective rate of 7% on the initial carrying value of ₦1,000,000. With no defaults, cash of ₦70,000 will also be received (as calculated using the coupon rate of 7% on the nominal value). Thus, prior to any impairment review the carrying value at the end of the first reporting period is ₦1,000,000.

However, to recognize the impairment loss on an expected loss basis, the actual net rate of return inclusive of expected defaults of 5% has to be considered. This gives a net ₦50,000,000) to be recognized in income. Thus, there is an expected loss adjustment of ₦20,000 (₦70,000 less ₦50,000) leaving the asset written down to ₦980,000 (₦1,000,000 less ₦20,000).

In the past, impairment reviews had been accounted using an “incurred loss model” (i.e. in order to recognize an impairment loss, there had first to be a specific past event indicating an impairment). In the above example, on this basis no allowance would have been made of the expected future losses so that the interest income recognized would be simply ₦70,000 and the asset stated at ₦1,000,000.

The “Incurred Loss Model” resulted in the failure of lenders to recognize what were arguably known losses and to overstate assets. The new approach of measuring impairment on an expected loss model is both in accordance with prudence, in those losses are anticipated and accruals in that the losses are in effect spread over the period of the life of the asset and not back loaded.

It is anticipated that there will be a re-exposure of proposals for requirements dealing with impairment in financial assets and a re-issuance of IFRS 9 thereafter.
IFRS 9 was updated in October 2010 to include recognition and measurement of financial liabilities. Essentially the same basic model as per IAS 39 is now contained in IFRS 9. There are two basic accounting models permitted i.e.

1. Fair value Through Profit or Loss and
2. Amortised cost

1. Financial liabilities at fair value through profit or loss (FVTPL)

Like the equivalent classification for financial assets, this will include financial liabilities incurred for trading purposes and also derivations that are not part of a hedging arrangement.

2. Other financial liabilities measured at amortised cost

If financial liabilities are not measured at FVTPL, they are measured at amortised cost.
IFRS 9 contains an option to designate a liability, which might normally be measured at amortised cost, to be measured at Fair Value Through Profit or loss, if in doing so, it reduces a measurement or recognition inconsistency, or the liability is part of a group of financial liabilities that is managed and its performance is evaluated on a Fair Value basis, in accordance with a documented risk management or investment management strategy and information on the group of liabilities is provided internally on that basis to the entity key management personnel.

Where this is the case, to the extent that part of the change in fair value of the financial liability is due in a change in the entity's own credit risk, this should be taken to other comprehensive income in the year, with the balance of any change in fair value taken to profit or loss. If this accounting treatment for the credit risk creates or enlarges an accounting mismatch in profit or loss then the gain or loss relating to credit risk should also be taken to profit or loss.

Example: Accounting for a financial liability at amortised cost

Tommy Timber raises finance by issuing zero coupon bonds at par on the first day of the current accounting period with a nominal value of €100,000. The bonds will be redeemed after two years at a premium of ₦14,490. The effective rate of interest is 7%.

Required:

Explain and illustrate how the loan is accounted for in the financial statements of Tommy Timber

<u>Solution</u>

Tommy Timber is acquiring cash that it is obliged to repay so this financial instrument it classified as <u>financial liability</u>

There is no indication that the liability is being held for trading purposes or that the option to have it classified as FVTPL has been made. Thus, the liability will be classified and accounted for at amortised cost, having been initials measured at fair value less the transaction costs. The bonds are being issued at par, so there is neither a premium nor discount on issue. Thus, Tommy Timber initially receives ₦100,000. There are no transaction costs and if there were, they would be deducted. Thus, the liability is initially recognized at ₦100,000.

In applying amortised cost, the finance cost to be charged to the profit or loss is calculated by applying the effective rate of interest in this example 7%) to the opening balance of the liability each year. The finance cost will increase the liability.

The fact that the bond is a zero coupon bond means that no actual interest is paid during the period of the bond. However, it is critical to understand that even though no interest is paid, there is still a finance cost in borrowing this money. This finance cost is the premium paid on redemption i.e. ₦14,490.

The finance cost is recognized as an expense in the Profit or Loss over the period of the loan. It would be not be appropriate to spread the cost evenly as this would ignore the compound nature of finance costs (thus the effective rate of interest is given) in the final year there is a single cash payment that wholly discharges the obligation. The workings for the liability being accounted for at amortized cost can be summarized and presented in the table as follows:

	Opening balance	Plus income statement finance charge @ 7% on the opening balance	Less the cash paid	Closing (the liability on the statement of financial position)
Year 1	₦100,000	₦7,000	(Nil)	₦107,000
Year 2	₦107,000	₦7,490	(₦114,490)	Nil
Total Finance Cost over 2 years		₦14,450		

Example: Accounting for a financial liability at amortised cost
Gooch raises finance by issuing ₦20,000 6% four-year loan notes on the first day of the current accounting period. The loan notes are issued at a discount of 10% and will be redeemed after three years at a premium of ₦1,015. The effective rate of interest is 12%. The issue costs were ₦1,000.

Required:

Explain and illustrate how the loan is accounted for in the financial statements of Gooch.

<u>Solution</u>

Gooch is receiving cash that is obliged to repay, so this financial instrument is classified as a financial liability. Again the liability will be classified and accounted for at amortised cost and thus, initially measured at the fair value of consideration received less the transaction costs.

With both a discount on issue and transaction costs, the first step is to calculate the initial measurement of the liability.

- Cash received (the nominal value less the discount on issue (€20,000 x 90%) ₦18,000
- Less the transaction costs (₦<u>1,000)</u>
- Initial recognition of the financial liability ₦<u>17,000</u>

In applying amortised cost, the finance cost to be charged to the profit or loss is calculated by applying the effective rate of interest (in this example 12%) to the opening balance of the liability each year. The finance cost will increase the liability.

The actual cash is paid at the end of the reporting period and is calculated by applying the coupon rate (in this example 6%) to the nominal value of the liability (in this example ₦20,000). The annual cash payment of ₦1,200 (6% x ₦20,000 = ₦1,200) will reduce the liability.

In the final year there is an additional cash payment of ₦21,015) (the nominal value of ₦20,000 plus the premium of ₦1,015), which extinguishing balance of the liability. The working for the liability being accounted for at --------------------------------------

	Opening balance (₦)	Plus income statement finance charge @ 12% on the opening balance (₦)	Less the cash paid (6% x 20,000) (₦)	Closing balance being the liability on the statement of financial position) (₦)
Year 1	17,000	2,040	(1,200)	17,840
Year 2	17,840	2,141	(1,200)	18,781
Year 3	18,781	2,254	(1,200)	19,835
Year 4	19,835	2,380	(1,200)	21,015
Total Finance Costs		8,815		

Because the cash paid each year is less than the finance cost, each year the outstanding liability grows and for this reason the finance cost increases year on year as well.

The total finance cost charged to income over the period of the loan comprises not only the interest paid, but also discount on the issue, the premium on redemption and the transaction costs.

Interest paid (4 years x 1,200)	=	₦4,800
Discount on issue (10% x 20,000)	=	₦2,000
Premium on redemption	=	₦1,015
Issue costs	=	₦1,000
Total finance costs		₦8,815

You will note from the table that this is the amount of the total finance cost charged over the 4 years of the instruments life. This ₦8,815 represents an effective cost of 12% per annum (compound) on an initial value of ₦17,000 (the net proceeds initially received.

Financial liabilities at FVTPL

Financial liabilities are only classified as FVTPL if they are held for trading or the entity so chooses. This is unusual (even more so in an examination question).

The option to designate a financial liability as measured at FVTPL will be made it, in doing so, it significantly reduces accounting mismatch that would otherwise arise form measuring assets or liabilities or recognizing the gains and losses on them on different bases of if the liability is part or a group of financial liabilities or financial assets and financial liabilities that is managed and its performance is evaluated on a fair value basis, in accordance with an investment strategy.

In addition a financial liability may still be designated as measured at FVTPL when it contains one or more embedded derivatives that would require separation.
Financial liabilities that are classified as FVTPL are initially measured at fair value and any transaction costs are immediately written off to the Profit or loss. By accounting for a financial liability at FVTPL, the financial liability is at increased by a financial cost and reduced by cash repaid but is then revalued at each reporting date with any gains and losses immediately recognized in the profit or loss. The measurement of the new fair value at the year-end will be its market value or, it not known, the present value of the future cash flows, using the current market interest rates. The interest rate used subsequently to calculate the finance cost will be this new current rate until the next revaluation.
Example: Accounting for a financial liability at FVTPL.
On 1 January 2013 Brogan issued three year 5% ₦30,000 loans notes at nominal value when the effective rate or interest is also 5%. The loan notes will be redeemed at par. The liability is classified at FVTPL. At the end of the first accounting period market interest rates have risen to 6%.

Required:

Explain and illustrate how the loan is accounted for in the financial statements of Brogan in the year ended 31 December 2013.

Solution

Brogan is receiving cash that is obliged to repay so this financial instrument is classified as a financial liability. The liability is classified at FVTPL so, presumably, it is being held for trading purposes or the option to have it classified as FVTPL has been made.
Initial measurement is at the fair value of ₦30,000 received and although there are no transaction costs in this example, these would be expensed rather than taken into account in arriving at the initial measurement.

With an effective rate of interest and the coupon rate both being 5% at the end of the accounting period the carrying value of the liability will still be ₦30,000. This is because the finance cost that will increase the liability is ₦1,500 (5% x ₦30,000 – the coupon ate applied to the nominal value).

As the liability has been classified as FVTPL, this carry value at 31 December 2013 now has to be revalued. The fair value of the liability at this date will be the present value (using the new rate of interest of 6%) of the next remaining two years payments.

	Cash flow		6% discount factor		PV of the future cash flow
Payment due 31 December 2014 (interest only)	₦,500	x	0.943	=	₦1,415
Payment due 31 December 2015 (the final interest payment	₦1,500	x	0.890	=	₦28,035

and the
December 2013
Fair value of the liability at
31 December 2013 ₦29,450

As Brogan has classified this liability as FVTPL, it is revalued to ₦29,450. The reduction of ₦550 in the carrying value of the liability from ₦30,000 is regarded as a profit, and this is recognized in the profit or Loss it, however, the higher discount rate used was not because general interest rates have risen, rather the credit risk of the entity has risen, then the gain is recognized in other comprehensive income. This can all be summarized in the following presentation.

	Opening balance	Plus income statement finance charge @ 5% on the opening balance	Less the cash paid (5% x 30,000)	Carrying value of the liability at year end	Fair value of the liability at year end	Gain to the profit or Loss
1/1/2013	₦30,000	₦1.500	(₦1,500)	(30,000)	₦29,450	₦550

The finance charge in the profit or loss for the year end 31 December 2014 will be the 6% x ₦29,450 = ₦1,767 and will the cash payment of ₦1,500 being made, the carrying value of the liability will be ₦29,717, ₦29,450 plus ₦1,767 less ₦1,500) at the year end.

If at 31 December 2014 the market rate of interest has fallen to, say, 4%, then the fair value of the liability at the reporting date will be the present value of the last repayment due of ₦31,500 in one years' time discounted at 4% (i.e. ₦1,500 x 0.962 = ₦30,288), which in turn means that as the fair value of the liability exceeds the carrying value, a loss of ₦571 (i.e. ₦30,288 less ₦29,717) arises which is recognized in the Profit or Loss.

In the final year ending 31 December 2015 the finance cost to the Profit or Loss will be 4% ₦30,288= ₦1,212, increasing the liability to ₦31,500 before the final cash payment of ₦31,500 is made, thus extinguishing the liability. As you may know from your financial management studies and as is demonstrated here, when interest rates rise so the fair value of bonds fall and when interest rates fall then the fair value of bonds rises.

DERECOGNITION

An entity should derecognize a financial asset when

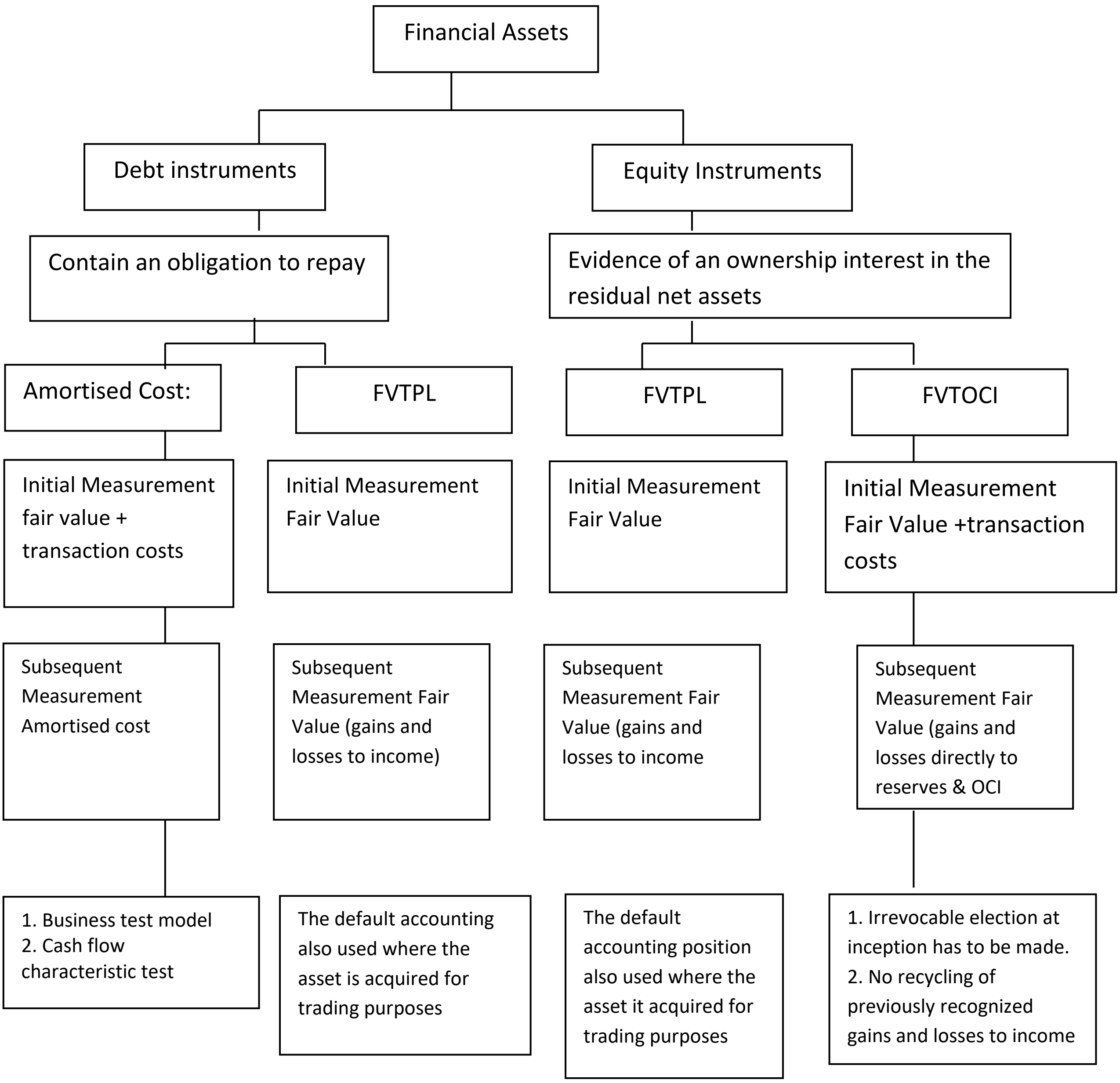
a. The contract rights to the cash-flows from the asset expire; or
b. It transfers substantially all the risks and rewards of ownership of the financial asset to another party.

It is very important to establish where the risk and rewards lie after the transaction has occurred. For example if a transaction occurs whereby shares are sold by one entity to another, but the contract includes a put and a call option to buy back the shares in the future, the entity has in fact retained substantially all of the risks and rewards of the investment and it should therefore not be de-recognised.

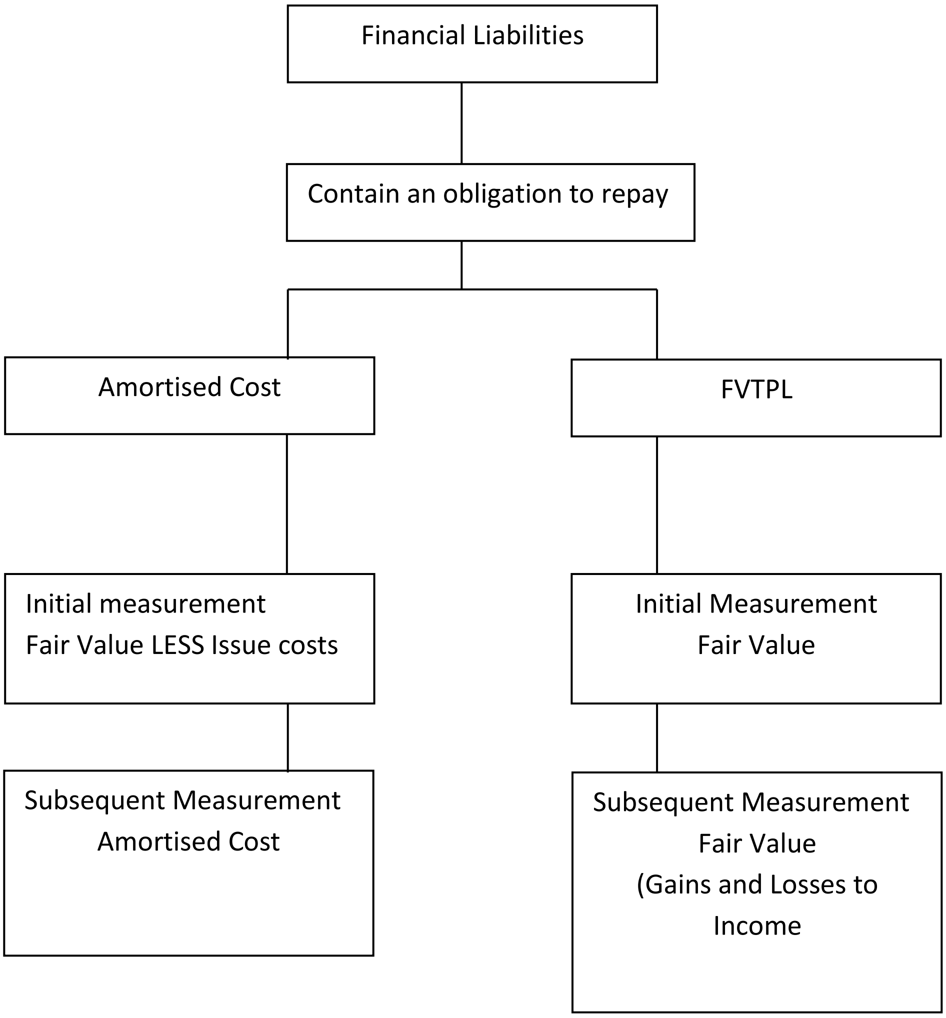
An entity should derecognize a financial liability when it is extinguished i.e. when the obligation specified in the contract is discharged, cancelled or expires. A financial liability may be partially derecognized is only part of the obligation is removed.

On derecognition, the difference between the carrying amount of the asset or liability at the date of sale and the sale proceeds should be recognized in the profit or loss for the period.

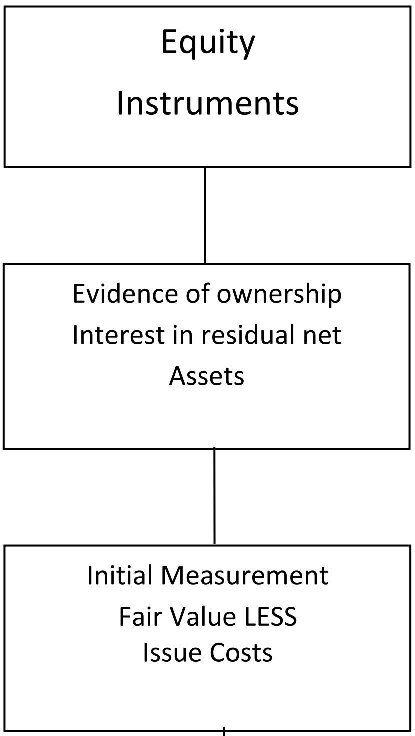
SUMMARY OF ACCOUNTING TREATMENT OF FINANCIAL ASSETS



SUMMARY OF ACCOUNTING TREATMENT OF FINANCIAL ASSETS



Summary of Treatment of Equity



IFRS 7 FINANCIAL INSTRUMENTS: DISCLOSURES

Objectives

The objectives of the standard are:

i. Add certain new disclosures about financial instruments to those currently required by IAS 32.

ii. Puts all financial instruments disclosures in a new standard. (The remaining parts of IAS 32 deal only will presentation matters).

Disclosure Requirements

As entity must group its financial instruments into classes of similar instruments and make disclosures by class (when disclosures are required)

IFRS 7 identifies two main categories of disclosures

1. Information about the significance of financial instruments
2. Information about the nature and extent of risks arising from financial instruments.

Information about the Significance of Financial Instruments

<u>Statement of Financial Position</u>

- Disclosure of the significance of financial instruments for an entity's financial position and performance.
- Special disclosures about financial assets and financial liabilities designated to be measured at fair value through profit and loss.
- Reclassifications of financial instruments form fair value to amortised cost or vice versa
- Information about financial assets pledged as collateral (or held as collateral)
- 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
- Disclosures about de-recognitions

<u>Other disclosures</u>

- Accounting policies for financial instruments
- Information about hedge accounting
- Information about the fair values of each class of financial asset and financial liability, together with
  - (i) comparable carrying amounts
  - (ii) description of how fair value was determined
  - (iii) 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 fair value, such as short term trade receivables and payables or for instruments whose fair value cannot be measured reliably).

Qualitative Disclosure

These describe

- Risk exposures for reach type of financial instrument
- Managements 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 include:

- Summary quantitative data about exposure to each risk at the reporting date
- Disclosures about credit risk, liquidity risk and market risk.
- Concentration of risk

Credit Risk

Includes:

- Maximum amount of exposure, description of collateral, information about credit quality of financial assets that are neither past due or impaired.
- For financial assets that are past due or impaired, analytical disclosures are required.

Liquidity Risk:

- A maturity analysis of financial liabilities
- Description of approach to risk management

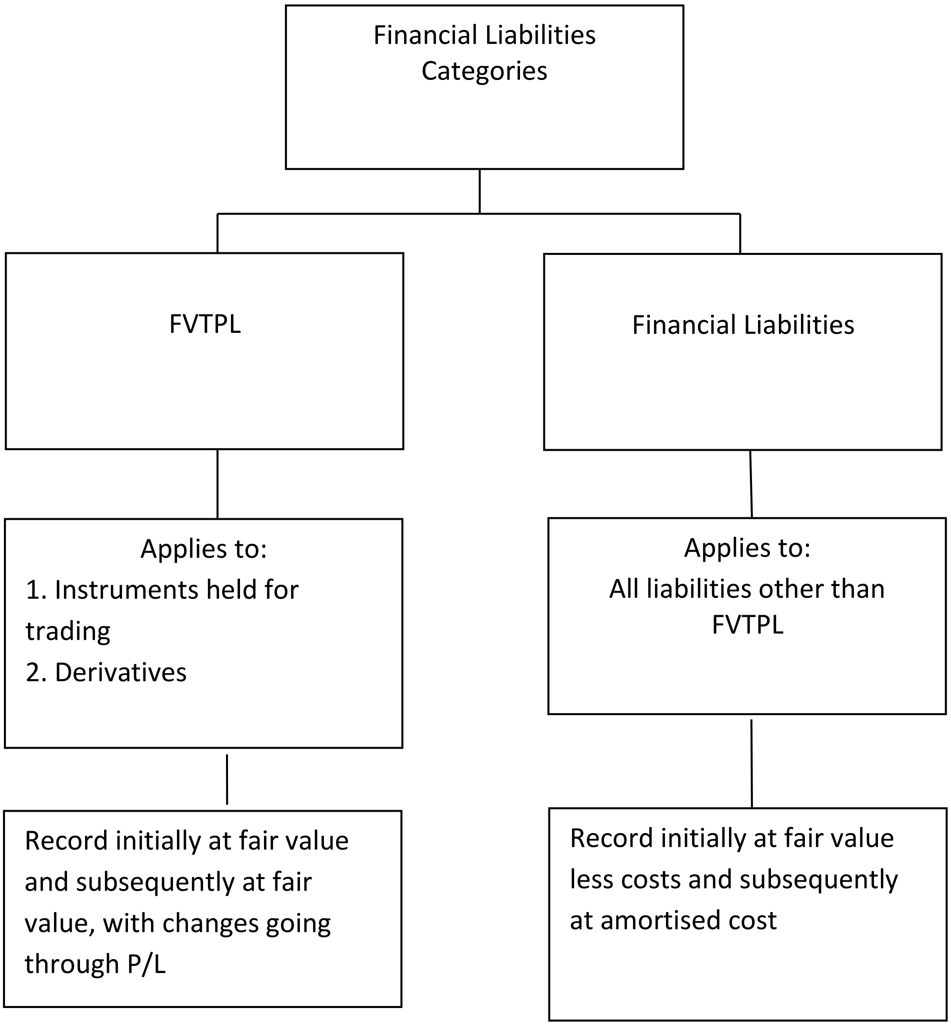
Market Risk

This 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, currently risk and other price risks.

IAS 39 Financial Instruments: recognition and measurement

IAS 39 outlines how financial instruments are measured and when they should be recognized in the financial statements. It will be eventually superseded by IFRS 9, but it still extent and examinable to competency level 2 in the CPA P2 examination.

The treatment of financial liabilities has not really changed under IFRS 9 and so, the accounting treatment will not be outlined again here in summary.



IAS 39: Financial Assets – Measurement

Under IAS 39, four types of financial assets are identified.

1. Fair Value through Profit or Loss
2. Held to Maturity
3. Loans and Receivables
4. Available for sale

Fair Value through Profit or Loss

Applies to:

- Shares held for short-term trading
- Derivatives

Measurement

- Initially record at fair value (excluding transaction costs)
- Restate to fair value at each reporting date
- Any gain or loss on revaluation is taken to the Profit or Loss

Held to Maturity

Applies to:

- Instruments paying fixed payments and with a fixed maturity and there is an intention to hold these instruments to maturity (e.g. investment in the debentures of another company).

Measurement

- Amortized cost

Loans and Receivables

Applies to:

- Instruments making fixed payments but not publicly quoted. Examples include trade receivables, loan receivables.

Measurement

- Amortized cost

Available For Sale

Applies to:

Any instrument not covered by another category. An example would be shares held in another entity that are not held for trading.

Measurement

- Record initially at fair values (including transaction costs)
- Restate to fair value at each reporting date
- Gains and losses arising on valuation are taken to reserves (and OCI)
- When the asset is sold, gains and losses up to that date are recycled through the Profit or Loss

IAS 39: EXAMPLES

VIDES acquired 40,000 shares in another entity JOHNEFF, in March 2013 for 52.68 per share. The investment was classified as available for sale on initial recognition. The shares were trading at ₦2.96 per share on 31 July 2013. Commission of 5% of the value of the transaction is payable on all purchases and disposals of shares.

Prepare the journal entries to record the initial recognition of this financial asset and its subsequent measurement at 31 July 2013 in accordance with IAS 39 Financial Instruments: Recognition and Measurement.

Available for sale (AFS) investment initially recorded at fair value plus transactions costs:

Dr.	AFS Investment (40,000 shares x 52.68)	₦107,200	
Cr.	Bank	₦107,200	
	Being initial recognition of AFS asset		
Dr.	AFS Investment	55,360	
Cr.	Bank	55,360	
	Being 5% commission paid on purchase		

The investment is subsequently measured at the fair value of the shares with the gain or loss calculated as fair value of the investment less its carrying amount. This is a valuation exercise, not a transaction, so there is no need to account for commission when calculating the year end valuation (40,000 x 52.96) x ₦112,560).

Dr	AFS investment	``	₦5,840
Cr	Equity – other reserves		₦5,840
	Being subsequent measurement of AFS asset		

BOND acquired an investment in a debt instrument on 1 January 2013 at its par value of ₦3 million. Transaction costs relating to the acquisition were ₦200,000. The investment earns a fixed annual return of 6% which is received in arrears. The principal amount will be repaid to BOND in 4 years' time at a premium of ₦400,000. The investment has been correctly classified as held to maturity. The investment has an effective interest rate of approximately 7.05%

Required:

(i) Explain how the financial instrument will be initially recorded AND subsequently measured in the financial statements of BOND. In accordance with IAS 39 Financial instruments: Recognition and Measurement.

(ii) Calculate the amounts that would be included in BOND's financial statements for the year to 31 December 2013 in respect of this financial instrument.

BOND acquired 100,000 shares in AB on 25 October 2013 for ₦3 per share. The investment resulted in BOND holding 5% of the equity shares of AB. The related transaction costs were ₦12,000. AB's shares were trading at ₦3.40 on 31 December 2013. The investment has been classified at held for trading.

Prepare the journal entries to record the initial AND subsequent measurement of this financial instrument in the financial statement of BOND for the year to 31 December 2013.

(i) The held to maturity investment will be initially recorded at fair value plus transaction costs. It will be subsequently measured at each year end at amortised cost using the effective interest rate.
(ii) Held to maturity investment amortised cost using effective interest rate of 7.05%

Year end	Opening Balance ₦	Effective interest 7.05% ₦	Interest Receive ₦	Closing Balance ₦
2013	3,200,000	225,600	(180,000)	3,245,600

SPLOCI
Investment income - income from HTM investment ₦225,600
SOFP
Non-current assets
Held to maturity investment ₦3,245,600

(b) Held for trading investment
Initial recording

Dr	Current asset investment	₦300,000
CR	Bank	₦300,000
	Being the purchase of shares	

Dr	Profit or loss ``	₦12,000
Cr	Bank	₦12,000

Being the write off the transaction costs to the profit or loss as the investment is an asset held at fair value through profit or loss.

Subsequent measurement

Dr	Current asset investment	₦40,000
Cr	Profit or loss – gain	₦40,000
	Being the uplift in value and the recording of the gain in the Profit or Loss	

IAS 39: Impairment of Financial Assets

Only those financial assets categorized as "Held TO Maturity" and "Loans and Receivables" are subject to impairment losses. That is, only financial assets that are measured at amortised cost.

Other financial assets are recorded at fair value, so that any impairment is already taken into account when measuring the fair value.
The impairment rules are:
- At each year end assess whether there any evidence of impairment
- If evidence exists, a detailed impairment review is undertaken

- The difference between the carrying amount of the financial asset and the present value of the future cash flows (discounted at the assets original effective interest rate) represents the impairment loss.
- Impairment losses are recognized through the Profit or Loss.

Dr	Profit or Loss
Cr	Financial Asset
	With the amount of the impairment loss

2.03 Consolidated Financial Statements

Introduction
An entity may expand by acquiring shares in other entities. Where one entity gains control over another entity, a parent-subsidiary relationship now exists between the two entities. Each will prepare their own individual financial statements, using the IFRS's in the normal way. However, in addition, the parent and subsidiary (collectively referred to as the group) are obliged by law to prepare a combined set of accounts known as the consolidated accounts. These consolidated accounts are prepared and presented as if all the companies in the group are just one single entity. This means that it is necessary to exclude transactions between group companies, as failure to do so could result in the assets and profits being overstated for group purposes.

The accounting rules governing the preparation of consolidated accounts (also known as group accounts) are set out in a number of standards namely:

a. IFRS 3 (Revised) Business Combinations
b. IFRS 10 Consolidated Financial Statements
c. IFRS 12 Disclosure of interests in Other Entities
d. IFRS 11 joint Arrangements
e. IFRS 27 Consolidated and Separate Financial Statements
f. IAS 28 investments in Associates and joint Ventures

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

<u>IFRS 10 Consolidated Financial Statements</u>
IFRS 10 Consolidated Financial Statements outlines the requirements for the preparation and presentation of consolidated financial statements. Simply put, an entity is required to consolidate the entities it controls. Determining control requires exposure or rights to variable returns and the ability to affect those returns through power over an investee. In examination questions, control is usually established based on ownership of more than 50% of the ordinary shares of the other entity (the ordinary shareholders normally have the voting power in the organization)

IFRS 10 established the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.
The standard requires that a parent entity must prepare and present consolidated financial statements. It defines the principle of control and establishes control as the basis for consolidation. Furthermore, it sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee and outlines the accounting requirements for the preparation of consolidated financial statements.

Control is identified by IFRS 10 as the sole determinant for consolidation. Control has three important elements:

1. Power over the investee
2. Exposure, or right to variable returns from its involvement with investee; and
3. The ability to use its power over the investee to affect the amount of the investor's returns

The investor must be exposed, or have rights, to variable returns from its involvement with an investee to control investee. These returns must have the potential to vary as a result of the investee's performance and can be Positive, negative, or both.

Control
The investor must determine whether it is a parent by assessing whether it controls the investee. Accordingly, the investor considers all relevant facts and circumstances when assessing whether it has control or not.

In essence, it is an example of the "principles approach" taken in the formation of accounting standards. It may require the exercise of judgment by the directors.
Power emanates from rights. These rights can be relatively straightforward (e.g. through voting rights from an investment in ordinary shares). However, it might also be a complex arrangement (e.g. rights embedded in contractual arrangements).
An investor that holds only "protective rights" cannot have power over an investee and so cannot control an investee. Protective rights include:

- `Lender's rights to restrict borrower's activities that adversely affect its credit risk to the lender's detriment;
- Rights of a non-controlling shareholder to approve exceptional capital expenditure or debt/equity issues; and
- Rights of a lender to seize assets upon default.

IFRS 10 requires investors to review periodically whether control has been gained or lost. Factors to consider when trying establishing whether the investor has power over the investee include:

- Can the investor exercise the majority of voting rights in the investee?
- If the investor holds less than 50% of the voting shares. power over the investee can still exist if all the other equity interests are held by a large, unconnected and disparate group

- Potential voting rights (such as convertible loans or share options) may result in an investor gaining or losing contro1 at some date
- Are there any contractual arrangements between the investor and other parties?

EXAMPLE

Until 1st January, 2013, TROUT operated a payroll services division providing payroll services for itself and also for a number of external customers. On January, 2013 the business of the division and assets with a value of ₦300, 000 were transferred into a separate entity called BREAM, which was set up by TROUT. The sales director of BREAM owns 100% of its equity share capital. A contractual agreement signed by both the sales director of BREAM and a director of TROUT, states that the operating and financial policies of BREAM will be made by the board of TROUT. BREAM has acquired a long-term loan of ₦1 million with TROUT acting as guarantor. Profits and losses of BREAM, after deduction of the sales director's salary, flow to TROUT. The directors of TROUT wish to avoid consolidating BREAM as the additional borrowings of BREAM would negatively impact TROUT's gearing ratio.

Required:

How should the relationship with BREAM be reflected in the financial statements of the TROUT group?

The central question is whether TROUT has control of BREAM and should it, therefore, be consolidated as part of the TROUT group. **Under IAS 27 Consolidated and Separate Financial Statements** and **IFRS 3 Business Combinations**, ownership of the majority of the equity share capital of an entity is normally sufficient to presume control, unless there is evidence to the contrary. The sales director holds all of the equity shares of BREAM which would normally infer control. However, he has no voting power, instead TROUT effectively exercises control by way of the signed agreement. Other factors which would indicate that TROUT effectively controls BREAM are as follows:

- The control over the financial and operating policies of BREAM enables TROUT to ensure that the economic benefits flow from BREAM to TROUT.
- BREAM is undertaking activities that TROUT would be conducting itself if BREAM did not exist.
- TROUT is acting as guarantor for the loan.

Taking all of this into account it should be concluded that TROUT controls BREAM, which is actually a special purpose entity (SPE) and should be consolidated by TROUT. The assets transferred are group assets and would be included in the consolidated statement of financial position. In addition, the loan of ₦1 million should also be consolidated.

Key definitions in IFRS 10

Consolidated Financial Statements	The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity
Control of an investee	An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee
Parent	An entity that controls one or more entities
Power	Existing rights that give the current ability to direct the relevant activities
Protective rights	Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate
Relevant activities	Activities of the investee that significantly affect the investee's returns

EXEMPTIONS FROM THE REQUIREMENT TO PREPARE CONSOLIDATED FINANCIAL STATEMENTS

In general, all parent entities must prepare and present consolidated financial statement that include all subsidiaries.

Under IFRS 10 the parent need not present consolidated financial statements if it meets all the following conditions

1. It is 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 presenting consolidated financial statements
2. Its debt or equity instruments are not traded in a public market (i.e. for example a domestic or foreign stock exchange)
3. It 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. Its ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRSs.

If these conditions are met, IAS 27 *Separate Financial Statements* requires the following disclosures:

1. A statement that consolidated financial statements has not been presented.
2. A list of significant investments (subsidiaries, associates) including the percentage shareholding held, the principal place of business and the country of incorporation.
3. The bases on which those investments have been accounted for in its separate financial statements (e.g. IAS 39, IFRS 9)

Example
P owns 75% of the ordinary shares of S and S own 60% of the ordinary shares of T.
P must prepare group accounts combining all three companies. S may have to prepare group accounts combinations and T. But if the other owners of S (25%) agree S is exempt from preparing such group accounts.
Remember, control is not determined by a percentage holding but by the ability to affect returns through the exercise of power.

EXCLUSIONS

All subsidiaries of the parent must be included in the consolidated accounts. Previously it was argued that some subsidiaries should be excluded from the group accounts. But now neither IFRS 10 nor IAS 27 (revised) specifies any other circumstances in winch a subsidiary must be excluded from consolidation.
However, there are two particular situations that must be carefully considered:

1. If on acquisition a subsidiary meets the criteria, it can be classified as held for sale in accordance with IFRS 5; it must be accounted for in accordance with that standard. This requires that the parent's interest is shown separately on the face of the consolidated Statement of Financial Position. There should be evidence that the subsidiary has been acquired with the intention of disposing it within 12 months and management is actively seeking a buyer.

2. Accounting standards do not apply to immaterial items. Therefore, if the subsidiary is immaterial in the context of the group, it need not be consolidated in the group accounts. However, the judgment that it is immaterial must be reviewed annually and the parent needs to consider each subsidiary, both on an individual and collective basis.

Even if a subsidiary is immaterial, it is arguable that the parent should consolidate it in all accounting periods, rather than reporting charges in group structure from period to period.

ACCOUNTING DATES

IFRS 10 requires that the financial statements of the individual companies in the group be prepared as of the same reporting date. If the reporting date of the parent and subsidiary differ, then the subsidiary should prepare additional financial statements as of the same date as the parent, unless it is impracticable to do so.
If it is considered impracticable, then the financial statements of the subsidiary should be adjusted for significant transactions or events that occur between the date of the subsidiary's financial statements and the date of the parent financial statements. However the reporting date of the subsidiary must not be more than three months earlier or later than the parents reporting date.

ACCOUNTING POLICIES

All companies in the group should have the same accounting policies, without exception. If a member of the group uses different policies to those adopted in the consolidated financial statements for like transactions and similar events, appropriate adjustments are made to its financial statements in preparing consolidated financial statements. This will bring conformity to the group accounting policies.

Loss of control

If a parent loses control of a subsidiary during the period, the parent must:

1. Derecognize the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
2. Recognize any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRSs. That fair value is regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9 *Financial Instruments* or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.
3. Recognize the gain or loss associated with the loss of control attributable to the former controlling interest.

There is no disclosure specified in IFRS 10. Instead, IFRS 12 Disclosure of interests in Other Entities outlines the disclosure required. The main disclosure requirements are as follows:

1. Significant judgments and assumptions

The entity must disclose information about any significant judgment and assumptions it has made (and change in those judgments and assumptions) in determining:

- That it controls another entity
- That it has joint control of an arrangement or significant influence over another entity.
- The type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle.

2. Interests in subsidiaries

An entity must disclose information that enables users of its consolidated financial statements to:

- Understand the composition of the group.
- Understand the interest that non-controlling interests have in the group.
- Evaluate the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group.
- Evaluate the nature of, and changes in the risks associated with its interests in consolidated structured entities.
- Evaluate the consequences of changes in its ownership interest in a subsidiary that do not result in loss of control.
- Evaluate the consequences of losing control of a subsidiary during the reporting period.
-

3. Interests in joint arrangements and associates

An entity must disclose information that enables users of its financial statements to evaluate:

- The nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of significant influence over, joint arrangements and associates
- The nature of, and changes in, the risk associated with its interests in joint ventures and associates.

4. Interests in unconsolidated structured entities

An entity must disclose information that enables users of its financial statements to: Understand the nature and extent of its interests in unconsolidated structured entities

- Evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

WHY WOULD A PARENT WISH TO EXCLUDE A SUBSIDIARY?

- The poor performance of the subsidiary, for example losses in the year.
- The poor financial position of the company, for example declining liquidity, high gearing.
- Significantly different activities to the rest of the group.

However, these are not considered to be legitimate reasons for excluding a subsidiary from the consolidation.

At the end of the consolidation process, consolidated financial statements are prepared that:

1. Combine the assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
2. Offset (eliminate) the carrying amount of the parents investment in each subsidiary and the parent’s portion of equity of each subsidiary. However, this investment will potentially be replaced by an intangible asset of goodwill.
3. Eliminate full intra group assets and liabilities equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intra group transactions that are recognized in assets, such as inventory and fixed assets, are eliminated in full).

The reporting entity will include the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the reporting entity ceases to control the subsidiary. Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognized in the consolidated financial statements at the acquisition date.

Non-controlling interests (NCIs)

The portion of the shareholding not held by the parent is said to belong to an outside group, referred to as the Non-Controlling Interest (previously known as the minority interest).

The parent must present non-controlling interests in its consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

The profit or loss and each component of other comprehensive income must be attributed to the owners of the parent and to the non-controlling interests. The proportion allocated to the parent and non-controlling interests will be based on the present ownership interests.

The reporting entity also attributes total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit (negative) balance.

IFRS 3 was revised in 2008 and became effective from 2010. The main changes that have been introduced as a result of this revision are as follows:

- Expenses that can he treated as part of acquisition costs has been restricted.
- The treatment of Contingent Consideration has been significantly altered.
- A new method of measuring Non-Controlling Interests (formerly known as Minority Interest) has been introduced. This new method (though not mandatory), if used, will have an effect on goodwill.
- The recognition and measurement of identifiable assets and liabilities of the acquired subsidiary has been refined. Guidance has now been provided on intangible assets such as marker related, customer related, artistic-related and technology-related assets

ACQU1SITION COSTS

In the previous version of IFRS 3, directly related costs such a professional fees (legal, accounting, valuation etc.) be included as part of the cost of the acquisition. This is now no longer the case and such costs must now be expected.
The cost of issuing debt or equity is to be accounted for under the rules of IAS 39 financial instruments: Recognition and Measurement.

CONTINGENT CONSIDERATION

The previous version of IFRS 3 required contingent consideration to be accounted for only if it was considered probable that it would become payable. This approach has now been amended.

The revised standard requires the acquirer to recognize the fair value of any contingent consideration at the date of acquisition to be included as part of the consideration for the acquiree. The “fair value” approach is consistent with the way in which other forms of consideration are valued. Fair value is defined as “the amount for which an asset could be exchanged, or liability settled between knowledgeable, willing parties in an arm’s length transaction”.

However, applying this definition to contingent consideration is not easy as the definition is largely hypothetic most unlikely that the acquisition-date liability for contingent consideration could be (or would be) settled by “willing parties in an arm’s length transaction”. It is expected that in an examination context, the fair value of any consideration at the date of acquisition will be given (or how to calculate it).

The payment of contingent consideration may be in the form of equity or a liability such as a debt instrument should be recorded as such under the rules of IAS 32 *Financial instruments: Presentation* (or other applicable standard).

The standard also addresses the problem of changes in the fair value of any contingent consideration after acquisition date. If the change is due to additional information obtained after acquisition date that affects the fact circumstances as they existed at acquisition date, this is treated as a "measurement period adjustment" and liability (and goodwill) are re-measured. In essence, this is a retrospective adjustment and is similar in nature and adjusting event under IAS 10 *Events after the Reporting Period.*
However, changes due to events after the date of acquisition (for example, achieving a profit target which requires higher payment than was provided for at acquisition) are treated as follows:
Contingent consideration classified as equity shall not be re-measured and its subsequent settlement will be accounted for within equity, e.g.

Debit	Retained Earnings
Credit	Share Capital / Share Premium

Contingent consideration classified as an asset or a liability that

- Is a financial instrument and is within the scope of IAS 39 must be measured affair value, with any resulting gain or loss recognized either in profit or loss, or in other comprehensive income in accordance with that IFRS
- Is not within the scope of IAS 39 shall be accounted for in accordance with IAS 37 *Provisions Contingency* Liabilities *and Contingent Assets* (or other IFRSs as appropriate)

*Contingent consideration is normally a liability but may be an asset if the acquirer has the right to a return of some of the consideration transferred, if certain conditions are met.
An acquirer has a maximum period of 12 months to finalize the acquisition accounting. The adjustment period ends when the acquirer has gathered all the necessary information, subject to the one year maximum. There is no exemption from the 12 months rule for deferred tax assets or changes in the amount of contingent consideration. The revised standard will only allow adjustment against goodwill within this one-year period.

DEFERRED CONSIDERATION

Deferred consideration should be measured at fair value at the date of acquisition. This means that future payments should be shown at its present value by discounting the future amount at the company's cost of capital. Each year, the discounts will be then "unwound." This will increase the deferred liability every year, with the discount treated as a finance cost in the Profit or Loss Account.

EXAMPLE

Winner Ltd acquires 27 million shares in Loser Ltd. The consideration is effected by a share for share exchange of two shares in Winner Ltd for every three shares acquired in Loser Ltd and a cash payment of ₦2 per share acquired, payable 3 years after acquisition. Winners Ltd.'s shares have a nominal value of ₦1 and a market value of ₦2.50 at acquisition.
Winner Ltd.'s cost of capital is 10%
The cost of investment is recorded as:

Shares	(27/3) x 2 = 18 million shares issued, valued at N2.50 each Consideration: N45 million
Cash	27 million shares x ₦2 = ₦54 million Present Value = ₦54m x 751 = ₦40.55m
Total consideration	₦45m + ₦40.55m = ₦85.55m

Therefore, at acquisition

		₦
Debit	Investment in Subsidiary	85.55m
Credit	Deferred Consideration (liability in SFP)	85.55m

The Present Value of the cash consideration is then unwound in years 1 to 3, for example
Year 1 40.55 x 10% = ₦4.055m
Debit Profit or Loss (Finance Cost) ₦4.055m
Credit Deferred Consideration (liability in SFP) ₦4.055m

MECHANICS AND TECHNIQUES

For the preparation of a Consolidated Statement of Financial Position, the following six steps should be followed:

1. **Establish Group Structure**
   Determine the holding in the subsidiary and when the control was established
2. **Carry out consolidation adjustments**
   For example, intercompany debts must be eliminated, revaluations of assets at acquisition must be accounted for, inter company profits must be adjusted for.
   These adjustments will be dealt with in detail in a later chapter.
3. **Calculate Goodwill arising on the acquisition of the subsidiary**
   Depending on the method of measuring Non-Controlling Interest in the question, goodwill can be measured in one of two ways.
4. **Eliminate Profit or Loss at acquisition from the group reserves**
   Whatever profit or loss available in the investee companies at the time of acquisition is termed pre-acquisition reserves and is included in the calculation of the investee's net assets as at the time of investment. It must be eliminated from the group's consolidated reserves. Conversely, it is a credit to the investment account of the investor company, thereby writing down the cost of acquisition.

Proportion of Net Assets Method		Fair Value Method	
	₦		₦
Cost of investment	X	Cost of investment	X
Less		**Add:**	
Parents share of net assets at date of		Fair value of NCI at acquisition	X
acquisition	(X)	**Less**	
Goodwill at Acquisition	X	Fair Value of net assets at acquisition	(X)
	X	Goodwill at acquisition	X
Less		**Less:**	
Total Goodwill impaired to date		Total Goodwill impaired to date	(X)
Carrying Value in SFP		Carrying Value in SFP	**X**
	(X)		
	X		
		Or Alternatively	
			₦
		Cost of investment	X
		Less	
		Parents % share of net assets at date of acquisition	(X)
		Goodwill at acquisition = Parents Share	X
		Fair value of NCI at acquisition	X
		Less:	
		NCI% share of net assets at acquisition	(X)
		Goodwill at Acquisition = NCI Share	**X**
		Then:	
		Parents Share + NCI Share	X
		Less:	
		Total Goodwill impaired to date	(X)
		Carrying Value in SFP	X

If goodwill on acquisition is positive, the following consequences should be observed:

- It is capitalized as an intangible asset in Non-Current Assets
- It should not be amortized
- It Should be tested for impairment on an annual basis

If impairment arises, the accounting entries for the treatment of the impairment loss depends or the method used to value NCI

Proportion of Net Assets Method:	**Fair Value Method:**
Debit Group Retained Earnings Credit Goodwill	Debit Group Retained Earnings (group %) Debit NCI (group %) Credit Goodwill That is, the impairment loss is split: Loss Group Share NCI Share

Negative Goodwill

IFRS 3 refers to negative goodwill as "discount on acquisition'. It arises when the fair value of the consideration given to acquire the subsidiary is less than the fair value of the net assets purchased.

It is an unusual situation to arise, and the standard advises that should negative goodwill should be calculated, the calculation should be reviewed, to ensure that the fair value of assets and liabilities are not inadvertently misstated.

Following the review, any negative goodwill remaining is credited to the Profit or Loss immediately, and will therefore form part of the group retained earnings too (i.e. credited to retained earnings)

5. Calculate Non-Controlling Interest

The value at which NCI is shown in the Statement of Financial Position depends on the method used to value it in the question:

Proportion of Net Assets Method		**Fair Value Method**	
	₦		₦
NCI % of net assets of subsidiary at the reporting date		NCI% of net assets of subsidiary at the reporting date	X
		PLUS	
		NCI share of goodwill	X
		LESS	
		NCI share of goodwill impairment	(X)
			X

6. Calculate Consolidated Reserves

The Retained Earning to be included in the consolidated statement of financial position is calculated as follows:

	₦
Retained Earnings of parent (subject to adjustment in step 2)	X
PLUS	
Group share of post-acquisition earnings of subsidiary (subject to adjustment in step 2)	X
LESS	
Total Goodwill impairments to date	(X)

*Deduct only the group share of the impairment loss if using the Fair Value method in the question.

Pre-Acquisition V Post-Acquisition

It is important to make a distinction between pre-acquisition and post-acquisition reserves.

- Pre-Acquisition reserves are the reserves existing at the date the subsidiary company is acquired. They are included in the goodwill calculation.
- Post-Acquisition reserves are reserves generated after the date of acquisition. They are included in group reserves.

6. Prepare Consolidated Statement of Financial Position

The assets and liabilities of the subsidiary and parent are combined in the final statement of financial position. The assets and liabilities will include any adjustments arising in Step 2.
In addition, the Goodwill, NCI and Consolidated reserves as calculated in Steps 3, 4 and 5 are included.
Note that the Share Capital and Share Premium to be included will be those of the parent company only.

EXAMPLE

The draft SOFPs of Pied Ltd and Piper Ltd at the 31st December 2013 are shown below;

	PIED	**PIPER**
	₦'000	**₦'000**
Assets		
Property, Plant and Equipment	90	100
Investment in Piper (at cost)	110	-
Current Assets	50	30
	250	130
Equity and Liabilities		
Ordinary share capital ₦1	100	100
Retained earnings	120	20
	220	120
¤ Current Liabilities	30	10
	250	130

Pied Ltd purchased 80% of the ordinary shares of Piper Ltd on 1st January 2013 when the retained profits of Piper were ₦15, 000. To date goodwill is not impaired.
Prepare the consolidated Statement of Financial Position at the 31st December 2013, assuming that the Pied Group values the non-controlling interest using the proportion of net assets method.

Solution

Step 1: Establish Group Structure

	Piper
Group	80%
NCI	20%

Piper is a subsidiary, having been acquired 1 year ago

Step 2: **Adjustments**

Not applicable in this question

Step 3: **Calculate Goodwill**

First, determine the net assets (i.e. capital and reserves) of the subsidiary

	At date of acquisition ₦'000		**At the date of SOFP ₦'000**
Share Capital	100		100
Retained Earnings	15		20
	115	<post acq = 5>	120

	₦'000
Cost of Investment	110
Less:	
Share of net assets acquired at acquisition	
(115 x 80%)	92
Goodwill	18

No Impairment of Goodwill has occurred. Thus, goodwill to be included in the consolidated SOFP is ₦18, 000

Step 4 **Calculate NCI**

20% x ₦120,000 = ₦24,000

Step 5 **Calculate Consolidated Retained Earnings**

Pied Ltd	**N'000**
Per SFP	120

Piper Ltd

Group share of post-acquisition reserves (80% x 5)	4
Consolidated Retained Earnings	124

Step 6 **Prepare Consolidated Statement of Financial Position**

PIED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2013

Assets	**₦'000**
NON-CURRENT ASSETS	
Goodwill	18
Property, Plant and Equipment (90+100)	190
	208
Current Assets (50 + 30)	80
	288
EQUITY AND LIABILITIES	
Ordinary share capital	100
Retained Earnings	124
	224
Non-controlling interest	24
	248
CURRENT LIABILITIES (30 + 10)	40
	288

IAS 27 SEPARATE FINANCIAL STATEMENTS

IAS 27 applies when an entity has interests in subsidiaries, joint ventures of associates and either elects to, or is required, to prepare separate non-consolidated financial statements.
IAS 27 does not direct which entities produce separate financial statements available for public use. It applies when an entity prepares separate financial statements that comply with International Financial Reporting Standards.
Financial statements in which the equity method is applied are not separate financial statements. Similarly, the financial statements of an entity that does not have a subsidiary, associate or joint venture's interest in a joint venture are not separate financial statements.

Choice of accounting method

When an entity prepares separate financial statements, investments in subsidiaries, associates, and jointly controlled entities are accounted for either:

- at cost, or
- In accordance with IFRS 9 *Financial Instruments.*

The entity must apply the same accounting for each category of investments.

- Investments that are accounted for at cost and classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* are accounted for in accordance with that IFRS.
- Investments carried at cost should be measured at the lower of their carrying amount and fair value less costs to sell.
- The measurement of investments accounted for in accordance with IFRS 9 is not changed in such circumstances.

Disclosure

Detailed disclosures are required if consolidated financial statements have not been prepared, including:

- The fact that the financial statements are separate financial statements
- Reasons why consolidated statements have not been prepared
- A list of significant investments in subsidiaries, jointly controlled entities, and associates, including the name, principal place of business (and country of incorporation if different), proportion of ownership interest and, if different, proportion of voting rights, and
- A description of the method used to account for the foregoing investments.

ADVANCED CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Once the basic concept of consolidating accounts has been understood, the more complicated adjustment can be introduced.

The adjustments involve a number of different scenarios, but a theme common to most of them is that they involve amounts that have been paid or remain payable between companies in the group.

DETERMINING THE FAIR VALUE OF NET ASSETS

When the parent company acquires the subsidiary company, the identifiable assets and liabilities acquired must be accounted for at their fair values on preparation of the subsequent consolidated financial statements (IFRS 3). This is to ensure that an accurate figure is calculated for goodwill (as well as to ensure the purchase price paid is accurate).
IFRS 13 defines the fair value of an asset as the price that would be received to sell an asset (or paid to transfer a liability) in an orderly transaction between market participants at the measurement date.
IFRS 13 is covered elsewhere in this text, but the essential features of fair value are that:

1. It is an exit price;
2. Observable in an active market (level 1 inputs): or
3. Estimated using a valuation technique (using level 2 and / or level 3 inputs)

In general, only assets and liabilities that existed at the date of acquisition can be included in the calculation of goodwill.

Acquired intangible assets must always be recognized and measured. Unlike the previous IFRS 3, there is no exception where reliable measurement cannot be obtained.

If further evidence regarding the fair values of acquired assets and liabilities only becomes available after acquisition (i.e. some asset or liability values were only estimated at acquisition), the consolidated financial statements should be adjusted to reflect this additional evidence. But, this adjustment can only be made if the new evidence becomes available within twelve months after the acquisition.

If this is the case, the assets or liabilities should be adjusted to the new values, as if these new values had been used from the date of acquisition.
If an asset is to be revalued upwards at the date of acquisition, from its carrying amount to its fair value, then the following adjustment is made when preparing the consolidated accounts:

Debit:	Asset Account
Credit:	Revaluation Reserve (Fair Value adjustment) of Subsidiary at date of acquisition and at the SEP date

With the amount of the increase, (If it is a decrease, reverse the above journal entry)

Example

P acquired 75% of the share capital of **S** four years ago. At the date of acquisition the fair value of a machine exceeded the book value by ₦10, 000 in the books of S.
S depreciates the machine at 20% per annum, straight-line

<u>**Solution**</u>

When preparing the consolidated accounts, the following journal adjustments will be carried out

		₦	₦
Dr	Machine Account	10,000	
Cr	Net Assets at acquisition and SOFP date		10,000

In addition, the depreciation will have to be accounted for. For group purposes, the depreciation should be based on the fair value.

Thus, ₦10,000 x 20% x 4 years = ₦80,000

For group purposes, this N80, 000 will have to be charged. Thus

		₦	₦
Dr	Reserves (S)	80,000	
Cr	Asset Account		80,000

(This is the shortest way of putting through the depreciation. The reserves of S fall by ₦80, 000, which is the effect ₦80,000 extra depreciation would have on reserves/profits. Likewise, the asset book value will fall also).

INTER-COMPANY INVENTORY PROFIT/UNREALIZED PROFIT

Companies in a group often trade with each other. If one company in the group sells goods to another company in the group at a profit, then a problem arises if the buyer has some or all of those goods in stock at the Statement of financial Position date.

The goods, shown in inventory, will contain an element of profit which from a group perspective, has not realized. Bearing in mind that the group accounts seek to present the members of the group as if they were one single entity, this profit must be eliminated.

Thus the action necessary is:

a. Calculate the profit on inter-company inventory
b. Eliminate the profit. This can be done by the following journal entry:

Dr Reserves of seller
Cr Inventory
With the profit on inventory

Example

P acquired 75% of S four years ago. During the year, P sold goods to S for ₦10, 000. This included a markup of 25%. At the end of the year, S has one quarter of the goods remaining in stock.

<u>Solution</u>

a. Calculate profit
The goods were sold to S for N10, 000 including a mark-up of 25%. This means the profit on the transaction was ₦2, 000.
One quarter of the goods remains in stock, so one quarter of the profit remains also. Thus ₦2, 000 x ¼ = ₦500 must be eliminated

b. Eliminate the profit

		₦	₦
Dr	Reserves of P*	500	
Cr	Inventory		500

*P sold the goods and records the profit. Thus, it is P’s reserves that are adjusted

INTER-COMPANY PROFIT ON SALE OF A NON-CURRENT ASSET
This is Similar to the previous situation. One company in the group sells a non-current asset to another company in the group at a profit. For the same reasons as above, this profit must be eliminated (and thus the asset shown at its original cost to the group).

a. Calculate the profit.
b. Eliminate the profit. This can be done by
Dr Reserves of seller
Cr Asset Account
With the profit on the sale

Example

P purchased 75% of S, four years ago. Two years ago, S sold a machine with a book value of ₦20, 000 to P for ₦23, 000 and charges depreciation on its assets at 20% per annum, straight-line.

Solution

a. Calculate the inter-group profit.

The profit made by S on the sale was ₦3, 000

b. Eliminate the profit

		₦	₦
Dr	Reserves of S	3,000	
Cr	Machine Account		3,000

However, there is also the extra problem of depreciation. P on buying the asset, charges depreciation on its cost to P (₦23000) but for group purposes the asset should be depreciated based on its original cost to the group (₦20, 000).

Thus, for group purposes, over the last two years, total extra depreciation charged by P on the asset would be:

₦3, 000 x 20% x 2 years = 1,200

To rectify this for the consolidated accounts

		₦	₦
Dr	Machine Account	1,200	
Cr	Reserves of P		1,200

Note that in this case, it is the reserves of the parent that will be adjusted for the depreciation (co-incidentally here, it is the buyer as well).

INTER-COMPANY DEBTS

As the entities in the group are being presented as if they are just one single economic entity amounts owing group companies must be eliminated for consolidation purposes.

The holding company and subsidiary are likely to trade with each other, which could lead to Inter-company and creditors arising at the year end. Inter-company indebtedness should be cancelled out when Preparing consolidated Statement of Financial Position.

Example:
Set out below are the respective Statement of Financial Positions of H Limited and S Limited.

Statement of Financial Position

	H Ltd	S Ltd
	₦	₦
Non-current Assets	700	300
Investment in subsidiary	500	-
Inventories	240	220
Receivables	190	180
Bank	70	170
	1,700	870
Ordinary share capital (N1 shares)	1,000	500
Reserves	500	250
	1,500	750
Payables	200	120
	1,700	870

H Limited acquired 100% of S Limited several years ago when the reserves of S Limited were Nil. At the year Limited's receivables figure includes ₦60 owing from S Limited. S Limited's payables figure includes ₦60 owing H Limited.

Consolidated Statement of Financial Position H Ltd Group

Assets	₦
Non-current assets (700 + 300)	1,000
Inventories (240 + 220)	460
Receivables (190 + 180 - 60)	310
Bank (70 + 170)	240
	2,010
Ordinary share capital	1,000
Reserves (500 + 250)	750
	1,750
Payables (200 + 120 – 60)	260
	2,010

Note:
The receivables and payables are reduced by ₦60, which is the inter-company indebtedness. Intercompany transactions include loans by the holding company to the subsidiary and vice versa and current account maintained by the holding company and subsidiary.

Example:
Set out below are the respective Statement of Financial Positions of H limited and S Limited

	Statement of Financial Position	
	H Ltd	S Ltd
	₦	₦
Non-current Assets	700	300
Investment in subsidiary	500	-
Loan to S Limited	300	-
Current account	200	-
Other current assets	50	350
	1,750	1,250
Ordinary share capital (N1 shares)	1,000	500
Reserves	750	250
	1,750	750
Loan from H Limited	-	300
Current account	-	200
	1,750	1,250

H Limited acquired 100% of S Limited several years ago when the reserves of S Limited were Nil. H Limited made a loan of ₦300 to S Limited to help finance the expansion of S Limited. H Limited and S Limited trade with each other and maintain a current account to identify their indebtedness.

Consolidated Statement of Financial Position H Limited Group

Assets	₦
Non-current assets (700 + 900)	1,600
Current Assets (50 + 350)	400
	2,000
Ordinary share capital	1,000
Reserves (750 + 250)	1,000
	2,000

The loan by H Limited to S Limited cancels out against the loan in S Limited's Statement of Financial Position. Likewise, the current account in H Limited cancels out against the current account in S Limited. Occasionally the receivables/payables or the current accounts maintained by the holding company and subsidiary company may not agree, the reason for this difference will be due to either inventory in transit and/or cash in transit from one entity to another.

Example:

Set out below are the respective Statement of Financial Positions of H limited and S Limited

	Statement of Financial Position	
	H Ltd	S Ltd
	₦	₦
Non-current Assets	1,800	1,000
Investment in subsidiary	500	-
Current account	200	-
Inventory	300	270
Receivables	250	260
Bank	150	100
	3,200	1,630
Ordinary share capital	2,000	500
Reserves	1,070	840
	3,070	1,340
Current account	-	150
Payables	130	140
	3,200	1,630

H Limited acquired 100% of S Limited for ₦500 several years ago when the latter had a reserves balance of Nil. Inventory in transit from S Limited to H Limited at cost price amounted to ₦20. Cash in transit from S Limited amounted to ₦30.
In this instance it is useful to:

- Open an inter-company account
- Insert the current account balances from the respective Statement of Financial Positions
- Increase (debit) inventory and bank in the consolidated Statement of Financial Position by the amount to inventory in transit and cash in transit
- Credit the inter-company account with the amounts for inventory and cash in transit thereby reconciling the current accounts.

Consolidated Statement of Financial Position H Limited Group

Assets	₦
Non-current assets (1,800 + 1,000)	2,800
Inventory (300 + 270 + 20)	590
Receivables (250 + 260)	510
Bank (150 + 100 + 30)	280
	4,180
Ordinary share capital	2,000
Reserves (1,070 + 840)	1,910
	3,910
Payables (130 + 140)	270
	4,180

Inter-Company Account

	₦		₦
Current Account – H Limited	200	Current Account – S Limited	150
		Inventory	20
	-	Bank	30
	200		200

PREFERENCE SHARES IN A SUBSIDIARY COMPANY

When establishing whether a parent-subsidiary situation exists, preference shares are generally ignored as they usually do not carry voting rights Therefore, the holders of these shares do not participate in deciding the financial and operating policies of the company. (There are rare exceptions to this rule).

However, the holders of preference shares are entitled to participate in the profits' of a company upon its winding up.

The parent, as well as purchasing ordinary (equity) shares, may also purchase preference shares, though the relevant percentage holdings may be different. For example, P might own 75% of the equity shares of S, but only 30% of the preference shares.

In calculating the goodwill figure, the cost of preference shares is compared to their nominal value. This will be done in the cost of control account.

The nominal value of the preference shares held by outside interests will be reflected in the Non-Controlling Interest account.

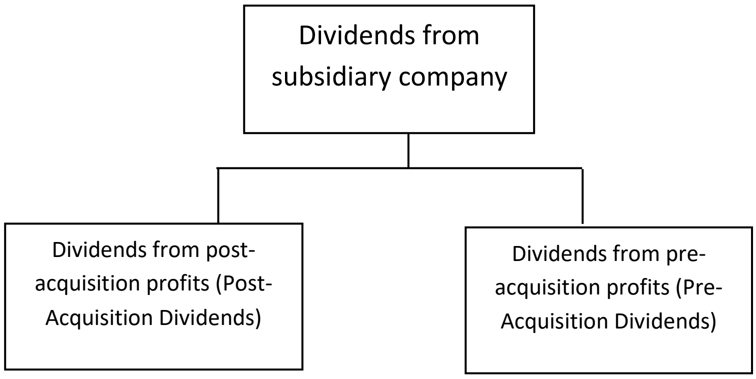
LOAN NOTES IN A SUBSIDIARY COMPANY

Loan notes/debentures/loan stock etc. does not affect the parent-subsidiary relationship either.

If the parent buys these loan notes, like preference shares, the difference between their cost and nominal value will be included in the cost of control account in arriving at the overall goodwill figure.

The balance of the loan notes not held by the parent, though held by outside interests, is not included in the Non-Controlling interest figure. Rather, it is shown separately as non-current liabilities in the consolidated Statement of Financial Position.

INTER-COMPANY DIVIDENDS



The treatment of inter-group dividends can be confusing. This is mainly because there are a number of different possible situations.
IAS 10 Events after the Reporting Date allows dividends to be included as a liability in the balance only if dividends had been declared before the year-end. Declared means that the dividends have been appropriately authorized and are no longer at the discretion of the entity.
So, in treating dividends payable in the question, make sure that they can be recognized in the first place.

There are two cases of dividends to be aware of when preparing consolidated accounts:

a. <u>Dividends out of post-acquisition profits.</u>
These are dividends paid or payable out of profits that have been earned since the date of acquisition.

b. Dividends out of pre -acquisition profits.
These are dividends paid or payable out of profits earned before the acquisition date.
It is an important distinction to make, as the accounting treatment of each is very different.

Dividends Out of Post-Acquisition Profits
There are *a* number of possible situations in regard to such dividends:

a. **Dividends paid by the Subsidiary to the Parent**
If the dividend has already been paid to the parent, then no further adjustment is required when preparing the consolidated Statement of Financial Position, because there is no inter-company amount outstanding.

b. Dividends declared by the Subsidiary and the Parent have taken account of this in its books.

Here, because the parent has taken credit for its share, it is rather similar to the treatment of inter-company debts. One company in the group owes money to another company in the group, in this case a dividend.

Inter-company amounts must be cancelled for group purposes. To do this
Dr Dividend's payable
Cr Dividend Receivable
With the inter-group amount

Example
P acquired 75% of S, four years ago. In the current year, the directors of S propose a dividend of ₦80, 000. The proposal is made prior to the year-end
P reflects the dividend receivable in its books.

Solution

Extracts from the Statements of Financial Position of P and S would show:

Dividends Receivable

	₦		₦
Balance b/d (p)	60,000	Dividends payable	60,000

Dividends Payable

	₦		₦
Dividend Receivable	60,000	Balance b/d (S)	80,000
Balance c/d	20,000		

The balance of N20, 000 dividends payable represents dividends payable to outsiders and would be shown as a current liability in the consolidated Statement of financial position.

Dividends declared by the subsidiary and the parent has not taken account of this in its books
In this case, the parent has not reflected the dividend due to it in its own books. The easiest treatment is to bring the dividend receivable into the books of the Parent Company and then cancel the intercompany amount. The procedure would be as follows:

Dr Dividends Receivable
Cr Reserves of Parent

With the amount of the inter-group dividend
Then

Dr Dividends Payable
Cr Dividends Receivable

With the amount of the inter-group dividend

Example
Same as before, except P does not reflect its share of the dividend in its books.

<u>Solution</u>
Extracts from the Statement of Financial Position of P and S would show;

	P	S		P	S
	₦	**₦**		**₦**	**₦**
Dividends Receivable	-	-	Dividends payable	-	80,000

The required journal entries would be

		₦	₦
Dr	Dividends Receivable	60,000	
Cr	Reserves of P		60,000

Being the parents share (75%) of the subsidiary's dividend
Then

		₦	₦
Dr	Dividends Payable	60,000	
Cr	Dividends Receivable		60,000

Being the cancellation of the inter-group amount
The "T' accounts would show

Dividends Payable

	₦		₦
Dividend Receivable	60,000	Balance b/d (S)	80,000
Balance c/d*	20,000		

Dividends Receivable

	₦		₦
Reserves (P)	60,000	Dividends payable	60,000

*Again this balance would be shown as a current liability in the consolidated Statement of Financial Position.

Dividends out of Pre-Acquisition Profits
These are dividends paid out of the subsidiary's reserves at the date of acquisition. The parent company should reduce the cost of its investment by the amount of the pre-acquisition dividend it receives.

Care should be taken to reduce the reserves of the subsidiary at the date of acquisition by the total dividend receives, Goodwill is then calculated using this reduced cost of investment and the subsidiary reserves after the dividend.
Thus, on receipt of such a dividend, the parent should

Dr Bank
Cr Cost of investment in the subsidiary

With the parent's share of the dividend

Example

H Limited acquired 80% of S Limited for ₦1, 700 when the latter company's reserves were ₦1, 000. Several months after the acquisition, S Limited paid a dividend of ₦150 out of their ₦1, 000 reserves. H Limited credited its share of the dividend, 80% of ₦150, i.e. ₦120 and reduced the cost of the investment from ₦1, 700 to ₦1, 700 - ₦120, i.e. ₦1, 580. The Statement of Financial Position of H Limited and S Limited are set out below several years after acquisition.

	Statement of Financial Position	
	H Ltd	S Ltd
	₦	₦
Non-current Assets	6,000	3,000
Investment in subsidiary	1,580	-
Current account	3,420	2,000
	11,000	5,000
Share capital	5,000	500
Reserves	6,000	4,500
	11,000	5,000

Calculation of Goodwill

		₦
Cost of investment in S		1,580
Less:		
Share of net assets acquired:		
Capital	500	
Reserves (1,000 - 150)	850	
	1,350	
Group share	80%	
		1,080
Goodwill		500

Assuming the group uses the proportion of net assets method for valuing NCI

Calculation of NCI:

20% x (500 + 4,500) = 1,000

Calculation of Consolidated Reserves:

H		
Per SFP		6,000
S		
Per SFP	4,500	
At acquisition (1,000 - 150)	850	
Post-acquisition	3,650	
Group share	X 80%	
		2,920
		8,920

Consolidated Statement of Financial Position H Limited Group

	₦
Non-current assets (6,000 + 3,000)	9,000
Goodwill	500
Current Assets (3,420 + 2,000)	5,420
	14,920
Share capital	5,000
Reserves	8,920
	13,920
Non-controlling interest	1,000
	14,920

Note:

Pre-acquisition dividends as with pre-acquisition reserves do not affect the calculation of the Non-Controlling interest.

Often in examination questions, the holding company may have credited its share of the pre-acquisition dividend to its reserves. In this case a correcting journal entry should be made in preparing the consolidated Statement of Financial Position, i.e.

Dr H Limited reserves
Cr Investment in Subsidiary

With group share of the pro-acquisition dividend
Thereby effectively reducing the cost of the investment

ACQUISITIONS OF SUBSIDIARY DURING THE YEAR

When the parent company acquires the subsidiary during a year, it may be necessary to calculate the revenue reserves at that date in order to determine goodwill.

Example

H Limited acquired 80% of S Limited on 30th June 20X4 for ₦350. The revenue reserves of S Limited at 2 January 20X4 were ₦100. Set out below are the respective Statements of Financial Position of H Limited and S Limited.

	Statement of Financial Position	
	H Ltd	S Ltd
	₦	₦
Non-current Assets	600	280
Investment in subsidiary	350	-
Current account	250	70
	1,200	350
Share capital	500	200
Revenue Reserves	700	150
	1,200	350

The profits of S Limited were ₦50 for the year and are deemed to have accrued evenly throughout the year.

Calculation of Goodwill

		₦
Cost of investment		350
Less:		
Share of net assets acquired:		
Capital	200	
Reserves (see below)	125	
	325	
X Group share	X 80%	
		260
Goodwill		90

Reserves at acquisition

	₦
Reserves at 1st January 20X4	100
Reserves accrued to 30th June 20X4 ₦50 x 6/12	25
	125

Consolidated Statement of Financial Position H Limited Group

	₦
Non-current assets (600 + 280)	880
Goodwill	90
Current Assets (250 + 70)	320
	1,290
Share capital	5,00
Reserves 700 + (150 -125 x 80%)	720
	1,220
Non-controlling interest	70
	1,290

Before we look at a comprehensive example requiring the preparation of Financial Position, remember the six steps to be taken in solving the question.

1. Establish Group Structure

Which company is the acquirer and to what extent do they control the acquiree? When was the subsidiary acquired?

Group structure is established by reference to the number of ordinary shares held by the parent (usually in questions, anyway. See alternative ways of establishing control at the beginning of this area).

2. Determine the adjustments to be made and the journal entries to implement these adjustments.

3. Calculate Goodwill arising on acquisition

Watch for the method of measuring NCI and the impact that this may have on the goodwill figure too.

The goodwill calculation, at its most basic, measures what was paid for the investment and what was acquired in return.

- What was paid is found in P's Statement of Financial Position in its investment in subsidiary (subject to an adjustments e.g. pre-acquisition dividends, deferred consideration, contingent consideration).
- What was received is its share of the capital and reserves (i.e.net assets) that existed at the date of acquisition.

The difference between these amounts will be either positive or negative goodwill.

Examine the question to see if goodwill has become impaired. If it has, reduce goodwill and set it against consolidated reserves.

4. Calculate Non-Controlling interest

Give the Non-Controlling Interest their share of all capital and all reserves that exist at the Statement of Financial Position date.

This figure will appear in the consolidated Statement of Financial Position

5. Calculate Consolidated Reserves

6. Prepare the consolidated Statement of Financial Position

Example

Cannon acquired 4 million of Ball's equity shares paying ₦4.50 each and ₦500, 000 (at par) of its 10% redeemable preference shares on 1st of April 2009. At this date the accumulated retained earnings of Ball were ₦8, 400,000. Reproduced below is the draft Statements of Financial Position of the two companies at 31 March 2012.

	Cannon		Ball	
	₦'000	**₦'000**	**₦'000**	**₦'000**
Assets				
Non-Current Assets				
Property, Plant and Equipment	42,450	-	22,220	-
Investment in Ball:				
Equity	18,000	-	-	-
Preference	500	-	-	-
		60,950		22,220
Current Assets				
Inventories	9,850		6,590	
Trade receivables	11,420		3,830	
Cash and bank	490		-	
		21,760		10,420
Total Assets		82,710		32,640
Equity and Liabilities				
Equity				
Equity capital ₦1 each	10,000		5,000	
Retained earnings	52,640		15,280	
		62,640		20,280
Non-Current Liabilities				
10% loan notes	12,000		4,000	
10% Redeemable Preference Capital	-		2,000	
		12,000		6,000
Current Liabilities				
Trade payables	5,600		3,810	
Operating overdraft	-		570	
Provision for income taxes	2,470		1,980	
		8,070		6,360
Total equity and liabilities		82,710		32,640

Extracts from the unadjusted Profit or Loss of Ball for the year to 31 March 20X8 are:

	₦'000
Profit before interest and tax	5,400
Interest paid	
10% Loan notes	(400)
Preference dividend	(200)
	4,800
Income taxes	(1,600)
Retained profit for period	3,200

The following information is relevant:

1. Included in the property, plant and equipment of Ball is a large area of development land at its cost of ₦5 million. Its fair value at the date Ball was acquired was ₦7 million and by 31st March 2012 this had risen to ₦8.5 million. The group valuation policy for development land is that it should be carried at fair value and not depreciated.
2. Also at the date that Ball was acquired, its property, plant and equipment included plant that had a fair value of ₦4 million in excess of its carrying value. This plant had a remaining life of 5 years. The group calculated depreciation on a straight-line basis. The fair value of Balls other net asset approximated to their carrying values.
3. During the year Ball sold goods to Cannon for ₦1.8 million. Ball adds a 20% mark-up on cost of all its sales. Goods with a transfer price of ₦450, 000 were included in Cannons inventory at 31st March 2012. The balance on the current accounts of the parent and subsidiary was ₦240, 000 on 31st March 2012.

Requirement

a. Prepare the Consolidated Statement of Financial Position of Cannon at 31st March 2012, assuming the group uses the proportion of net assets method for measuring Non-Controlling Interest. Goodwill is not impaired.

b. Calculate the Non-Controlling interest in the adjusted profit of Ball for the year to 31st March 2012.

<u>Solution</u>

1. <u>Establish Group Structure</u>

	Ball	Preference shares
Group (4m/5m)	80%	25%
Non-controlling interest	20%	75%

3. <u>Journal Adjustments</u>

4.

a. Revaluation of Property Plant and Equipment

There are two increases to consider:

From ₦5 million to ₦7 million as acquisition

From ₦7 million to ₦8.5 million in the post-acquisition period

i. The first increase occurs at acquisition.

		₦'000	**₦'000**
Dr	Property, Plant and Equipment	2,000	
Cr	Revaluation reserve at acquisition and SFP date		2,000

ii. The second increase occurs in the post-acquisition period

		₦'000	**₦'000**
Dr	Property, Plant and Equipment	1,500	
Cr	Revaluation reserve		1,500

b. Revaluation of Plant at Acquisition

		₦'000	₦'000
Dr	Property, Plant and Equipment	4,000	
Cr	Revaluation reserve at acquisition and SFP date		4,000

Also, the depreciation implication must be considered.
Additional Depreciation is:

Therefore,

		₦'000	₦'000
Dr	Reserves Ball	2,400	
Cr	Property, Plant and Equipment		2,400

*Acquisition occurred three years ago.

c. Inter-Company Profit on Inventory
Ball sold goods to Cannon for ₦1.8 million
20% mark-up on cost
₦450, 000 goods remain in stock

i. Calculate profit on inventory
₦450, 000 = 120%
₦375, 000 = 100%
₦75, 000 = profit

ii. Cancel profit

		₦'000	₦'000
Dr	Reserves Ball (seller)	75	
Cr	Inventory		75

d. Inter-Company Debts
Balance on current accounts is ₦240, 000.
Cancel it.

		₦'000	₦'000
Dr	Payables	240	
Cr	Payables		240

3. <u>Calculate Goodwill</u>

First, determine net assets of Ball:

	At date of acquisition ₦'000		**At the date of SOFP ₦'000**
Capital	5000		5000
Retained Earnings	8,400		15,280
Fair value adjustment: land	2,000		2,000
Plant	4,000		4,000
Post-Acq revaluation: land	-		1,500
Depreciation adjustment	-		(2,400)
Inventory adjustment	-		(75)
	19,400	<post acq = 5,905>	25,305

Cost of investment	18,00
Less:	
Share of net assets acquired (19,400 x 80%)	(15,520)
Goodwill on Acquisition	2,480

The redeemable preference shares were acquired as par No premium was paid, thus no goodwill implication

4. Calculate NCI:

20% x 25,305 = 5,061

Note

Because the preference capital is redeemable, the portion belonging to the Non-Controlling interest must be shown as a liability, in accordance with IAS 32.

5. Calculate Consolidated Reserves:

The post-acquisition reserves of ball are ₦5, 905 in total. Of this amount, ₦1, 500 is the increase in the post-acquisition revaluation reserve and the rest (₦4, 405) is the post-acquisition increase in retained earnings.

Retained Earning

Cannon	52,640
Per SFP	
Ball	3,524
Group share of post-acquisition reserves (80% x 4,405)	
Consolidated Retained Earnings	56,164

Revaluation Reserve

Cannon	Nil
Ball	
Group share of post-acquisition revaluation reserve (80% x 1,500)	1,200

6. Prepare Statement of Financial Position

	₦'000	**₦'000**
Assets		
NON-CURRENT ASSETS		
Property, Plant and Equipment (W1)	69,770	-
Consolidated goodwill (Step 3)	2,480	72,250
Current Assets		
Inventories (9,850 + 6,590 - 75)	16,365	
Trade receivables (11,420 + 3,830 - 240)	15,010	
Cash and bank	490	31,865
		104,115

Equity and Liabilities

Equity attributable to equity holders of the parent		
Equity capital	10,000	
Reserves: (step 5)		
Revaluation	1,200	
Retained earnings	56,164	67,364
Non-controlling interest (Step 4)		5,061
		72,425
Non-Current Liabilities		
10% Loan notes (12,000 + 4,000)	16,000	
10% Redeemable preference capital (NCI share)	1,500	17,500
Current Liabilities		
Trade payables (5,600 + 3,810 - 240)	9,170	
Operating overdraft	570	
Provision for income taxes (2,470 + 1,980)	4,450	
		14,190
Total Equity and Liabilities		104,115

Workings (Note all figures in ₦'000)

(W1) Property, plant and equipment

Balance from question	- Cannon	42,450
	- Ball	22,220
Revaluation of land		3,500
Revaluation of plant		4,000
Deduct additional depreciation (20% x 4,000 for three years)		(2,400)
		69,770

(b) Non-Controlling Interest in adjusted profit of Ball

	₦'000
Profit before tax per question	4,800
Additional depreciation	(800)
Unrealized profit on inventories	(75)
Adjusted profit before tax	3,925
Taxation	(1,600)
Adjusted profit after tax	2,325

Thus the Non-Controlling interest is: ₦2, 325,000 x 20% = ₦465, 000

EXAMPLE

Pink plc purchased 80% of the shares in saffron Ltd on 1st April 2009 in a 1 for 2 share exchange. Pink plc issued 5 own shares for every 2 it acquired in Saffron. The market value of Pink plc shares on 1st April was ₦3 each share issue has not yet been recorded in Pink plc. The retained earnings of Saffron at acquisition were ₦430, 000.

The summarized statements of financial position of both companies are:

Statement of Financial Position at 31st March 2012

	PINK		SAFFRON	
	₦'000	**₦'000**	**₦'000**	**₦'000**
Assets				
Non-Current Assets				
Property, Plant and Equipment		620		660
Investment		20		10
		640		670
Current Assets				
Inventory	240		280	
Receivables	170		210	
Bank	20		40	
		430		530
		1,070		1,200
Equity and Liabilities				
Capital and Reserves				
Ordinary shares of ₦1 each		400		150
Retained earnings		450		700
		850		850
Non-Current Liabilities				
7% Debentures				150
Current Liabilities				
Trade payables	170		155	
Taxation	50		45	
		220		200
		1,070		1,200

You are provided with the following additional information:

1. Saffron had plant in its financial statements at the date of acquisition with a carrying value of ₦100, 000 but with fair value of ₦120, 000. The plant had a remaining life of 10 years at acquisition.
2. Goodwill is to be measured in full. The fair value of the non-controlling interests at the date of acquisition of ₦250, 000. Goodwill is to be impaired by 30% at the reporting date.
3. At the start of the current financial year, Pink transferred a machine to Saffron in exchange for ₦15, 000 the asset had a remaining economic life of 3 years at the date of transfer. It had a carrying value of ₦22, 000 in the books of Pink at the date of transfer.
4. Saffron sold goods to Pink for ₦60, 000, including a mark-up of 20%. At the year end, Pink had 40% of these goods remaining in inventory.
5. At the year end, Safford's books showed a receivables balance of ₦6, 000 as being due from Pink. This amount disagreed with the payables balance of ₦1, 000 in Pinks books. The difference is caused by a payment sent to Saffron shortly before the year end which Saffron had not received prior to cut-off.

Prepare the consolidated Statement of Financial position for the year ended 31st March 2012.

All workings in ₦'000

Step 1: Establish Group Structure

	SAFFRON
Group	80%
NCI	20%

Saffron is a subsidiary acquired 3 years ago

Step 2 Adjustments

i. Record the purchase of Saffron

Saffron has	150,000 shares
Pink acquired	80%
Thus	
Pink acquired	120,000
Terms of Share Exchange	5 for 2
Shares issued by Pink	(120,000/2) x 5 = 300,000 shares
Fair value of shares	N3 per share

Debit	Investment in Saffron	900,000	
Credit	Share capital Pink		300,000
Credit	Share premium Pink		600,000

ii. Revaluation at acquisition

Debit	PPE	20,000	
Credit	Revaluation at acq date and date of SFP		20,000

Depreciation

	Retained Reserves (S)	6,000	
Debit			
Credit	PPE		6,000

iii. Sale of Non-Current Asset at a profit

Debit	Retained Reserves (P)	3,000	
Credit	PPE		3,000

Depreciation

	PPE	1,000	
Debit			
Credit	Retained Earnings (S)		1,000

iv. Intercompany profit on inventory

60,000	=	Cost + 20% (or 120% of cost)
50,000	=	Cost
10,000	=	Profit
X 40%		
4,000		

Debit	Retained Earnings (S)	4,000	
Credit	Inventory		4,000

v. Intercompany debt

Debit	Cash	5,000	
Credit	Receivables		5,000

Then;

Debit	Payables	1,000	
Credit	Receivables		1,000

Step 3 Calculate Goodwill (Fair Value Method)
First determine net assets of Saffron:

	At date of acquisition ₦'000		**At the date of SFP ₦'000**
Capital	150		150
Retained Earnings	430		700
Fair value adjustment: PPE	20		20
Depreciation adjustment: PPE	-		(6)
Depreciation adjustment	-		1
Inventory adjustment	-		(4)
	600	<261 post acq>	861
Cost of investment			900
Fair value of NCI at acquisition			250
			1,150
Fair value of net assets at acquisition			600
Goodwill at acquisition			550

Goodwill impaired by 30% i.e. 550 x 30% = 165

Debit	Retained Earnings (Pink)	132	
Debit	NCI	33	
Credit	Goodwill		165

= 50 – 165

Goodwill to be included in Consolidated Statement of Financial Position = 385

Step 4 Calculate NCI

FV of NCI at acquisition	250.0
NCI share of post-acquisition reserves (261 x 20%)	52.2
Impairment of goodwill	(33.0)
	269.2

Step 5 Calculate Consolidated Reserves

The consolidated reserves will be the reserves of the Parent Company's (as adjusted for consolidation purposes) plus the group share of the post-acquisition reserves of the Subsidiary (as adjusted for consolidation purposes).

PINK

Per SFP	450
Profit on sale of asset	(3)
Goodwill impaired	(132)
	315.0

SAFFRON

Group share of post-acq reserves	208.8
(80% x 261)	523.8

Step 6 Prepare the Consolidated Statement of Financial Position

	₦'000	₦'000
Assets		
NON-CURRENT ASSETS		
Property, Plant and Equipment (620 + 660 + 20 – 6 – 3 + 1)		1,292
Goodwill		385
Investment (20 + 10)		30
		1,707
Current Assets		
Inventory (240 + 280 - 4)	516	
Receivables (170 + 210 – 5 - 1)	374	
Bank (20 + 40 + 5)	65	955
		2,662
Equity and Liabilities		
Capital and Reserves		
Ordinary shares of N1 each (400 + 300)		700
Share premium		600
Retained Earning		523.8
		1,823.8
Non-controlling interest		269.2
		2,093

Non-Current Liabilities		
7% Debenture		150
Current Liabilities		
Trade payables (170 + 155 - 1)	324	
Taxation (50 + 45)	95	
		419
		2,662

Under previous rules contained in IAS 31 interest in joint ventures, a choice of treatment for investment in joint ventures was allowed.

1. Proportionate consolidation
2. Equity method

IAS 31 has been replaced by IFRS 11 and this choice has now been removed. Entities now use the equity method in treating its investment in the joint venture in the consolidated financial statements. Essentially, this means dealing with the Joint Venture in the group accounts the same way that the Associate Company is dealt with.
In the individual financial statement of the joint venture, it will recognize:

1. The cost of the investment (e.g. the cost of the shares purchased in the joint venture), shown as an asset in the statement of financial position; and
2. Any returns received from the joint venture (e.g. dividends received).

In the consolidated financial statements, the joint venture must treat the investment under the rules of equity accounting.

Note however that if the joint venture engages in transactions with the joint venture, the joint venture must only recognize only the gain attributable to the interests of the other joint venture parties. It cannot recognize a profit from transactions with itself!

DISCLOSURE
There are no disclosures specified in IFRS 11. Instead IFRS 12 *Disclosure of Interests in Other Entities* outlines the disclosures required.

INTRODUCTION
The purpose of consolidated statement of profit or loss and other comprehensive income (SPLOCI) is to present the results of the parent company and the subsidiary as if it were a combined/single entity.

When preparing the consolidated SPLOCI the revenue and expenses of both the parent and the subsidiary are combined to calculate the profit of the group, derived by utilizing the resources of the group members.

Once profit for the year has been calculated, it is split between the amount attributable to the equity shareholders of the parent and the amount attributable to the Non-Controlling

Interest. Likewise, the total comprehensive income of the group (if different) will be split along the same lines.

MECHANICS AND TECHNQUES

The following approach should be adopted when preparing the consolidated statement of profit or loss and other comprehensive income for a parent and subsidiary:

1. **Establish Group structure**
   Determine the % holding in the subsidiary and when that control was established.
2. **Calculate Goodwill arising on the acquisition of the subsidiary (if required)**
   This is not always required in a consolidated SPLOCI question
3. **Set up the columnar working schedule**
4. **Combine the individual line items of the parent and subsidiary companies**
   When consolidating the SPLOCI headings, eliminate any intercompany items, such as sales, revenue, interest etc.
5. **Calculate the NCI share of profit and total comprehensive income**
   If there is a Non-Controlling Interest (NCI) in a subsidiary, give the NCI their share of the profit after tax of the subsidiary. The NCI is shown below the consolidated Profit or Loss, alongside the share of profit attributable to the parent.

Note that the full profit before tax and tax of the subsidiary are consolidated.
Furthermore, if the Fair value method is being used, then the NCI share of any goodwill impairment must be deducted in arriving at the NCI amount in the consolidated Profit or Loss.

A useful guide to the rules governing the consolidation of the individual line items in the statements of comprehensive income is given below.
Where P is the Parent company and S is the Subsidiary company, combine items as follows:

Line Item	**Rule**
Revenue	P + S – intercompany sales
Cost of Sales	P + S – intercompany purchases, but watch for the question for any required • Inventory adjustment • Depreciation adjustment
Distribution Cost	P + S
Administration Expenses	P + S + total goodwill impaired in period
Investment Income	P + S – Intercompany income
Finance Costs	P + S – intercompany interest
Tax	P + S
NCI	PAT of S (as adjusted) x NCI % LESS NCI share of goodwill impairment in period if Fair value method is being used But watch for impact of preference shares

The NCI calculation is then calculated

	₦
Profit After Tax (as adjusted in question) **x** NCI*%*	X
Less: NCI share of the goodwill impairment (if the Fair Value method is being used)	X
	X

If the NCI also have an investment in the preference share of the subsidiary, remember to adjust the calculation of the NCI figure for the preference dividends receivable.

INTERCOMPANY TRANSACTIONS

1. Sales and purchases

When combining the sales and cost of sales, a problem arises if the group companies have been buying and selling goods with each other.

The intercompany amounts of sales and purchases must be eliminated from the group accounts so that the consolidated statement of profit or loss and other comprehensive income reflects only goods bought and sold with outside third parties.

If one company in the group sold goods to another company in the group, these sales are deducted from total group sales. And because purchases form part of the cost of sales, this figure must be adjusted too

Example

P owns 80% of the ordinary shares of S for the past 4 years. During the year ended 30th September 2012, P sold goods to S for ₦1,000. S sold all of the goods on to third parties by the year end.

The Profit or Loss of each company is;

	₦'000	**₦'000**
Revenue	10,000	5,000
Cost of sales	(6,000)	(2,000)
Gross Profit	4,000	3,000
Operating expenses	(1,000)	(1,000)
Profit before tax	3,000	2,000
Tax	(750)	(500)
Profit for the year	2,250	1,500

Group Structure

Group	80%
NCI	20%

Columnar Workings

	P	S	Adjustment	Total
Revenue	10,000	5,000	(1,000)	14,000
Cost of sales	(6,000)	(2,000)	1,000	(7,000)
Gross profit	4,000	3,000		7,000
Operating expenses	(1,000)	(1,000)		(2,000)
Profit before tax	3,000	2,000		5,000
Tax	(750)	(500)		(1,250)
Profit for the year	2,250	1,500		3,750

Calculate NCI

Profit after tax of S	1,500
X NCI%	20%
	300

P GROUP CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR YEAR ENDED 30TH SEPTEMBER 2012

	₦'000	
Revenue	14,000	
Cost of sales	(7,000)	
Gross profit	7,000	
Operating expenses	(2,000)	
Profit before tax	5,000	
Tax	(1,250)	
Profit for the year	3,750	
Profit attributable as follows:		
Equity holders of parent	3,450	(balancing figure)
NCI	300	(as calculated above)
	3,750	

2. Intercompany profit on inventory:

If there have been intercompany sales during the year and at the end of the year, some or all of the goods remain in the closing inventory of the purchasing company, any profit element contained in that inventory must be removed.

This is an unrealized profit from a group perspective and as such, it must be eliminated. Remember, that the overriding principle of consolidated accounts is to combine the companies as if they were just one single entity. Therefore, any intercompany profit must be removed.

When the profit is removed, the impact will be to increase cost of sales (as the closing inventory falls). The inventory will now be stated at its original cost to the group.
When preparing the consolidated Statement of Financial Position we saw that the approach was:

1. Calculate the profit
2. Eliminate the profit

The journal entry was shown as:

Debit	Retained earnings (seller)
Credit	Inventory

With the profit on the remaining inventory

In the consolidated SOCI, the same approach is taken and the adjustment is again carried out in the books of the seller

EXAMPLE

P owns 80% of the ordinary shares of S for the past 4 years. During the year ended 30th September 2012 S sold goods to P for ₦1, 000. This included a markup of 20%. P sold 60% of the goods on to third parties by the year end.

The profit or Loss of each company is:

	₦'000	**₦'000**
Revenue	10,000	5,000
Cost of sales	(6,000)	(2,000)
Gross Profit	4,000	3,000
Operating expenses	(1,000)	(1,000)
Profit before tax	3,000	2,000
Tax	(750)	(500)
Profit for the year	2,250	1,500

Group Structure

Group	80%
NCI	20%

Adjustments

1,000	=	Cost + 25% (or 125% of cost)
800	=	Cost
200	=	Profit
X 40%	=	Amount of goods remaining in inventory at year end
80	=	Profit on inventory

Debit	Retained earnings (S)	80
Credit	Inventory	80

(With the profit on the remaining inventory)

Columnar Workings

	P	**S**	**Adjustment**	**Total**
Revenue	10,000	5,000	(1,000)	14,000
Cost of sales	(6,000)	(2,000)	1,000	(7,080)
Inventory adjustment		(80)		
Gross profit	4,000	2,920		6,920
Operating expenses	(1,000)	(1,000)		(2,000)
Profit before tax	3,000	1,920		4,920
Tax	(750)	(500)		(1,250)
Profit for year	2,250	1,420		3,670

Calculate NCI

Profit after tax of S	1,420
X NCI%	20%
	284

P GROUP CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR YEAR ENDED 30TH SEPTEMBER 2012

	₦'000	
Revenue	14,000	
Cost of sales	(7,080)	
Gross profit	6,920	
Operating expenses	(2,000)	
Profit before tax	4,920	
Tax	(1,250)	
Profit for the year	3,670	
Profit attributable as follows:		
Equity holders of parent	3,386	(balancing figure)
NCI	284	(as calculated above)
	3,670	

The unrealized profit arose originally in the books of the subsidiary, as it was the seller of the goods. As a result, the NCI must be adjusted for its share of this unrealized profit. By putting the adjustment in the column of the subsidiary, its PAT was adjusted in the workings and accordingly, the NCI calculation then reflects the impact of the inventory profit, as it is based on the PAT of the subsidiary.

3. Intercompany profit on the sale of a non-current asset

This will be similar to treatment of the profit on inventory.

Calculate the profit on the sale and eliminate that profit (adjusting the books of the seller) from the consolidated accounts.

There will be the added problem of depreciation, since the depreciation must be based on the cost of the asset to the group (i.e. after the profit has been removed). The adjustment for the year must be reflected in the consolidated accounts (adjusting the books of the buyer for this depreciation).

4. Dividends

Dividend received/receivable from the subsidiary which have been credited to the parent company's Profit or Loss should or eliminated in preparing the consolidated accounts. The profits of the subsidiary, out of which the dividend have been appropriated, are being consolidated, if the dividends were not eliminated, a duplication would arise in the consolidated accounts

In a situation where a dividend has been provided by the subsidiary but not yet credited to profit and loss by the parent company in this case no adjustment is required to the profits before tax (as the dividend from the subsidiary not included in the parent company's profit before tax). However, the transfer between the subsidiary and the parent company will ultimately be paid out and increase the parent company's reserves in the future.

5. Preference Dividends

The same principles that apply to ordinary dividends are also applied to preference dividends. However, it is important to note that the existence of preference dividends will impact on the calculation of the NCI figure for the year.

Preference dividends rank ahead of ordinary dividends and so are deducted from Profit after Tax, in advance of ordinary dividends being deducted. If the NCI have ownership of some or all of the preference shares in the subsidiary, an appropriate level of dividend is receivable by the NCI.

This is deducted first and the NCI share of the remaining profit attributable to the ordinary shareholders is then calculated.

Consider the following example:

P acquired 80% of the ordinary shares of S four years ago. It also acquired 30% of the 100,000 10% ₦1 preference share. S profit after tax for the year was ₦75, 000. What is the NCI figure for inclusion in the consolidated SPLOCI?

The NCI own:

20% of ordinary shares

70% of preference shares

Therefore, the NCI calculation is as follows

	₦				₦	
PAT	75,000					
Preference Dividends (N100, 000 x 10%)	(10,000)	X	70%	=	7,000	
Profit attributable to ordinary shares	65,000	X	20%	=	13,000	
					20,000	= NCI

6. Interest

The amount of interest charged in the consolidated SPLOCI is that which has been paid out to non-group debenture holders. Any intercompany interest must be eliminated.

Thus, if one company in the group has charged interest to another company in the group, one company will show interest payable and the other will show interest receivable in their individual accounts.

In the group accounts, these must be removed and as a result, should cancel each other out.

7. Fair value

When parent takes control of a subsidiary, the assets (and liabilities) of the subsidiary must be restated to their Fair Values for consolidation purposes.

If a non-current asset is revalued, there will also be a depreciation adjustment necessary as the subsidiary's SPLOCI will include depreciation based or the value of the asset in the subsidiary's individual accounts. The consolidated accounts will have the asset restated to its fair value and so there will be a difference in depreciation.

The depreciation difference must be calculated and included in the consolidated SPLOCI for the period. This depreciation will be included in the cost category indicated in the examination question.

8. Acquisition of subsidiary during the year

If a subsidiary is acquired during the year, only the post-acquisition results of the subsidiary are consolidated. This means that the revenue and expanses will have to be time-apportioned. (Questions usually state that revenue and expenses occur evenly throughout the year). If not, the question will specify how the pre and post-acquisition results must be split

Example

P Ltd acquired 82% of S Ltd half way through the year. The respective non-consolidated Profit or Loss is set out below. Prepare the consolidated Profit or Loss.

Profit or Loss	**P Ltd**	**S Ltd**
	₦	₦
Sales	1,300	1,200
Cost of sales	(660)	(530)
Gross profit	640	670
Administration	(210)	(180)
Distribution	(130)	(120)
Interest	(80)	(30)
Profit before tax	220	340
Tax	(70)	(90)
Profit after tax	150	250

Solution

	P Ltd	**6/12 S Ltd**	**Total**
	₦	₦	₦
Sales	1,300	600	1,900
Cost of sales	(660)	(265)	(925)
Gross profit	640	335	975
Administration	(210)	(90)	(300)
Distribution	(130)	(60)	(190)
Profit	300	185	485
Interest	(80)	(15)	(95)
Profit before tax	220	170	390
Tax	(70)	(45)	(115)
Profit after tax	150	125	275

Calculate NCI

PAT of S:	125
X NCI%	X 20%
	25

Consolidated Profit or Loss of P for Year ended xx/xx/xxx

	₦
Revenue	1,900
Cost of sales	(925)
Gross profit	975
Administration	(300)
Distribution	(190)
Finance Cost	(95)
Profit before tax	390
Tax	(195)
Profit for the year	275
Profit attributable as follows:	
Equity of the parent	250
Non-Controlling Interest	25
	275

ASSOCIATE COMPANIES IN THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

A reporting entity that prepares consolidated financial statements must include its associates in those statements using the equity method of accounting.
Under this method the associate company's revenue, cost of sales, expenses etc. are not consolidated with those of the investing group. Instead, the investor's share of the profit after tax of the associate is brought into the consolidated statement of profit or loss and other comprehensive income. The share of the associates profit is included in the group profit before tax figure.

This share of profit after tax will include any accounting adjustments that arise in the question in relation to the associate, as well as any impairment that must be accounted for.
In addition, if shares in the associate company have been held for less than a year, the share of the associates profit must be time apportioned accordingly

EXAMPLE

The following are the financial positions of Benue investment companies with her investee companies:

	Benue	Makurdi	Takum
Fixed asset	1,970	894	504
Trademarks	-	90	-
Goodwill	-	111	-
Investment Mkd	1,720	-	-
Investment Tak	300	-	-
Net current asset	2,397	796	427
	6,387	1,891	931
Issued share capital			
Ordinary Share of	1,000	1,000	400
Pref. share of N	900	-	100
Reserves	2,687	(309)	304
Loan stock	1,300	1,100	-
Deferred tax	500	100	127
	6,387	1,891	931

i. Benue acquired its holding of 900 shares in Makurdi on 1st January 1987, when the reserves of Makurdi were N315.

The directors of the Benue valued the net tangible assets of Makurdi at that date at N1, 250, trademarks at N71 and goodwill at book value. A revaluation took place to reflect this on 1/1/87.

ii. Benue acquired its holding of 120 N1 ordinary shares in Takum Pic on 1st July. 1988, when the reserves were N212.

iii. At 31/12/02 Benue held in stock purchases from Makurdi for N300. Makurdi operates on a standard 25% gross profit.

Required:

Prepare the consolidated balance sheet of Benue with subsidiary and associated companies.

Adapted: From ANAN PEB 2003 with modifications.

Solution

THE CONSOLIDATION SCHEDULE OF BENUE INVESTMENT COMPANY

	Cost of Control	**N.C. Int.**	**Cons. Res.**
	90%	**10%**	
Investment in Makurdi			
Shares 1000	900	100	
P or L 28	283.50	2.8	(258.30)
Net asset acquired	1,183.50		
Cost of investment	(1,720.00)		
Goodwill on acquisition	536.50		
Goodwill b/f Makurdi 111.00			
Goodwill C/D	647.50		
Profit from associated coy:			
(304 – 212 = 92 x 30%)			27.6
Unrealized profit			(75)
Profit b/f			2,687
Profit C/D			2381.30
Non C. interest		102.8	

Interest Levels

1. Benue in Makurdi
   900/ 1000 X 100/1 = 90%
   Non C. interest in Makurdi = 10%

2. Benue in Takum = 120/400 x 100/1 = 30% associated company.

Workings:

Revaluation

Trade mark	19	Fixed asset	356
P & L	337		
	356		356

P & L

Unrealized	75	B/f	2,687
Cost of control acquisition	283.500	Makurdi	28
Non C. interest		Share of associated coy	
10% x 28	2.80	Reserve post	
C/D	2,381.30	304 – 212 = 92 X 30% 27.60	
	2,742.60		2,742.60

Net Current Asset

B/f	2,397	Unrealized profit	75
		c/d	2,322
	2,397		2,397

Working:

1. Unrealized profit

   300 x 25% 75

P or L Makurdi

B/f	309	Revaluation	337
C/d	28		
	337		337

Cost of Control

Cost	1,720	Pre-acquisition 90% x 315		283.50
		Share of capital 1,000 x 90%	900	
		Goodwill		536.50
	1,720			1,720

Or

Check at acquisition

Share 90% x 1,000	=	900		
Add pre-reserve 90% x 315	283.5			
		1,183.50		
Cost		1,720.00	Goodwill	536.50

Or

Cost	1,720.00
Less pre-acquisition	283.50
Cost of Acquisition	1,436.50
Share acquired	900.00
Goodwill	536.50

Investment in Associates

Cost	300.00	C/D	327.60
Post profit	27.60		
	327.60		327.60

Non C. interest in Makurdi

B/s	102.80	Share 10% x 1000	100.00
		Reserve 10% x 28	2.80
	102.80		102.80

CONSOLIDATED FINANCIAL POSITION OF BENUE GROUP

Goodwill	B	536.50 + 111	647.50	
NCA	M	1,970		
	T	1,270		3,220.00
Investment				327.60
Trademarks				71.00
Net current assets:				
	B	2,322		
	T	796		3,118.00
				7,384.10
Funded by:				
Share capital				1,000.00
P & L				2,381.30
Shareholders fund				3,381.30
Non C. int: Ordinary shares		102.80		
Pref. shares		900.00		1,002.80
Loan 1,300 + 1,100				2,400.00
Tax 50 + 100				600.00
				7,384.10

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (SOCIE)

Introduction

The purpose of a Statement of Changes in Equity is to explain the change or movement in the capital and reserves section of the Statement of Financial Position from the previous reporting date to the current reporting date

In the consolidated accounts, the equity of group belongs to the part to the Parent and in part to the NCI. As a consequence, the consolidated statement of changes in equity will have two main sections:

1. The changes in equity attributable to the shareholders of the Parent.
2. The changes in equity attributable to the shareholders of the NCI.

A Sample consolidated Statement of Changes in Equity is as follows:

Consolidated Statement of changes in Equity for the year ended 31st December 2012

	Ordinary Shares		**Share Premium**		**General Reserves**		**Retained Earnings**		**NCI**		**Total**
	₦'000		**₦'000**		**₦'000**		**₦'000**		**₦'000**		**₦'000**
At 1 January 2012	25,000		17,500		5,720		12,630		10,680		71,530
Share issue	5,000		2,500								7,500
Comprehensive income							15,754		232		15,986
Dividend	-		-		-		(5,000)		(400)		(5,400)
At 31 December 2012	30,000		20,000		5,720		23,384		10,512		89,616

In the sample consolidated SOCIE above:

Opening balance

The opening balance of the various items of equity is the closing balance coming forward from the previous year. Remember, the share capital and share premium is that of the parent company only. The opening reserves comprise the parent plus the group share of the post-acquisition reserves of the subsidiary (up to the start of the current year).

The opening NCI figure is the closing figure from the previous year. It includes only the pot acquisition reserves up to the start of the current period (end of last Period).

Comprehensive Income

The figure in consolidated SOCIE for the comprehensive income for the year are taken from the end of the consolidated SPLOCI, where the comprehensive income for the period is split between the amount attributable to the equity holders of the parent and the amount attributable to the NCI.

Dividends

The dividend in the consolidated SOCIE is those that are paid outside of the group. That is the parent company's dividend and separately, the share of the subsidiary's dividend that is paid/payable to the NCI.

The share of the subsidiary's dividend that belongs to the parent is eliminated in the group accounts because it is an intercompany transaction.
The consolidated SOCIE could be shortened a little by combining the share capital, share premium and reserves of the group into the single heading of Equity and showing the NCI figures in a separate column.

Example
HAPPY owns 70% of the ordinary share capital of GRUMPY. The total group equity as at 31 December 2011 was 4,000,000 which included ₦650, 000 attributable to non-controlling interest.

During the year to 31 December 2012, HAPPY issued 2 million ₦1 ordinary shares, fully paid, at ₦1.30 per share.
Dividends were paid by both group entities in December 2012. The dividends paid by HAPPY and GRUMPY were ₦200, 000 and ₦100, 000, respectively.
Total comprehensive income for the year ended 31 December 2012 for HAPPY was ₦900, 000 and for GRUMPY was ₦600, 000. Income is assumed to accrue evenly throughout the year.

Required:

1. Prepare the consolidated statement of changes in equity for the year ended 31 December 2012 for the HAPPY Group, showing the total equity attributable to the parent and to the non-controlling interest.

Solution

W1
Share out the Total Comprehensive Income of GRUMPY between the group and NCI:

	₦
Amount attributable to NCI (N600, 000 x 30%)	180,000
Amount attributable to group (bal fig)	420,000
	600,000

Therefore, total TCI attributable to the equity holders of the parent is: ₦900, 000 **+** ₦420, 000 = ₦1, 320,000

W2

NCI Share of the dividend paid by GRUMPY: ₦100, 000 x 30% = ₦30, 000

HAPPY Group

Statement of Changes in Equity for the Year Ended 31 December 2012

	Attributable to equity holders of parent	Non-Controlling Interest	Total Equity
	₦'000	₦'000	₦'000
Opening balance at 1st January 2012	3,350	650	4,000
TCI for year	1,320	180	1,500
Share issue (2m x ₦1.30)	2,600		2,600
Dividends	(200)	(30)	(230)
Closing balance at 31st December 2012	7,070	800	7,870

2.04 Review Questions

1. Friar Ltd acquired 80% of the share capital of Tuck Ltd on the 1st January 2012, when the reserves of Tuck Ltd was ₦125, 000. Friar Ltd paid initial cash consideration of ₦1, 000,000. In addition Friar Ltd issued 200,000 share consideration with a nominal value of ₦1 and a market value of ₦1.80 at the date of acquisition it was also agreed on acquisition that Friar Ltd would pay a further ₦500,000 in three years' time (i.e. 1st January 2011) Current interest are 10% pa. The shares and the deferred consideration have not yet been recorded.
   The following are the Statements of Financial Position of Friar Ltd and Tuck Ltd as at 31st December 2013

	FRIAR	TUCK
	₦'000	₦'000
Assets		
NON-CURRENT ASSETS		
Property, Plant and Equipment	5,500	1,500
Investment in Tuck (at cost)	1,000	-
CURRENT ASSETS		
Inventory	550	100
Receivables	400	200
Cash	200	50
	7,650	1,850
Equity and Liabilities		
Capital and reserves		
Share capital	2,000	500
Retained earnings	1,400	300
	3,400	800
Non-Current Liabilities	3,000	400
Current Liabilities	1,250	650
	7,650	1,850

The Friar Group values the Non-Controlling Interest using the fair value method. At the date of acquisition, the fair value of the 20% Non-Controlling interest was ₦380, 000. The consolidated goodwill has been impaired by one fifth of its value.

Prepare the consolidated statement of financial position as at 31 December 2013.

2. Anyakwu Ltd has the following financial assets.
    1. Shares held for trading purposes
    2. Debentures that will be redeemed in 3 years
    3. Trade receivables
    4. Equity shares that Patrick has no intention of selling
    5. A convertible bond which is due to be converted into equity shares in 4 years' time.

    How should Anyakwu Ltd classify its financial assets?

MODULE 3

3.00 INTERNATIONAL FINANCIAL REPORTING

3.01 Learning Outcomes

On successful completion of this Module, Students should be able to:

i. Elucidate the circumstances under which organisations may, or must, apply IFRS or local UK and Irish GAAP demonstrating an understanding of the key accounting and presentation differences between them if Local GAAP were to be applied.
ii. Evaluate the refinement of Accounting through their knowledge of the various technical pronouncements.
iii. Appraise the import of the extant current issues in Corporate Reporting.
iv. Present the various reasons for Accounting Diversity, their consequences and of course Harmonization.
v.
vi. Explain the difference and similarities in accounting presentations of different countries.
vii. Appraise and apply the acquisition method of accounting and related disclosure requirements in financial statements and notes.
viii. Critically evaluate the main accounting issues currently in the field of corporate reporting.

3.02 Technical Pronouncements Currently In Issue

Characteristics of Government Accounting

a. There are distinct aspects of accounting information, classification and procedures which apply only to transactions made by Government Examples are the budgeting system and applicable procedures, fiscal policy, accounting methods and sources of revenue. The peculiar nature of Government transaction makes it desirable and indeed mandatory to treat them in accordance with specific, but cohesive and standardized measurement approaches and rules.

b. In view of the requirement to obtain legislative approval for Government revenue and expenditure, budgeting largely determines the structure of Public Sector Accounting. The Government sometimes finds it necessary to segregate its resources into specific or special purpose compartments, a set-up of receipts and expenditure known as 'Funds'. The method of accounting adopted in recording and measuring the Funds is referred to as 'fund accounting'.

c. Another peculiarity of Government operations is that the accounting system is maintained on "cash basis" Only transactions involving the movement of cash come into reckoning. Although the approach has its inadequacies, the general practice is to adopt the 'cash bases of accounting. All assets are written off as they are regarded consumed at the point they are paid for. Accordingly, Government's balance sheet does not contain information on fixed assets and neither is depreciation charged in the revenue and expenditure accounts.

Introduction and Pronouncements

In spite of the obvious importance of Public Sector Accounting in the1conomic development process, significant attention was not given to it. The development of the private sector depends largely on the activities in the public sector. The fact is that in developing countries as Nigeria, the public sector is not only the biggest actor-but the hub of economic activities.

Moreover, Government has the responsibility for the efficient management of the environment of commercial transactions, through the maintenance of law and order and enactment of legislations. Political stability is very essential for the growth of the economy and the Government has to provide the enabling environment. It is in the realisation of the above and to bridge the gap between the public and private sectors that many professional pronouncements have made, as follows:

a. A United Nations Survey was conducted and recommendations made for improvements in the Government accounting systems of 'third world' countries, especially in budgeting practices, training, data classifications, and methods and accounting procedures.

b. In the United States of America, the National Committee on Government Accounting issued a manual titled "Government Accounting, Auditing and Financial Reporting (GAAFR)". The manual is generally referred to as "The Blue Book". The Blue Book and other pronouncements of the committee set forth the basic accounting and reporting principles covering the following are, viz:
    (i) Basis of Accounting
    (ii) Legality
    (iii) Funds and 'Fund Accounting'.
    (iv) Budgetary, planning and control
    (v) Fixed Assets and Depreciation
    (vi) Terminologies and Accounting/Classifications
    (vii) Financial Reporting.

The Committee recommended the 'accrual basis' of accounting for public enterprises, capital projects and trust funds; the 'modified accrual basis' for special revenue and debt service funds and that depreciation is not chargeable on fixed assets.

a. The International Federation of Accountants (IFAC) issued International Public Sector Accounting Standards, effective from year 2003.

b. The Nigerian Public Sector Auditing Standards, effective from December, 1997, were issued by the Auditor – General for the Federation and Auditors-General for the States.

c. The American Institute of Certified Public Accountants (AICPA) recommended that the financial statements of each governmental unit should be prepared in accordance with the generally accepted accounting principles while supplementary schedules should accord with legal compliance.

d. The International Organisation of Supreme Audit Institutions (INTOSAI), which is the association of all Auditors-General in the world, meets annually and draws up resolutions on accounting and audit practices and procedures to be followed by member countries.

The Objectives of Professional Pronouncement

These are put in place in order to:

(a) Develop and harmonize public sector financial reporting, accounting and auditing practices.

(b) Put into practice the same accounting standards throughout the world, in order to make comparisons possible and meaningful

(c) Make guidelines available for practitioners, in order to maintain high reporting standards.

The various pronouncements made so far can be summarised as shown below and compared with the position of Nigeria, in the following vein:

UNITED NATIONS PRESCRIPTIONS	**NIGERIA'S ACCOUNTING SYSTEM**	**REMARKS**
(a) Accounting systems should be designed to comply with the constitutional statutory and other legal requirements of third world countries.	Government Accounting system in Nigeria adheres with the Nigeria Constitution. Financial (Control and Management) Act, Cap 144 LFN 1990 (as amended); the Audit Act of 1956: Revenue Allocation laws; Revenue Allocation laws; other Federal and State laws and Regulations; Local Government bye-laws, etc.	Government Accounting System effectively complies with the United Nations Pronouncements.
(b) Accounting systems should be related to the budget classifications. The	Accounts are kept on the basis of budgetary classifications at all levels of	Remark is as in (a) above

budgetary and accounting functions are complementary Elements of financial management. They should therefore be closely integrated.	Government.	
(c) The accounts should be maintained in a way that will clearly identify the objects and purposes for which funds have been received and expended, and the executive authorities who are responsible for custody and use of funds in programme executions.	The budgetary provisions specify the sources of revenue and the purposes for which funds are provided and expended. The budget documents also show the vote controllers for both recurrent and capital expenditure.	Remark is as in (a) above
(d) Accounting systems have to be maintained in a way that facilitate audit by external reviewing authorities, and readily furnishes the information needed for performance appraisal and stewardship	The Financial Regulations of the Federal and State Government and the Financial Memoranda of local Government Councils specify the expenditure control measures, payment procedures and the internal control system which are in operation.	The 'three-tiers' of Government in Nigeria do comply, accordingly.
(e) Accounting systems ought to be developed in a manner that will permit effective control of fund operation management and internal audit appraisal	The Financial Regulations stated in (d) above meet substantially the international requirements.	Programme management is however in its infancy under the planning programming Budgeting System which has been introduced.
(f) The accounts should be developed and prepared so that they would effectively disclose the economic and financial results of programme operations, including the measurement of revenues, identification of costs and determination of	The cash basis of accounting adopted does not allow the underlying pronouncement to be incorporated in Nigeria	Nigeria Accounting System partially complies with this. There is notional compliance.

the operating results (the surplus or deficit positions) of the Government and its Agencies.		
(g) Accounting systems should be capable of serving the basic financial information needs of development, planning and appraisal of performance in physical and financial terms.	-do-	Cash accounting basis seems to constrain the realization of this useful objectives.
(h) The accounts should be maintained in a manner which will provide financial data useful for economic analysis and re-classification of governmental transactions.	-do-	Planning, Programming and Budgeting System and the accrual accounting basis need to be firmly implanted for this as well as for the United Nations recipes under (f) and (g) above.

Alternative Classifications for Government Accounting

The conventional classification systems are fashioned along organisational lines. They are concerned mainly with the listing of receipts by the various descriptions and sources. Expenditures by objectives (e.g. personal services and supplies); this kind of presentation is referred to as the "object-cum-organisational classification". The mode serves limited purpose. It does not assist in effective managerial and economic analyses, planning and decision-making.

Illustration

Object-Cum-Organisational Presentation of Government Expenditure Descriptions

(a) Personnel Services and Benefits

Item No	Description
11	Personnel Compensation
12	Personnel benefits
13	Benefits for Former Personnel

(b) Contractual services and supplies

Item no	Description
21.	Travel and transportation of staff
22.	Transportation of material.
23.	Recent communication and utilities.
24.	Printing and reproduction.
25.	Other services.

26.	Supplies and materials.

(c) Acquisition of capital assets:

Item no	Description
31.	Equipment
32.	Land and building
33.	Investments and loans.

(d) Grants and fixed charges:

Item no	Description
41.	grants, subsidies and contribution
42.	Insurance claims and indemnities
43.	Interest and dividends
44.	Refunds

A better arrangement is one in which government receipts and disbursements are classified by economic categories, and split by current and capital items (e.g. current expenditures on goods and services, interest payments). Apart from economic classification, services provided should be grouped functionally (e.g. expenditure by community services and social services), as shown below. However, the functions can be further classified into programmes, activities or projects.

Illustration

(a) General/services:

Item no	Description
11.	General administration.
12.	Defense.
13.	Justice and police.

(b) Community service:

Item no	Description
21.	Road and waterways
22.	Fire protection, water supply and sanitation.
23.	Other community service.

(c) Social Service:

Item no	Description
31.	Education
32.	Health
33.	Social security and special welfare services.
34.	Other social.

(d) Economic services

Item no	Description
41.	Agriculture and non-mineral resources.
42.	Fuel and power
43.	Other mineral resources, manufacturing & construction
44.	Transportation, storage and communications.
45.	Other economic services.

(e) Disallowable Expenditure:

Item no	Description
51.	Interest on general debt.
52.	Subsidies not included elsewhere
53.	General transfers to local governments councils.
54	foreign economic aid and other unallowable transfers to abroad

GOVERNMENT ACCOUNTING IN OTHER COUNTRIES

It is difficult to report on the accounting in all the advance countries of the world in one book. An attempt is hereby made on a broad summary of the accounting practices in the United States of America which adopts the presidential system of government, and the United Kingdom from which Nigeria originally derived its accounting system.

United States of America

The practice of government accounting in United States of America has come a long way through criticism, research studies backed by public hearings and political evolution. The American congress has the power of the "purse", politically, in consonance with the stipulations of the country's constitutions, as far back as 1901, when the American society was in search of an efficient accounting system, many agencies and public bodies had criticised the existing accounting system.

In that year, for example, the firm of Haskins and sells, certified public accountants, made an investigation into the affairs of the city of Chicago at the request of the merchants club and subsequently installed a completely new system of accounting for that city. Revolution in system of accounting swept through the cities of Newton, Massachusetts and Baltimore. In view of well informed and volatile nature of the society dynamic reforms had gone on since then.

On 1 July, 1974, the national council on government accounting (NCGA) was formed. The council conducts and sponsors research, holds public hearing and issues formal statements and interpretations with regards to principles and standards of government budgeting, accounting, reporting and auditing.

United Kingdom

Government accounting in the United Kingdom is the same approach adopted by Nigeria, since the colonial era. While, however, the United Kingdom has not stooped research work, Nigeria's system has not experienced radical charge. The last comprehensive review made by the country was in 1976.

In 1984, two scholars, conducted, in the United Kingdom, a research entitled, "The Structure and Form of Government Expenditure Report: Proposals and Reforms." The research effort conducted that government should continue to adopt the 'cash basis' of accounting.

Some Observation on Government Accounting System in "Third World" Countries

Unlike the advance countries, where research work has been documented and published, the records of general practice in the individual countries in the 'third world' are difficult to obtain.

The general features of government accounting system are published by the United Nations are as follows:

a. Relatively little has been given to social government accounting and budgetary control system.
b. Accounting procedures in government departments which reflect complicated systems of check and balances tend to hamper the efficacy and timeliness of the accounting information and statistics produced.
c. Government accounting is seen mainly as an accountability device for the public receipts and expenditure. Efficiency, effectiveness and economy of the operations tend be neglected.
d. Bookkeeping or administrative legal compliance procedures are more common than modern accounting approaches.
e. Accounting tends to be identified with expenditure control. The fact is that expenditure is subject to multiple checks.
f. The amount of paper work is much, but no efficiency accountability or financial control is achieved.
g. The accounting data upon which government budgets and plans are based are frequently inaccurate and incomplete.
h. Financial reports are delayed and generally in arrears. They consequently become obsolete at the point of implementation.

Performance budgeting systems and methods need to be installed. Care should be taken in changing from the traditional budgets to performance budgets. It is better to start first with performance budgeting procedures which are geared towards national plans, and graduate into elaborate areas of planning, programming and budgeting system.

Features of a Good System of Government Accounting as Contained in a United Nations Manual on Government Accounting

The system must:

a. Comply with constitutional, statutory and other legal requirements of the relevant country;
b. Be related to budget classification. Budgetary financial management must be closely integrated;
c. Be maintained in a manner that will clearly identify the objects and purpose for which funds have been received and expended, and the executive authorities who are responsible for the custody and used of funds in Programme I budget implementation;
d. Maintained records in a way that will facilitates audit by external review authorities and readily furnish the information needed for effective audit;
e. Be developed in a manner that will permit administrative control of funds;
f. Be developed so that it effectively discloses the economic and financial results of programmes operations, including the sources of revenue, identification of costs and determination of the operating results of government programmes and organization;
g. Be maintained in a manner that will provide financial data useful for economic analysis and identification of governmental transactions and also assist in the development of the country's accounts.

3.03 Current Issues

This is an area that can cover many different areas, including:

i. Recently issued or revised financial reporting standards
ii. Discussion papers and exposure drafts
iii. Recent developments in international harmonisation
iv. Current business issues which impact financial reporting.

The problem facing students is that there are many current issues, and so it is difficult to know where to focus study efforts. This article does not try to cover every current issue in the world of corporate reporting, but instead provides some information on three of the 'hot topics' that arise from documents issued by the International Accounting Standards Board (IASB). We will look at the issues of leasing, income tax and management commentary as these are all the subjects of examinable documents for exams in 2010.

Leases

In March 2009, the IASB and the FASB (Financial Accounting Standards Board – the source of US GAAP), published a discussion paper 'Leases: Preliminary Views'. This document is part of the IASB's long-term convergence project, the aim of which is to eliminate a variety of differences between IFRS and US GAAP.

The aim of the leases project is to develop a new single approach to lease accounting that would ensure that all assets and liabilities arising under lease arrangements are recognised in the statement of financial position (balance sheet). The topic of lease accounting has been long debated, with many preparers and users of financial statements claiming that the current treatment under IAS 17, Leases is too subjective and can too easily result in off-balance sheet finance.

The Discussion Paper is extremely significant, because it proposes a fundamental change in the way that leases are accounted for. It introduces the 'right-of-use' model, under which the lessee will recognise an asset and a liability for all leases entered into. This effectively eliminates the current category of an operating lease, and would ensure that all leases are treated in a consistent way. This change would have a massive impact in terms of financial reporting for the many companies who use operating leases within their business as all leases would now have to be recognised, with implications for measures such as return on capital employed and liquidity ratios.

The accounting treatment is explained as follows. The asset represents the lessee's right to use the leased item for the lease term (hence the term 'right-of- use' model) and the liability represents the obligation to pay rentals. The asset would be initially recognised at cost, with cost defined as 'the present value of the lease payments discounted using the lessee's incremental borrowing rate'. The asset would be amortised over the shorter of the lease term and the economic life of the asset, or if the lessee expects to obtain the title to the asset at the end of the lease term, over the economic life of the asset. The liability would be recognised initially at the same amount as the asset, i.e. 'the present value of the lease payments discounted using the lessee's incremental borrowing rate'. The liability would be subsequently amortised using an amortised cost-based approach.

The Discussion Paper also includes proposals on more complex issues, such as renewal options, contingent rentals, and residual value guarantees. All of the proposals are focused on lessee accounting. It is thought that lessor accounting will be dealt with once the tentative proposals in the Discussion Paper have been fully considered by the IASB. To conclude on leases, if the proposals do eventually form the basis of a new financial reporting standard, it will be one of the most significant developments to arise from the IASB's convergence project. Having one method to account for all types of leases will go a long way to improve consistency and comparability, though some may argue that using one method for all types of lease is too simplistic. An Exposure Draft on leases is expected in the third quarter of 2010.

Income tax

In March 2009, the IASB issued an Exposure Draft 'Income Tax'. This exposure draft is also part of the IASB's long-term convergence project. The Exposure Draft is proposing to replace IAS 12, Income Taxes and is an examinable document for Paper P2 exams in 2010.

The proposals retain the basic IAS 12 approach to accounting for deferred tax, known as the temporary difference approach. The objective of that approach is to recognise immediately the future tax consequences of past events and transactions. Although the proposals retain the same basic principle, the IASB intends to change the methodology used to calculate deferred tax, change some of the definitions, eliminate some recognition exceptions, and introduce guidance on dealing with uncertainties.

In addition, the IASB proposes a changed structure for the standard that will make it easier to use. The proposals also more closely align with FASB Statement 109, Accounting for Income Taxes, though some differences may remain.

A change in the methodology used to calculate deferred tax assets and liabilities is proposed. It would only be necessary to consider deferred tax in respect of assets and liabilities where the company expects the recovery or settlement of the carrying amount to affect taxable profit. For example, if a nil tax rate would apply to any taxable or deductible amounts, then no deferred tax arises, as there is no future tax consequence.

A new definition for 'tax basis' (previously known as 'tax base') is proposed as 'the measurement, under applicable substantively enacted tax law, of an asset, liability or other item'. The definition is not very different from before, but the further guidance in the Exposure Draft makes an important point that the tax basis of an asset should be determined based on the assumption that an asset will be sold, and for liabilities on the assumption that the liability will be settled for its carrying amount.

The Exposure Draft proposes the elimination of recognition exceptions on initial recognition of assets and liabilities and for many investments. The current IAS 12 exception prohibits the recognition of deferred tax liabilities and assets in relation to temporary differences arising on the initial recognition of an asset or liability (other than in a business combination where the asset or liability does not impact accounting profit or taxable profit at the time of recognition). The proposal could result in the recognition of deferred tax arising on the difference between the initial carrying amount of an asset or liability and its tax basis, even if the recognition is nothing to do with a business combination. It is therefore likely that many more balances recognised in the financial statements could result in an associated deferred tax asset or liability.

New guidance has been included to help companies to account for uncertain tax positions. A probability weighted average amount of all possible outcomes should be calculated, based on the assumption that the tax authorities will review the amounts submitted and have full knowledge of all relevant information. Examples of the calculation are provided in the Exposure Draft. In conclusion, there are many detailed changes proposed in relation to the calculation and recognition of deferred tax, though the fundamental principle of comparing book values with tax bases in determining temporary differences remains unchanged.

Management Comment

Most large companies provide some kind of management commentary, which is published alongside the financial statements. The commentary could be known as an Operating and Financial Review (OFR), Business Review, Management's Discussion and Analysis (MD&A) or Management's Report. Management commentary is therefore already an important means by which companies communicate with capital markets and with their stakeholders.

In some jurisdictions there is already a framework to be used by companies in preparing management commentary, and indeed in some countries there are specific legal requirements regarding its content.

In June 2009 the IASB published an Exposure Draft 'Management Commentary' which proposes a framework for the preparation and presentation of management commentary to accompany financial statements that are prepared under IFRS. The intention is that the final document would have the status of a best practice framework. Following the framework would not be compulsory, and the framework could be adapted to the legal and economic circumstances of individual jurisdictions.

The Exposure Draft states that the purpose of management commentary is to provide existing and potential capital providers with information that helps them place the related financial statements in context. Management commentary should explain management's view on not only what has happened, but also why management believes it has happened and what management believes the implications are for the entity's future. It should explain the main trends and factors that are likely to affect the entity's future performance, position and development. Consequently, management commentary looks not only at the present, but also at the past and the future.

The IASB proposes that management commentary should contain information on the following:

i. The nature of the business.
ii. Management's objectives and strategies for meeting those objectives.
iii. The entity's most significant resources, risks and relationships.
iv. The results of operations and prospects, and
v. The critical performance measures.

And indicators that management uses to evaluate the entity's performance against stated objectives.

The Exposure Draft provides detailed guidance as to the types of disclosures that would be relevant for each of the categories above. In brief, there should be a mixture of narrative and numerical disclosures, and the performance measures should be both financial and non-financial in nature.
Consistent reporting of performance measures and indicators increases the comparability of management commentary over time. However, as strategies and objectives change, management might decide that the performance measures and indicators presented in the previous period management commentary are no longer relevant. Therefore, the content of management commentary should be seen as something that continually evolves over time, to match with changes in the company itself. In conclusion, management commentary should supplement and complement the financial statements, include orientation to the future, and fairly present the views of management on the relationship between the financial statements and the company's strategies and objectives.

This article has looked at three of the many current issues in corporate reporting. In the past few years, current issues have been tested in the final question of the paper, using a mixture of requirements asking for narrative and numerical answers. Though the subject matter has not been covered in this article, I would recommend that students read Question 4 from the December

2009 session (this question was on complexity in the measurement of financial instruments and was based on the relevant Exposure Drafts on financial instruments), and from the June 2009 exam session (this question was on employee benefits and again based on the relevant Exposure Draft).

3.04 Reasons for Accounting Diversity

Although accounting standards and practices are the same across the board in their origin, the Accounting and taxation structures of different countries around the world make them vary between countries. Different countries apply different accounting practices. This accounting diversity is the reason that one company may seem profitable while another seems to be operating at a loss. This difference between global accounting practices can head to poor business decision-making difficulties in raising capital in different or foreign markets, and difficulty in monitoring competitive factors across firms, industries and nations. These accounting practices are linked to the objectives of the parties who will use the financial information, including investors, lender and governments.

While International Accounting Standard Committee is trying to make a single set of high quality understandable, enforceable accounting standards worldwide, the USA is resisting, insisting that no standard is good as ours. We use the GAAP, or the Generally Accepted Accounting Principles. However, because of the Enron situation, the US standards dropped and support for the international standards increased. To engage in social interaction, it amount to playing a language game that is the conventional application of certain concept or the interaction of certain rules which define a particular version of the world as relevant. The rules of the language-game, when they are eventually internalized, thereby constitute a cognitive matrix of varying complexity, through which one perceived and interprets events taking place in the World. The difference in accounting principles between countries could really cause inconsistencies between international operations. Maybe if an international standard were set for all countries, there would be less quarrelling and more agreement in accounting between countries. There would be less discrepancy in the accounting principles. Considerable differences exist across countries in the accounting treatment of many items. For example, companies in the United States are not allowed to report property, plant, and equipment at amounts greater than historical cost.

In contrast, companies in the European Union are allowed to report their assets on the balance sheet at market values. Research and development costs must be expensed as incurred in Japan, but development costs may be capitalized as an asset in Canada and France. Chinese companies are required to use the direct method in preparing the statement of cash flows, whereas most companies in the United States and Europe use the indirect method.

Differences in accounting can result in significantly different amounts being reported on the balance sheet and income statement.

Economic Factors for Accounting Harmonization:

The economic factors which influenced and will continue to influence the development of international accounting are:

1. The emergence of the globalize economy
2. The introduction of multilateral trading cooperation and trade liberalization at the global and regional levels.
3. The developments in the international monetary system.
4. The activities of the IMF and the World Bank
5. The increase in foreign direct investment, and
6. The role of the multinational companies.

The activities and roles of these economic factors or groups on the international business scene were discussed in chapter two. They are mainly responsible for the growing internationalization and deeper economic integration among the world economies, as well as for the interdependence of countries in international trade, investment, and financial and capital flows. The continued existence and activities of these factors or groups underline the great necessity for international accounting harmonization.

Some additional needs for international accounting harmonization may be summarized as follows:

a. Harmonization of accounting principles is needed in a world where some countries have involved differing principles and have also established or are establishing some form of national harmonization by means of accounting standard as in UK, or accounting plans France, or legal codification as in Germany or GAAP as in USA. Other countries have inadequate codified standards of accounting and auditing, while some countries have done little or nothing to address the same issue.
b. Investors, stocks exchanges, and securities commissions world-wide would all like to see an increase in the of multinational offerings and foreign listings by world class companies, but they also would want companies to publish relevant and reliable financial information that is comparable with the information published by bother companies. Equally, the companies themselves want access to the world's capital markets but without the burden of having to comply with different accounting requirements. As well as being a burden on the companies, different national

accounting requirements add to confusion when a profit under another set of requirements, as was the case in 1993 with Daimler Benz.

c. With the diversity in accounting and auditing standards as well as in disclosure requirements among nations, cross-border analysis of financial information will be an uphill task for investors who would want to achieve an efficient investment portfolio through comparison of financial statements of companies on an internationally compatible basis.
d. The multinational companies that wish to diversity globally by attracting foreign investments would be denied such opportunities if prospective investors in international markets shy away from making such investments due to the difficulty in subjecting financial information of the MNCs to cross-border analysis. In other worlds, investors in international markets who rely on financial information to guide their investment decisions show a preference for financial reports that are comparable.
e. In a country where accounting standards are hitherto non-existent, international accounting standards could be adopted as the country's local accounting practices and of making the financial reports emanating from that country internationally and compatible. Besides, it will reduce the set-up cost in time and money for a national standard or the country.
f. In countries where national accounting standards are already in place, they may be compared with the international accounting differences.
g. In countries where the accounting regulatory framework is legally codified, the accounting rules could be harmonized in line with the international comparability.

The world-wide harmonization effort of the IASC aimed at improving the accounting practices and principles used in preparing financial statements used internally presupposes the existence of national accounting standards in many cases. The achievement of global harmonization of accounting principles will not be impaired by the existence of national accounting frameworks based on the adaptation of their national circumstances, provided that reduction of disparities in national standards should be given a priority and be done within a framework of candidness and transparency.

The IASC, which is in the forefront in the harmonization effort, maintains that an important factor in the improvement and harmonization of accounting practices will be the extent to which international accounting standards, or national standards compatible with them, are adopted as the most suitable basis for accounting and reporting. An increasing number of countries already do so, recognizing the benefits of the worldwide acceptability of international accounting standards, their appropriateness in international commerce and trade, and the advantages of comparability and compatibility that flow from them. Therefore, "…the adoption by two or more countries of a common improvement to their existing accounting standards represents and enhancement of international comparability and a step toward the ultimate goal of developing a body of superior international accounting standards".

Why do financial reporting practices differ across countries? Accounting scholars have hypothesized numerous influences on a country's accounting system, including factors as varied as the nature of the political system, the stage of economic development, and the state of accounting education and research. A survey of the relevant literature has identified the following five items as being commonly accepted as factors influencing a country's financial reporting practices:

(1) Legal system, (2) taxation, (3) providers of financing, (4) inflation, and (5) political and economic ties.

Legal System

There are two major types of legal systems used around the world: common law and codified Roman law. Common law began in England and is primarily found in the English-speaking countries of the world. Common law countries rely on a limited amount of statute law, which is then interpreted by the courts. Court decisions establish precedents, thereby developing case law that supplements the statutes. A system of code law, followed in most non-English-speaking countries, originated in the Roman *jus civil* and was developed further in European universities during the middle Ages. Code law countries to have relatively more statute or codified law governing a wider range of human activity.

What does a country's legal system have to do with accounting? Code law countries generally have corporation law (sometimes called a commercial code or companies act), which establishes the basic legal parameters governing business enterprises. The corporation law often stipulates which financial statements must be published in accordance with a prescribed format. Additional accounting measurement and disclosure rules are included in an accounting law debated and passed by the national legislature. In countries where accounting rules are legislated, the accounting profession tends to have little influence on the development of accounting standards. In countries with a tradition of common law, although a corporation law laying the basic framework for accounting might exist (such as in the United Kingdom), specific accounting rules are established by the profession or by an independent non-governmental body representing a variety of constituencies. Thus, the type of legal system in a country tends to determine whether the primary source of accounting rules is the government or a non-governmental organization.

In *code law* countries, the accounting law tends to be rather general and does not provide much detail regarding specific accounting practices and may provide no guidance at all in certain areas. Germany is a good example of this type of country. The German accounting law passed in 1985 is only 47 pages long and is silent with regard to issues such as leases, foreign currency translation, and cash flow statements. When no guidance is provided in the law, German companies refer to other sources, including tax law, opinions of the German auditing profession, and standards issued by the German Accounting Standards Committee, to decide how to do their accounting. Interestingly enough, important sources of accounting practice in Germany have been textbooks and commentaries written by accounting academicians.

In *common law* countries, where there is likely to be a non-legislative organization developing accounting standards, much more detailed rules are developed.
The extreme case might be the Financial Accounting Standards Board (FASB) in the United States, which provides a substantial amount of implementation guidance in its accounting standards codification (ASC) and updates and has been accused of producing a "standards overload. "To illustrate this point, consider the rules related to accounting for leases established by the FASB in the United States and in German accounting law. In the United States, leases must be capitalized if any one of four very specific criteria is met. Additional guidance establishes rules for specific situations such as sales with leasebacks, sales-type leases of real estate, and changes in leases resulting from refunding of tax-exempt debt. In contrast, the German accounting law is silent with regard to leases. The only guidance in the law can be found in paragraph285, which simply states that all liabilities must be recorded.

Taxation

In some countries, published financial statements form the basis for taxation, whereas in other countries, financial statements are adjusted for tax purposes and submitted to the government separately from the reports sent to stockholders. Continuing to focus on Germany, the so-called congruency principle in that country stipulates that the published financial statements serve as the basis for taxable income. In most cases, for an expense to be deductible for tax purposes it must also be used in the calculation of financial statement income. Well-managed German companies attempt to minimize income for tax purposes, for example, through the use of accelerated depreciation, so as to reduce their tax liability. As a result of the congruency principle, accelerated depreciation must also be taken in the calculation of accounting income. In the United States, in contrast, conformity between the tax statement and financial statements is required only with regard to the use of the last-in, first-out (LIFO) inventory cost flow assumption. U.S. companies are allowed to use accelerated depreciation for tax purposes and straight-line depreciation in the financial statements. All else being equal, because of the influence of the congruency principle, a German company is likely to report lower income than its U.S. counterpart.

The difference between tax and accounting income gives rise to the necessity to account for deferred income taxes, a major issue in the United States in recent years. Deferred income taxes are much less of an issue in Germany; for many German companies, they do not exist at all. This is also true in other code law countries such as France and Japan.

Providers of Financing

The major providers of financing for business enterprises are family members, banks, governments, and shareholders. In those countries in which company financing is dominated by families, banks, or the state, there will be less pressure for public accountability and information disclosure. Banks and the state will often in compliance with European Union regulations, Germany requires publicly traded companies to use International Financial Reporting Standards (IFRS) to prepare their consolidated financial statements.

German accounting law continues to be used by privately held companies and by publicly traded companies in preparing parent company financial statements.

German taxable income is computed by comparing an opening and closing tax balance sheet, the *Steuerbilanz*. The tax balance sheet is based on the published balance sheet, the *Handelsbilanz* be represented on the board of directors and will therefore be able to obtain information necessary for decision making from inside the company. As companies become more dependent on financing from the general populace through the public offering of shares of stock, the demand for more information made available outside the company becomes greater. It simply is not feasible for the company to allow the hundreds, thousands, or hundreds of thousands of shareholders' access to internal accounting records. The information needs of those financial statement users can be satisfied only through extensive disclosures in accounting reports.

There can also be a difference in financial statement orientation, with stockholders more interested in profit (emphasis on the income statement) and banks more interested in solvency and liquidity (emphasis on the balance sheet). Bankers tend to prefer companies to practice rather conservative accounting with regard to assets and liabilities.

Inflation

Countries experiencing chronic high rates of inflation found it necessary to adopt accounting rules that required the inflation adjustment of historical cost amounts. This was especially true in Latin America, which as a region has had more inflation than any other part of the world. For example, throughout the 1980s and1990s, the average annual rate of inflation rate in Mexico was approximately 50 percent, with a high of 159 percent in 1987. 7 Double- and triple-digit inflation rates render historical costs meaningless. Throughout most of the latter half of the20th century, this factor primarily distinguished Latin America from the rest of the world with regard to accounting. Adjusting accounting records for inflation results in a write-up of assets and therefore related expenses. Adjusting income for inflation is especially important in those countries in which accounting statements serve as the basis for taxation; otherwise, companies will be paying taxes on fictitious profits.

Political and Economic Ties

Accounting is a technology that can be relatively easily borrowed from or imposed on another country. Through political and economic links, accounting rules have been conveyed from one country to another. For example, through previous colonialism, both England and France have transferred their accounting frameworks to a variety of countries around the world. British-style accounting systems can be found in countries as far-flung as Australia and Zimbabwe. French accounting is prevalent in the former French colonies of western Africa. More recently, it is thought that economic ties with the United States have had an impact on accounting in Canada, Mexico, and Israel.

Correlation of Factors

Whether by coincidence or not, there is a high degree of correlation between legal system, tax conformity, and source of financing. As Exhibit 2.4 shows, common law countries tend to have greater numbers of domestic listed companies, relying more heavily on equity as a source of capital. Code law countries tend to link taxation to accounting statements and rely less on financing provided by shareholders.

3.05 Consequences of Accounting Diversity

Preparation of Consolidated Financial Statements

The diversity in accounting practice across countries causes problems that can be quite serious for some parties. One problem relates to the preparation of consolidated financial statements by companies with foreign operations. Consider General Motors Corporation, which has subsidiaries in more than 50 countries around the world. Each subsidiary incorporated in the country in which it is located is required to prepare financial statements in accordance with local regulations.

These regulations usually require companies to keep books in local currency using local accounting principles. Thus, General Motors de Mexico prepares financial statements in Mexican pesos using Mexican accounting rules and General Motors Japan Ltd. prepares financial statements in Japanese yen using Japanese standards.

To prepare consolidated financial statements in the United States, in addition to translating the foreign currency financial statements into U.S. dollars, the parent company must also convert the financial statements of its foreign operations into U.S. GAAP. Each foreign operation must either maintain two sets of books prepared in accordance with both local and U.S. GAAP or, as is more common, reconciliations from local GAAP to U.S. GAAP must be made at the balance sheet date.

In either case, considerable effort and cost are involved; company personnel must develop an expertise in more than one country's accounting standards.

Access to Foreign Capital Markets

A second problem caused by accounting diversity relates to companies gaining access to foreign capital markets. If a company desires to obtain capital by selling stock or borrowing money in a foreign country, it might be required to present a set of financial statements prepared in accordance with the accounting standards in the country in which the capital is being obtained. Consider the case of the semiconductor manufacturer STMicroelectronics, which is based in Geneva, Switzerland. The equity market in Switzerland is so small (there are fewer than8 million Swiss) and ST's capital needs are so great that the company has found it necessary to have its common shares listed on the Euro next-Paris and Borsa Italian stock exchanges in Europe and on the New York Stock Exchange in the United States. To have stock traded in the United States, foreign companies must either prepare financial statements using U.S. accounting standards or provide are conciliation of local GAAP net income and stockholders' equity to U.S. GAAP.

Relationship between Several Factors Influencing Accounting Diversity

This can be quite costly. In preparing for a New York Stock Exchange (NYSE) listing in 1993, the German automaker Daimler-Benz estimated it spent $60 million to initially prepare U.S. GAAP financial statements; it expected to spend $15 million to $20 million each year thereafter. 9 The appendix to this chapter describes the case of Daimler-Benz in becoming the first German company to list on the NYSE. As noted in Chapter 1, the U.S. SEC eliminated the U.S. GAAP reconciliation requirement for those foreign companies using IFRS to prepare their financial statements. However, foreign companies not using IFRS continue to provide U.S. GAAP information.

Comparability of Financial Statements

A third problem relates to the lack of comparability of financial statements between companies from different countries. This can significantly affect the analysis of foreign financial statements for making investment and lending decisions.

In 2003 alone, U.S. investors bought and sold nearly $3 trillion worth of foreign stocks while foreign investors traded over $6 trillion in U.S. equity securities. In recent years there has been an explosion in mutual funds that invest in the stock of foreign companies. As an example, the number of international stock funds increased from 123 in 1989 to 534 by the end of 1995. T. Rowe Price's New Asia Fund, for example, invests exclusively in stocks and bonds of companies located in Asian countries other than Japan. The job of deciding which foreign company to invest in is complicated by the fact that foreign companies use accounting rules different from those used in the United States and those rules differ from country to country. It is very difficult if not impossible for a potential investor to directly compare the financial position and performance of an automobile manufacturer in Germany (Volkswagen), Japan (Nissan), and the United States (Ford) because these three countries have different financial accounting and reporting standards.

According to Ralph E. Walters, former chairman of the steering committee of the International Accounting Standards Committee, “either international investors have to be extremely knowledgeable about multiple reporting methods or they have to be willing to take greater risk.”

A lack of comparability of financial statements also can have an adverse effect on corporations when making foreign acquisition decisions. As a case in point, consider the experience of foreign investors in Eastern Europe. After the fall of the Berlin Wall in1989, Western companies were invited to acquire newly privatized companies in Poland, Hungary, and other countries in the former communist bloc. The concept of profit and accounting for assets in those countries under communism as so different from accounting practice in the West those most Western investors found financial statements useless in helping to determine which enterprises were the most attractive acquisition targets. In many cases, the international public accounting firms were called on to convert financial statements to a Western basis before acquisition of a company could be seriously considered.

There was a very good reason why accounting in the communist countries of Eastern Europe and the Soviet Union was so much different from accounting in capitalist countries. Financial statements were not prepared for the benefit of investors and creditors to be used in making investment and lending decisions.

Instead, financial statements were prepared to provide the government with information to determine whether the central economic plan was being fulfilled. Financial statements prepared for central planning purposes have limited value in making investment decisions.

Lack of High-Quality Accounting Information

A fourth problem associated with accounting diversity is the lack of high-quality accounting standards in some parts of the world. There is general agreement that the failure of many banks in the 1997 East Asian financial crisis was due to three factors: a highly leveraged corporate sector, the private sector’s reliance on foreign currency debt, and a lack of accounting transparency. To be sure, inadequate disclosure did not create the East Asian meltdown, but it did contribute to the depth and breadth of the crisis. As Rahman explains, “It is a known fact that the very threat of disclosure influences behaviour and improves management, particularly risk management. It seems that the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practices of the corporations and banks in the crisis-hit countries."

International investors and creditors were unable to adequately assess risk because financial statements did not reflect the extent of risk exposure due to the following disclosure deficiencies:

i. The actual magnitude of debt was hidden by undisclosed related-party transactions and off-balance-sheet financing.
ii. High levels of exposure to foreign exchange risk were not evident.
iii. Information on the extent to which investments and loans were made in highly speculative assets (such as real estate) was not available.
iv. Contingent liabilities for guaranteeing loans, often foreign currency loans, were not reported.
v. Appropriate disclosures regarding loan loss provisions were not made.

Because of the problems associated with worldwide accounting diversity, attempts to reduce the accounting differences across countries have been on-going for over three decades. This process is known as *harmonization.* The ultimate goal of harmonization is to have one set of international accounting standards that are followed by all companies around the world.

3.06 Harmonization of Accounting Diversity

The convergence or harmonization of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally and in particular the effort to reduce the differences between the US Generally Accepted Accounting Principle (US GAAP) and the International Financial Reporting Standards (IFRS).

Convergence in some form as been taking place for several decades, and efforts accelerated when the main standard-setting body in the USA, the Financial Accounting Standards Board (the FASB), and the International Accounting Standard. Board agrees at their Norwalk meeting in 2002, to work towards making their existing and future financial reporting standards fully compatible.

Convergence is motivated by several factors, including the belief that having a single set of accounting requirements would increase the comparability of different entities financial statements, which will contribute to the flow of international investment and benefit a variety of stakeholders. Criticisms of convergence include its cost and pace, and the idea that the link between convergence and comparability may not be strong.

Motivations for convergence include the belief that it will result in increased comparability between financial statements, which will benefit a variety of stakeholders. For example, the FASB believes that *'investors, companies, auditors, and other participants in the U.S.*

financial reporting system" will benefit from converged standards because it will result in increased comparability between the financial statements of different firms.

A report by PricewaterhouseCoopers (PwC) in 2008 stated that convergence of accounting standard would contribute to the flow of international investment and benefit '*all capital markets stakeholders"* because it:

1. Renders international investments more comparable to investors;
2. Reduces the cost of complying with accounting requirements for global businesses;
3. Potentially establishes a more transparent accounting system with greater accountability;
4. Reduces "operational challenges" for accounting firms; and
5. Gives standard-setter. The opportunity to "improve the reporting model'.

Criticisms

The goal of and various proposed steps achieve convergence of accounting standards has been criticized by various individuals and organizations. For example, in 2006 senior partners at PricewaterhouseCoopers (PwC) called for convergence to be "shelved indefinitely" in a draft paper, calling for the IASB to focus instead on improving its own set of standards.

In particular, senior academics have called the link between convergence and comparability "overblown', while the cost out-ways the benefits and the pace of adoption have been cited as the most common criticism.

Nature of standards

Other criticisms centre on the nature of the converged standards. For example, some critics are concerned that convergence will increase the use of fair value accounting.

Other critics have also respectively cited shortcomings with rules-based and principles-based standards as reasons. Principles-based standards allow for "different interpretations for similar transactions", and have also been described as "less precise", while rules-based standards contain more exceptions and use bright-line rules and specific details to deal with 'as many potential contingencies as possible". The abovementioned PwC senior partners expressed their Concern that convergence will lead to an accounting system that is too rules-based for non-US listed companies, while other critics conversely criticize the principles-based nature of the IFRS as making it difficult for preparers of financial statement to defend against litigation.

Advantages of International Harmonization

i. Investors have greater comparability of financial statements which enables easier investment decisions. This is important in the context of global investment which has become more significant in the last decade.

ii. Governments will not have to develop accounting standards for their own countries, reducing bureaucracy and cost.

iii. Accounting firms with international practices will find it easier to deal with staff resourcing in countries experiencing boom or recessionary times due to common accounting standards allowing staff transferability between countries wish no major impact or services delivered.

iv. Companies:

   a. Management control of foreign subsidiaries will be different

   b. Consolidation of financial statements of subsidiaries will be easier as they will operate under the same standards

   c. Easier to comply with stock exchange reporting requirement

   d. Investment more likely as investors will have a greater knowledge and reliance on the financial statements.

Obstacles to International Harmonization

i. Different purposes of financial statements i.e. IFRS's aimed at investment decision-making, whereas many countries use financial statements for tax purposes

ii. Nationalism — possible unwillingness to accept another countries standards

iii. Different legal systems whereby some countries require certain accounting practices and policies and other countries do not;

iv. Different users of financial statements. Countries vary in the importance they place on users groups

v. Lack of strong accountancy bodies. Many accountancy bodies in various countries are not independently strong enough to press for harmonization of accounting standards in their jurisdiction;

vi. Language and cultural differences. Both of these can cause difficulties in the adoption of standards accounting standards.

ACCOUNTING CLUSTERS

Given the discussion regarding factors influencing accounting practice worldwide, it should not be surprising to learn that there are clusters of countries that share common accounting orientation and practices. One classification scheme identifies three major accounting models: the Fair Presentation/Full Disclosure Model, the Legal Compliance Model, and the Inflation-Adjusted Model.

The Fair Presentation/Full Disclosure Model (also known as the Anglo-Saxon or Anglo-American model) is used to describe the approach used in the United Kingdom and United States, where accounting is oriented toward the decision needs of large numbers of investors and creditors. This model is used in most English-speaking countries and other countries heavily influenced by the United Kingdom or the United States. Most of these countries follow a common law legal system.

The Legal Compliance Model originated in the code law countries of continental Europe; it is also known as the Continental European model. It is used by most of Europe, Japan, and other code law countries. Companies in this group usually are tied quite closely to banks that serve as the primary suppliers of financing. Because these are code law countries, accounting is legalistic and is designed to provide information for taxation or government-planning purposes.

The Inflation-Adjusted Model is found primarily in South America. This model resembles the Continental European model in its legalistic, tax, and government planning orientation. This model distinguishes itself, however, through the extensive use of adjustments for inflation.

A Judgmental Classification of Financial Reporting Systems

Concentrating on the Anglo-Saxon and Continental European Model countries, Nobes developed a more refined classification scheme that attempts to show how the financial reporting systems in 14 developed countries relate to one another.

The terms *micro-based* and *macro-uniform* describe the Anglo-Saxon and Continental European Models, respectively. Each of these classes is divided into two subclasses that are further divided into families. Within the micro-based class of accounting system, there is a subclass heavily influenced by business economics and accounting theory. The Netherlands is the only country in this subclass.

One manifestation of the influence of theory is that Dutch companies may use current replacement cost accounting to value assets in their primary financial statements. The other micro-based subclass, of British origin, is more pragmatic and is oriented toward business practice, relying less on economic theory in the development of accounting rules. The

British-origin subclass is further split into two families, one dominated by the United Kingdom and one dominated by the United States. Nobes does not indicate how these two families differ.

On the macro-uniform side of the classification, a "government, economics" subclass has only one country, Sweden. Swedish accounting distinguishes itself from the other macro-uniform countries in being closely aligned with national economic policies. For example, income smoothing is allowed to promote economic stability and social accounting has developed to meet macroeconomic concerns. The "continental: government, tax, legal" subclass primarily has Continental European countries. This subclass is further divided into two families. Led by Germany, the law-based family includes Japan. The tax-based family consists of several Romance-language countries. The major difference between these families is that the accounting law is the primary determinant of accounting practice in Germany, whereas the tax law dominates in the Southern European countries.

The importance of this hierarchical model is that it shows the comparative distances between countries and could be used as a blueprint for determining where financial statement comparability is likely to be greater. For example, comparisons of financial statements between the United States and Canada (which are in the same family) are likely to be more valid than comparisons between the United States and the United Kingdom (which are not in the same family). However, the United States and the United Kingdom (which are in the same subclass) are more comparable than are the United States and the Netherlands (which are in different subclasses). Finally, comparisons between the United States and the Netherlands (which are in the same class) might be more meaningful than comparisons between the United States and any of the macro-uniform countries.

THE INFLUENCE OF CULTURE ON FINANCIAL REPORTING

In addition to economic and institutional determinants, national culture has long been considered a factor that affects the accounting system of a country.

Hofstede's Cultural Dimensions

Using responses to an attitude survey of IBM employees worldwide, Hofstede identified four cultural dimensions that can be used to describe general similarities and differences in cultures around the world: (1) individualism, (2) power distance, (3) uncertainty avoidance, and (4) masculinity. More recently, a fifth dimension, long-term orientation, was identified. *Individualism* refers to a preference for a loosely knit social fabric rather than a tightly knit social fabric (collectivism).

Power distance refers to the extent to which hierarchy and unequal power distribution in institutions and organizations are accepted. *Uncertainty avoidance* refers to the degree to which individuals feel uncomfortable with uncertainty and ambiguity. *Masculinity* refers to an emphasis on traditional masculine values of performance and achievement rather than feminine values of relationships, caring, and nurturing. *Long-term orientation* stands for the "fostering of virtues oriented towards future rewards, in particular perseverance and thrift."

Gray's Accounting Values

From a review of accounting literature and practice, Gray identified four widely recognized accounting values that can be used to define a country's accounting subculture: professionalism, uniformity, conservatism, and secrecy. Gray describes these accounting values as follows: *Professionalism versus Statutory Control* —a preference for the exercise of individual professional judgment and the maintenance of professional self-regulation as opposed to compliance with prescriptive legal requirements and statutory control.

Uniformity versus Flexibility —a preference for the enforcement of uniform accounting practices between companies and for the consistent use of such practices over time as opposed to flexibility in accordance with the perceived circumstances of individual companies.

Conservatism versus Optimism —a preference for a cautious approach to measurement so as to cope with the uncertainty of future events as opposed to a more optimistic, laissez-faire, risk-taking approaches.

Secrecy versus Transparency —a preference for confidentiality and the restriction of disclosure of information about the business only to those who are closely involved with its management and financing as opposed to a more transparent, open, and publicly accountable approach.

Gray argues that national culture values affect accounting values. The accounting values of conservatism and secrecy have the greatest relevance for the information content of a set of financial statements.

The relationship between culture and each of these two accounting values is explained as follows:

Conservatism can be linked perhaps most closely with the uncertainty-avoidance dimension and the short-term versus long-term orientations. A preference for more conservative measures of profits and assets is consistent with strong uncertainty avoidance following from a concern with security and a perceived need to adopt a cautious approach to cope with uncertainty of future events. A less conservative approach to measurement is also consistent with a short-term orientation where quick results are expected and hence a more optimistic approach is adopted relative to conserving resources and investing for long-term trends. There also seems to be a link, if less strong, between high levels of individualism and masculinity, on the one hand, and weak uncertainty avoidance on the other, to the extent that an emphasis on individual achievement and performance is likely to foster a less conservative approach to measurement.

A preference for secrecy is consistent with strong uncertainty avoidance following from a need to restrict information disclosures so as to avoid conflict and competition and to preserve security. [High power-distance societies are likely to be characterized by the restriction of information to preserve power inequalities.

Secrecy is also consistent with a preference for collectivism, as opposed to individualism, In that its concern is for the interests of those closely involved with the firm rather than external parties. A long-term orientation also suggests a preference for secrecy that is consistent with the need to conserve resources within the firm and ensure that funds are available for investment relative to the demands of shareholders and employees for higher payments. A significant but possibly less important link with masculinity also seems likely to the extent that in societies where there is more emphasis on achievement and material success there will be a greater tendency to publicize such achievements and material success.

Gray extended Hofstede's model of cultural patterns to develop a framework that identifies the mechanism through which culture influences the development of corporate reporting systems on a national level. According to this framework the particular way in which a country's accounting system

Relationships between Accounting Values and Cultural Dimensions Accounting Values Cultural Dimension Professionalism Uniformity Conservatism Secrecy

Power distance develops is influenced by accountants' accounting values and by the country's institutional framework, both of which are influenced by cultural values. Thus, culture is viewed as affecting accounting systems indirectly in two ways: through its influence on accounting values and through its institutional consequences.

Using measures of each of the cultural values for a group of 40 countries, Hofstede classified countries into 10 different cultural areas. The Anglo cultural area, for example, is characterized by high individualism, low uncertainty avoidance, low power distance, and moderate masculinity. Given this pattern of cultural values, Gray hypothesized that Anglo countries (which include Australia, Canada, New Zealand, the United States, and the United Kingdom) would rank relatively low on the accounting values of conservatism and secrecy (or high on optimism and high on transparency). Exhibiting the opposite pattern of cultural values, the countries of the less developed Latin cultural area (which includes countries like Colombia and Mexico) are expected to rank relatively high in conservatism and secrecy.

Countries that require limited disclosures in financial statements (high secrecy) are expected to more strictly adhere to the notion of conservatism (high conservatism) in the measurement of assets and liabilities.

A number of studies have empirically examined the relationship between Hofstede's cultural values and national accounting systems. Although the results of this research are mixed, most studies find a relationship between cultural values and disclosure consistent with Gray's hypothesis. However, these studies are unable to determine whether culture influences disclosure through its effect on accounting values or through its effect on institutional consequences. Research results on the relationship between culture and conservatism are less conclusive.

Religion and Accounting

Religion plays an important role in defining national culture in many parts of the world and can have a significant effect on business practice. Under Islam, for example, the Koran provides guidance with respect to issues such as making charitable contributions and charging interest on loans. In some Islamic countries, banking companies operate under Sharia, the Islamic law of human conduct derived from the Koran. Because traditional accounting rules do not cover many of the transactions carried out by Islamic financial institutions (IFIs), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a standard-setting body based in Bahrain, has been active in developing and promoting Islamic accounting standards.

Based on the AAOIFI's work, the Malaysian Accounting Standards Board (MASB) developed MASB i-1, *Presentation of Financial Statements of Islamic Financial Institutions,* in 2001.

MASB i-1 states:

The general purpose of financial statements is to provide information about the financial position, performance and cash flows of IFIs, which are useful to a wide range of users in making economic decisions. It also portrays aspects of the management's stewardship of the resources entrusted to it. All this information, along with other information in the notes to financial statements, allows users in assessing the degree of compliance of the IFIs with the prescribed Sharia requirements (para. 10).

In developing MASB i-1, the MASB consulted with the Malaysian Central Bank's National Sharia Council on issues relating to Sharia. In April 2004, the MASB announced that it would introduce four new Islamic accounting standards related to *ijarah* (leasing), *zakat* (income tax), *takaful* (insurance), and *mudarabah* (deferred payments).

REASONS FOR INTERNATIONAL DIFFERENCES IN FINANCIAL REPORTING

Sifting through the many reasons that have been hypothesized to affect international differences in financial reporting, Nobes developed a model with two explanatory factors: culture and the nature of the financing system. 26 Nobes argues that the major reason for international differences in financial reporting is different purposes for that reporting. A country's financing system is seen as the most relevant factor in determining the purpose of financial reporting. Specifically, whether or not a country has a strong equity financing system with large numbers of outside shareholders will determine the nature of financial reporting in a country.

Nobes divides financial reporting systems into two classes, labelled A and B.
Class A accounting systems are found in countries with strong equity–outside shareholder financing. In Class A accounting systems, measurement practices are less conservative, disclosure is extensive, and accounting practice differs from tax rules. Class A corresponds to what may be called Anglo-Saxon accounting.

Class B accounting systems are found in countries with weak equity–outside shareholder financing systems. Measurement is more conservative, disclosure is not as extensive, and accounting practice more closely follows tax rules. Class B corresponds to Continental European accounting.

Nobes posits that culture, including institutional structures, determines the nature of a country's financing system. Although not explicitly defined, Nobes's notion of culture appears to go beyond the rather narrow definition used in Gray's framework, which relies on Hofstede's cultural dimensions. Nobes assumes (without explaining how) that some cultures lead to strong equity-outsider financing systems and other cultures lead to weak equity-outsider financing systems. His simplified model of reasons for international accounting differences is as follows:

Most countries in the developed world have a self-sufficient culture. For these countries, Nobes applies his model as follows:

Many countries in the developing world are culturally dominated by another country often as a result of European colonialism. Nobes argues that culturally dominated countries use the accounting system of their dominating country regardless of the nature of the equity financing system. Thus, countries with a Type 1 culture as well as countries historically dominated by a Type 1 country use
Class A accounting systems.

Examples of Countries with Class an Accounting

The United Kingdom is a culturally self-sufficient Type 1 country with a strong equity-outsider system. It has an outside shareholder–oriented Class A accounting system. New Zealand is culturally dominated by the United Kingdom. It also has a strong equity-outsider financing system, probably because of the influence of British culture. New Zealand also has a Class A accounting system. According to Nobes's model, this can be the result of New Zealand being culturally dominated by the United Kingdom (a Type 1 culture country), having a strong equity outsider financing system, or both. The African nation of Malawi has a weak equity-outsider financing system, but as a former British colony (culturally dominated by the United Kingdom) it has adopted a Class A accounting system even though it has a weak equity-outsider financing system.

Nobes further suggests that as the financing system in a country evolves from weak equity to strong equity, the accounting system will also evolve in the direction of Class A accounting. He cites China as an example. Finally, Nobes argues that companies with strong equity-outsider financing will attempt to use Class A accounting even if they are located in a Class B accounting system country. He cites the German firms Deutsche Bank and Bayer and the Swiss company Nestlé as examples.

Recent Changes in Europe

The simplified model developed by Nobes appears to explain accounting developments that occurred in Europe over the past two decades. Because of the desire for companies to be competitive in attracting international equity investment, several European countries (with Class B accounting systems) developed a two-tiered financial reporting system in the late 1990s. Austria, France, Germany, Italy, and Switzerland gave stock-exchange-listed companies the option to use International Financial Reporting Standards (IFRS), a Class A accounting system, in preparing their consolidated financial statements.

The parent company statements, which serve as the basis for taxation, continued to be prepared using local accounting rules. Large numbers of German and Swiss companies (including Deutsche Bank, Bayer, and Nestlé), in particular, availed themselves of this opportunity to use IFRS.

This desire for companies to be competitive in the international capital market ultimately led the European Commission in 2005 to require all publicly traded companies within the European Union to use IFRS in preparing consolidated financial statements. Thus, it is no longer appropriate to think in terms of all German (or all French, all Italian, etc.) companies following the traditional Continental European model of accounting. Publicly traded companies in the EU now use a set of accounting standards based upon the Anglo-Saxon model of accounting in preparing their consolidated statements. However, in most cases, privately held companies in the EU continue to use local GAAP, as do public companies in preparing parent company financial statements.

FURTHER EVIDENCE OF ACCOUNTING DIVERSITY

In the remainder of this chapter we provide additional evidence of some of the differences in accounting that exist across countries. We categorize accounting differences in the following manner and provide examples of each of these types of difference:

1. Differences in the financial statements included in an annual report.
2. Differences in the format used to present individual financial statements.
3. Differences in the level of detail provided in the financial statements.
4. Terminology differences.
5. Disclosures differences.
6. Recognition and measurement differences.

We illustrate these differences by considering a typical set of U.S. financial statements as a point of reference.

Financial Statements

U.S. companies are required to include a balance sheet, income statement, and statement of cash flows in a set of financial statements. In addition, schedules explaining the changes in retained earnings and accumulated other comprehensive income must be presented. Many U.S. companies provide this information in a separate statement of stockholders' equity.

Virtually all companies worldwide provide a balance sheet and an income statement in a set of financial statements. Although not universal, most countries now also require presentation of a statement of cash flows. Mexico, for example, implemented such a requirement in 2008. In addition to a balance sheet, income statement, and statement of cash flows, the Austrian firm Strabag SE includes a statement of changes in fixed assets as one of its primary financial statements.

This statement provides detail on the change during the year in the historical cost of noncurrent intangible assets, tangible assets, and investment property. A statement of changes in noncurrent assets often also is found in financial statements Prepared by German companies.

Format of Financial Statements

U.S. companies list assets and liabilities on the balance sheet in order of liquidity, from most liquid (cash) to least liquid (often intangible assets). The same is true in Canada, Mexico, and Japan. Companies in many countries (including most of Europe) list assets and liabilities in reverse order of liquidity.

In the income statement format commonly used by U.S. companies, sales revenue and cost of goods sold are generally reported as separate line items, the difference being gross profit. Cost of goods sold includes manufacturing costs (materials, labour, and overhead) related to those items sold during the year. In addition to cost of goods sold, selling expense, administrative expense, research and development costs, and other operating expenses are subtracted to calculate operating income. Each of these line items includes costs related to materials (including supplies), labour, and overhead.

Level of Detail

Differences exist in the level of detail provided in the individual financial statements. U.S. companies tend to provide relatively few line items on the face of the financial statements and then supplement these with additional detail in the notes.

Terminology

The examination of Vodafone PLC's balance sheet earlier in this chapter revealed a number of differences in the terminology used by Vodafone and a typical U.S. company. New Zealand–based Fletcher Building Group includes the following current assets on its balance sheet: Cash and liquid deposits, Current tax asset, Debtors, and Stocks. A "translation" of these terms into terminology commonly used in the United States would be: Cash and cash equivalents, Taxes receivable, Accounts receivable, and Inventories. Many non-English-language companies translate their annual reports into English for the convenience of English speakers.

These companies typically choose between the British and the American formats and terminology in preparing convenience translations. Occasionally terms unfamiliar to both British and U.S. accounting are found in English language reports to reflect business, legal, or accounting practice unique to a specific country.

For example, the Brazilian petrochemical firm, Braskem SA, includes the line item *judicial deposits and compulsory loan* as an asset on its balance sheet. Note 11discloses that the judicial deposits relate to *Tax contingencies* and *Labour and other claims,* but provides no further information with regard to this asset. SK Telecom includes a noncurrent asset on its balance sheet called *Guarantee deposits,* which represents the amount of cash that customers have paid as a deposit to initiate telephone service. Among its current liabilities, SK Telecom reports the line item *Withholdings,* with no further explanation as to what this might be.

Disclosure

Numerous differences exist across countries in the amount and types of information disclosed in a set of financial statements. Many of the disclosures provided by companies are required by law or other regulations. In addition, many companies around the world provide additional, voluntary disclosures often to better compete in obtaining finance in the international capital markets. The disclosures required to be made by publicly traded companies in the United States generally are considered to be the most extensive in the world. Saudagaran and Biddle developed a ranking of the level of disclosure required by stock exchanges in eight major countries. One must be careful in generalizing these disclosure rankings to all companies within a country. For example, the Swiss banking firm UBS AG provides extensive notes (108 pages in length) to its consolidated financial statements that are similar in scope and content to what is found in the annual reports of Anglo companies.

The same can be said for other Swiss multinational corporations as well as for many multinationals in other non-Anglo countries.
There are an infinite number of differences that can exist in the disclosures provided by companies. To illustrate the wide diversity, we provide several examples of disclosures uncommon in the United States and most other countries.

Recognition and Measurement
Perhaps the most important international differences that exist in financial reporting are those related to the recognition and measurement of assets, liabilities, revenues, and expenses. *Recognition* refers to the decision of whether an item should be reported in the financial statements. *Measurement* refers to the determination of the amount to be reported. For example, national accounting standards establish whether costs associated with acquiring the use of a resource should be recognized as an asset on the balance sheet.

Summary

1. Considerable diversity exists across countries with respect to the form and content of individual financial statements, the rules used to measure assets and liabilities and recognize and measure revenues and expenses, and the magnitude and nature of the disclosures provided in a set of financial statements.

2. Many environmental factors are thought to contribute to the differences in financial reporting that exist across countries. Some of the more commonly mentioned factors include legal system, the influence of taxation on financial reporting, corporate financing system, inflation, political and economic ties between countries, and national culture.

    2. The diversity that exists in financial reporting creates problems for multinational corporations in preparing consolidated financial statements on the basis of a single set of accounting rules. Accounting diversity also can result in increased cost for companies in tapping into foreign capital markets. The comparison of financial statements across companies located in different countries is hampered

by accounting diversity. Low-quality financial reporting contributed to the financial crisis in East Asia in the 1990s.

4. Several authors have classified countries according to similarities and differences in financial reporting. Two dominant models of accounting used in the developed world are the Anglo-Saxon model and the Continental European model.

5. Concentrating on the Anglo-Saxon and Continental model countries, Nobes developed a classification scheme that attempts to show how the financial reporting systems in 14 developed countries relate to one another. Nobes breaks down the two major classes of accounting system first into subclasses and then into families. This classification scheme shows how different families of accounting are related.

6. Culture has long been considered a determinant of accounting. Using the cultural dimensions identified by Hofstede, Gray developed a framework for the relationship between culture and accounting systems. Cultural values affect a country's accounting system in two ways: (1) through their influence on the accounting values of conservatism, secrecy, uniformity, and professionalism shared by a country's accountants and (2) through their influence on institutional factors such as the capital market and legal system.

7. In a more recent model of the reasons for international differences in financial reporting, Nobes suggests that the dominant factor is the extent to which corporate financing is obtained through the sale of equity securities to outsider shareholders. For whatever reason, some cultures lead to a strong equity outsider financing system and other cultures lead to a weaker equity-outsider financing system. In countries with strong equity-outsider financing, measurement practices are less conservative, disclosure is extensive, and accounting practice differs from tax rules. This is consistent with what may be called Anglo-Saxon accounting. In accounting systems found in countries with weak equity– outside shareholder financing systems, measurement is more conservative, disclosure is not as extensive, and accounting practice follows tax rules. This is consistent with the Continental European accounting model.

8. Differences in financial reporting exist with regard to the financial statements provided by companies; the format, level of detail, and terminology used in presenting financial statements; the nature and amount of disclosure provided; and the principles used to recognize and measure assets, liabilities, revenues, and expenses.

3.07 Review Questions

1. The International Accounting Standards Board (IASB) and the standard-setter in the USA, the Financial Accounting Standard Board (FASB) has been working together towards convergence of their respective accounting standards. Part of this accounting process has been the review of the IASB's *Framework for the Preparation and Presentation of Financial Statements*

Required:

(a)

- i. Explain why it is viewed as a significant step towards convergence that the bodies are working jointly on a conceptual framework for accounting.
- ii. Explain the potential benefits that a common conceptual framework could bring, to the standard-setting process.

(b)

- i. Discuss the potential benefits of convergence to investors.
- ii. Discuss the potential impact of convergence on entities that operate globally.

2. Enumerate the causes and reasons for accounting diversity and their possible remedies to the diversity with practical illustrations.

MODULE 4

4.00 DEVELOPMENT OF INTERNATIONAL ACCOUNTING

4.01 Learning Outcomes

On successful completion of this Module, Students should be able to:

i. Explain the economic factors that have influenced the development of international accounting.
ii. Elucidate the environmental factors shaping national accounting practices.
iii. Explain current trends in less developed and emerging economies towards convergence with international accounting practices.
iv. Evaluate the success of efforts towards harmonization of accounting practices across the globe.
v. Explain and demonstrate the treatment of foreign currency transactions and translation.
vi. Analyse and evaluate foreign financial statements.

4.02 Economic Factors Influencing International Accounting

Introduction

One of the many approaches adopted by researchers in classifying international accounting systems is by linking the system to economic or business factors. Economic or business factors are integral parts of environmental factors usually considered in the classification of international accounting practices. According to Arpan and Radebaugh (1985) and Haller and Walton (1998), economic factors or events are the most influential factors, among the environmental factors, that affect a country's accounting development.

Generally speaking, the economic environment of any nation is composed of two aspects – macro and micro. The macro aspect usually includes such factors as type of economic system, level of economic development, level of trade and investment, inflation and level of government involvement in economic activities. The micro aspect includes such factors as sources of finance and stage of development of capital market, business innovation and complexity of business, level of sophistication of business and financial report client, and degree of international business activity.

Macroeconomic factors

(i) Economic system

According to the belkaoui (1985) as cited by zhang (2005), distinction is usually made between four economic systems. These are capitalist, capitalist-statist, capitalist- socialist and socialist. He defined capitalist states are those that rely on the option of the market and on private provision for individual welfare. Capitalist-statist states are however state that has very large government productive enterprises, either because of an elitist development philosophy or a major dependence on the key resources such as oil. Capitalist-socialist states on the other hand are those that provide social services on a large scale through government or other not-for-profit institutions. Consequently, private control is property is sacrificed to egalitarian purposes. He finally defined socialist state as those state that strive programmatically to place an entire national economy under direct or indirect control of government.

Belkaoui argued that a capital system might be more favourable to accounting development than the three other economic systems because under the capital economic system, the survival of private enterprises is dependent upon not only production of goods service but adequate information to various stakeholders ranging from investors to the capital market in general.

(ii) Level of economic development

It is generally believed that the higher the level and growth of the economic development (as proxies by income level), the higher the political and economic freedom and the better the adequacy of reporting and disclosure. This is applicable to all economic systems. States with low levels of economic development often experienced few economic activities resulting in little financial, tax, or managerial accounting. Belkaoui indicates that accounting activities increase with increase in the level of economic activity and size of companies, and this continues through each successive stage of development, albeit with certain lags.

(iii) Level of Trade and Investment

The level of exports and imports may have a positive effect on the development of accounting. The higher the level of exports and imports, the higher the need for better reporting disclosure. Free-trade policies generally, and export promoting policy in particular increase cooperation with other countries for comparable reporting and adequate disclosure (Belkaoui, 1985)

(iv) Inflation

Inflation is often associated with economic growth and is a major influence on accounting especially where hyperinflation is rife to the extent that an alternative to the conventional historical cost approach is preferred. A long inflation trend can render accounting information meaningless unless it is appropriately adjusted. This explains why countries with low levels of inflation have been slower in developing inflation accounting rules than countries that have witnessed hyperinflationary situation such as Brazil and Argentina.

(v) Level of government Involvement

The level of government involvement in a country's economic activities is a product of a country's economic system or orientation. Communist countries that witness high level of government involvement have a highly standardized and uniform accounting system which is used to facilitate government's planning and control function. These countries usually have few users of accounting information other than the government. Hoverer, in capitalist economies where private ownership is predominant, with greater individual freedom in economic activity and decision making, a greater diversity in accounting practices is permitted. Several users of accounting information also exist, such as shareholders, debtors, creditors and the government (Arpan and Radebaugh, 1985 as cited by Zhang, 2005).

Micro-economic Factors

(I) Sources of Finance and Stage of Development of Capital Market

There are two orientations to the sources of funds according to Choi and Mueller (1978). These are: creditor and equity orientation. These may influence the degree of investor orientation versus creditor orientation of the accounting system. Under the creditor oriented accounting system, loans from banks, financial intermediaries or wealthy individual are the major sources of funds. Capital market activities are low and therefore less reliance on such market for funds. Hence accounting rules, principles, and procedures will tend to be more conservative and reflective to creditor preferences and requirements. Examples are, France and Germany. Conversely, under the equity-oriented accounting system, investors' funds are the major source of funds. Capital markets are well developed and hence reliance on such markets for funds. The accounting system here will require more extensive public disclosures as part of listing requirements. This is the case with United States.

(II) Business Innovations and Complexity of Business

Some new challenges in accounting usually emaciate from new business innovations. Business innovation such as business combination through mergers and acquisition instance, led to the need for accounting standards and practices relating to mergers and acquisitions of going concerns in some European countries. Stock distribution (stock dividend) in the United States affected U.S. accounting system while the need for lease accounting standards in some countries became paramount following the emergence of equipment leasing practices.

Similarly, firms of different size and complexity may have varying needs for accounting. Thus the accounting needs of small businesses will differ from the accounting needs of large conglomerate firms. In like manner, the accounting needs of domestic enterprises will be different from the accounting needs of multinational enterprises.

(III) Lack of Sophistication of Business and Financial Reporting Client

Businesses with higher level of management and financial information user will have higher need for accounting. "Highly refined accounting standards and practices have no place in environment where they are misunderstood and misused. A complex technical report on cost behaviour variances is meaningless unless the reader understands cost accounting well.

Statements of changes in financial position are useless unless they can be read competently. Capitalization of leases, consolidation of foreign subsidiaries, separate parent company financial statements, or financial forecasts are all counterproductive techniques in the hands of the unsophisticated (choi and Mueller, 1978 as cited by zhang, 2005).

(ii) Degree of international business activity

According to Arpan and Radebaugh (1985), the greater the amount of a country's international trade, the greater is its need for accounting practices concerning foreign exchange transactions and translations. Furthermore, the number and size of a country's multinational firms is directly related to development of accounting rules for consolidation of foreign source income.

4.03 Environmental Factors Shaping National Accounting

Within the framework of international accounting research, environmental influence is critical to the understanding of a country's accounting system. Thus, Radebaugh and Gray (1997) state that: "to a large extent, accounting is a product of its environment. That is, it is shaped by, reflects, and reinforces particular characteristics unique to its national environment". Practically speaking, although all accountants will follow a set of rules, whether explicit or implicit, no set of rules covers every eventuality. Hence there is always room for professional judgment and this will depend on the accountants' environment.

Several researchers have utilized a series of criteria in order to categorize, describe and compare accounting systems of different countries. As Zhang (2005) indicates, the importance of such categorization is the assumption that it promotes improved understanding of complex realities of accounting practices as well as factors that shape a country's accounting regulations; provides useful information for solving some important global accounting problems; assists the training of accountants and auditors who operate internationally; and enable a developing country (like Nigeria) to better understand the available types of financial reporting that exit and the one(s) that is/are appropriate to its environment. By observing other countries in its group, it is possible for a country to predict the problems that it is about to face, and the solution that might be appropriate.

Although there seems to be a consensus on the environmental factors involved in shaping financial reporting, there is still disagreement on the dominant factor that shapes one country's accounting development and the extent to which each factor affects its accounting development.

This section discusses some of the environmental factors that influence national accounting policies. Based on a review of a number of studies Zhang (2005) concluded that the environmental factors that influence national accounting could logically be classified under seven groups. These are: political, legal, economic, international, cultural, educational and professional factors. Six of the factors are highlighted in the discussions that follow. It is to be noted that economic factors have been excluded because they have already been discussed.

1. Political Factors

A number of political factors have influence on accounting system and practices of nations. Gastil (1978) as cited by Zhang (2005) suggested a political structure index in which he ranks countries into five types; multiple-party systems, dominant party systems, one-party systems, military dictatorships and traditional monarchies. The ranking was based on the perceived level of political freedom in a country.

A different sophisticated classification of political system was earlier provided by Shils (1966). He identified five types of political systems; political democracy, tutelary democracy, modernized oligarchy, totalitarian oligarchy, and traditional oligarchy.
Political systems can determine one country's economic system and hence it's accounting patterns. An accounting system that is used by centrally controlled economy must necessarily differ from that used by market oriented economy.

Political systems also export and import accounting rules and practice. The impact on accounting practices is even large with modern political systems.

Political freedom in a country impacts heavily on the development of accounting, reporting and disclosures. This largely depends on political rights, civil liberties, and the type of political system. The higher the political rights and civil liberties, the more the freedom and flexibility the accounting profession will have and accounting disclosure will be more honest and balanced.

2. Legal Factors

These relate to a country's legal system, taxation and/or accounting legislation. These factors impact on a country's source of or authority for accounting standards, accounting function, accounting pattern, as well as the details of accounting regulations.
Generally, countries that use the Roman (or civil) law, place more restriction on accounting judgment than countries that use the common law which are non-legislative.
In many countries, tax law provides the basis for accounting. Some countries (such as German) do not distinguish tax accounting from financial accounting. In countries where commercial rules are separated from tax rules, tax laws are used to specify accounting procedures to be used in the tax area.

3. International Factors

Economic ties to, and relationships with other countries may influence a country's accounting system development. There are stronger and stronger pressures to change to international accounting. The pressures emanated from growing international economic/political interdependence, new trends in FDI, changes in multinational corporate strategy, impact on new technology, rapid growth of international financial markets, expansion in business services, and the activities of international regulatory organizations.
The trend started from colonialism to globalization and harmonization of markets, involvement of international organizations, and finally the significant impact that multinational enterprises (MNEs) continue to exert on the cultural and social development of host countries.

4. Cultural Factors

As early as 1952, Kroeber and Kluckhorn defined the term culture as consisting of patterns, explicit and implicit of and for behaviour acquired and transmitted by symbols, constituting the distinctive achievements of human groups, including their embodiments in artefacts; the essential core of culture consists of traditional ideas and especially the attached values; cultural systems may on the one hand be considered as products of action, on the other as conditioning elements of further action (Kroeber and kluckhorn, 1952 as cited by Zhang, 2005).

Although, numerous cultural factors that influence accounting practice exist, the most important of such factors are: society's degree of conservatism in the use of accounting rules; secrecy in disclosure of accounting information; and people's attitudes toward business and the accounting profession.

5. Educational Factors

The features of a country's educational system greatly affect its accounting practices. As Arpend and Radebaugh (1985) explained, educational traits encompass the degree of literacy, including numerical literacy; percentage of people that passed through schooling at various levels; the basic orientation of the educational system (religion, vocational, liberal, arts, science, professional); and the appropriateness of the educational system's output for a country's economic and societal needs.

6. Professional Factors

The strength, size and competence of the accounting profession in a country may follow to a large extent from the various factors earlier discussed and from the type of financial reporting they have helped to produce.

In countries (such as United Kingdom and United States) with more developed accounting profession, and democratic institutes, public accounting systems rather than uniform systems are more likely to be developed (Nobes, 1998). This is also true for a country where there is substantial body of private shareholders and public companies. The need for auditors in such countries will be higher than in countries with few public companies.
There are several other factors that might influence a country's accounting practices that have not been addressed above such as language, history, geography, religion, and many others. Most of these factors are usually considered too generic and vague to influence national accounting practices.

From the Nigerian perspective, while some of the environmental factors might be considered directly relevant and significant, some may not be significant in influencing the country's accounting practice. For example, political factors have no significant influence on Nigeria's accounting practice. Although it could be argued that accounting profession enjoys more freedom and flexibility during democratic dispensations, there may be no evidence to suggest that military dictatorship regimes hampered the freedom and flexibility of the accounting profession in Nigeria. This point also extends to legal factors. Nigeria, for instance, uses both the civil law and common law systems. A discussion on the overriding effect of one of the two legal systems on the other may therefore not be significantly relevant to Nigeria.

Furthermore, cultural factors such as conservation, secrecy and attitudes toward business and the accounting profession are less relevant to the Nigerian environment. This is because most of the disclosure requirements in Nigeria are compulsory rather than voluntary.

However, such other factors as international, educational, and professional are believed to have significant and direct influence on accounting practices in Nigeria. For example, the adoption of the international financial reporting standards (IFRS) in Nigeria has been attributed to international pressures especially those from international organizations and MNEs. Similarly, some of the educational factors have direct influence on accounting practice in Nigeria. Prior to the emergence of the Association of National Accountant of Nigeria (ANAN) the basic orientation of the accounting education de-emphasized professionalism because of the mechanistic approach to the treatment of accounting problems and issues. ANAN now places significant emphasis on professionalism with the accounting profession now considered as a science. This has today, changed the basic orientation of accounting education in Nigeria. Finally, the professional factors are directly relevant to the development of accounting practice in Nigeria. It is only recently that the accountancy profession in Nigeria began to grow in size, strength and competence. The growth is yet to reach an appreciable level because of the continuous dominance of international audit firms, especially in the audit of publicly listed firms.

4.04. Accounting in Less Developed Countries (LDCs and In Emerging Economies (EEs)

Less Developed Countries (LDCs) also referred to as developing countries are broadly defined as countries seeking to advance to a higher state of economic well-being (Wallace, 1990 as cited by Johan, 1999). The term usually includes a wide range of countries in Africa, Asia and Latin America.

Emerging economies are generally defined as nations whose economies are advancing toward becoming advanced (Investopedia). Such economies are considered to be in transition phase between developing and developed status (Wikipedia).
In the 1970s, LDCs was the common term used to describe markets that are less developed in relation to developed countries like US, Europe and Japan. It was later criticized as being politically incorrect; hence the emerging market label was created originally by the World Bank economist Antorie Van Agtmae in the 1980s. The general criteria for categorizing a country as emerging economy include:

1. Intermediate income (defined as countries with PPP per capital within the range of 10% - 75%)
2. Catching-up growth (that is, brisk economic growth that has narrowed a country's income gap with that of developing economies) and institutional transformations and economic opening.

Four countries are considered to be the largest emerging economies, abbreviated BRIC (Brazil, Russia, India and China). These are closely followed by the next four-abbreviated as MIKT (Mexico, Indonesia, South Korea and Turkey). In recent time, a listing of emerging economies by Goldman Sachs investment bank and economist Jim O' Neil led to a new term known as BRIC + Next Eleven. The next Eleven is: Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, the Philippines, Turkey, South Korea and Vietnam. Other terms include BRICET (BRIC + Eastern Europe and Turkey), BRICS (BRIC + South Africa) and CIVETS (Columbia, Indonesia, Vietnam, Egypt, Turkey and South Africa).

Since the measures used to categorize a country as emerging are both objective and subjective, it is usually difficult to find a clear cut dividing line between LDCs and emerging markets (hereafter referred to an EMs). More so, LDCs and EMs have common traits. Apart from the quest for economic development, most of the countries were colonized and received their independence from late 1950s onwards. In addition, they share the common characteristic of the presence of poverty and wide disparities in their development levels (Wallace, 1990 as cited by Johan, 1999).

Problems Associated with LDCs and EMs

The general problems commonly associated with LDCs and EMs include – poverty, rapid population growth, high levels of unemployment, unequal income and wealth distribution, regional unbalances, insufficient domestics savings, large foreign and/or domestic debt, low levels of technology, and a need to improve education (Johan, 1999).

As Nobes and Parker (2008) rightly observed, colonial history may be the most appropriate factor that can be used to explain the development of accounting practices or systems of many Asian or African countries.

Similarly, Wallace and Briston (1993) as cited by Johan (1999) indicated that the international transfer of accounting technology (especially to some LDCs and EMs) has occurred for many years in a non-formalized manner through the following methods:

i. Colonial legacies;
ii. Importation of accounting qualifications from developed countries;
iii. Activities of multi-national enterprises;
iv. Role of international organizations such as the World Bank and regionaldevelopment agencies like the African development Bank (ADB);
v. Efforts by developed countries' aid institutions;
vi. Roles of the International Federation of Accountants (IFAC) and the International Accounting Standards Board (IASB) and regional groups such as Pan African Federation of Accountants (PAFA) and the Association of Accounting Bodies of West Africa (ABWA);
vii. The fact that English is the first or second language in many of these countries, has led to the use of British, American or Australian textbooks for accountancy training.

Effect of Non-Formalized Methods of Accounting Technology Transfer on Accounting Systems of LDCs and EMs

Subsequent discussions will dwell on the effect of the above listed factors on the accounting systems of LDCs and EMs. The reason for this is obvious. The accounting systems of most LDCs and EMs are imported from developed countries. The question is: How suitable or appropriate are these imported accounting systems to the environments, circumstances and needs of LDCs and EMs? As Wallace and Briston (1993) as cited by Mir and Rahaman (2002) argued, LDCs have continued to adopt foreign accounting and educational systems. The main issue is whether the objectives of the importing country and the country from where it is imported are congruent. Incongruity of objective between the two countries may render the imported accounting system inappropriate for the purpose of addressing the problems of the importing country.

The effect of importing accounting systems of developed countries by LDCS and EMs could be discussed under the six headings proposed by Johan (1999). There are: different environments and needs, different user groups, market forces in LDCs and EMs, acceptance of international accounting standards, uses of financial statements in LDCs and EMs and uniform accounting system for all LDCs and EMs.

1. Different environments and needs

There is a significant difference between the environment in which accounting systems of developed countries operate and those of LDCs and EMs. This will consequently produce information that may not address the problems of the LDCs and EMs. Although LDCs and EMs are homogeneous, they face varying degrees of problems. Their accounting systems should necessarily reflect this heterogeneity. Financial reports of LDCs should, for instance, indicate the extent to which business enterprises have been involved in alleviating typical problems associated with each LDC or EM.

2. Different user groups

User groups that are considered most important in developed countries differ from the most important user groups in LDCs and EMs. It has also been argued that accounting objectives of developed countries differ from those of LDCs and EMs and that conventional accounting statements are investor-driven and therefore of little relevance to LDCs and EMs with few private investors, under-developed stock markets and very strong government involvement in the economy.

3. Market forces in LDCs and EMs

It has been argued that the accounting systems of developed countries are designed to suit situation where most crucial decisions concerning allocation of resources are made according to market forces. This may not necessarily be the case in LDCs and EMs. Since the measurement and reporting practices implicit in accounting standard of developed countries are designed to suit their circumstances and environment, such standards and practices may not appropriately apply to LDCs and EMs.

4. Acceptance of International Accounting Standards

Initially, national accounting systems of most LDCs and EMs were designed and became enshrined in colonial days. However, subsequent accounting developments have been derived mainly from international trends dictated by developed countries, especially the U.K. and U.S. There are arguments that although the International Accounting Standards Board (IASB) seeks to pronounce standards that will have universal application, the Board’s pronouncements effectively mirror standards developed in the U.K. and U.S. This view could explain the absence, for a long time, of standards on mining and agricultural businesses which are potential engine of growth of some LDCs and EMs.

5. Uses of Financial Statements in LDCs and EMs

There are arguments that the economic and social policies pursued by LDCs and EMs usually differ from those of developed market economies. This, therefore, calls for different kinds of accounting information. Financial reporting in the developed economies is primarily concerned with satisfying the information needs of investors while the information needs of other users are not seen as the primary concern of the accountant. For financial reporting to be useful in LDCs and EMs, they must be adapted to disclose additional information that will help solve national problems.

6. Uniform Accounting System for all LDCs and EMs

Peasnell (1992) as cited by Johan (1999) has argued that the accounting needs of LDCs and EMs differ from one country to another. For instance, countries like Singapore, Korea, and Taiwan are rapidly industrializing and have promising future. Some other countries, such as Nigeria and Indonesia are rich in natural resources and their relative lack of development has much to do with colonial legacy, the birth pains of nationhood, and difficulties in establishing good governance. The diversity of economic and social systems in LDCs and EMs would require evolutionary changes rather than revolutionary changes in existing national accounting systems. Therefore, the accounting systems and accounting standards of LDCs and EMs need to be adapted to the circumstances of each LDC and EM.

4.05 International Harmonization of Accounting

Harmonization (sometimes used to mean convergence) refers to the goal of establishing a single set of accounting standards or rules that may be used internationally and in particular the effort to reduce the differences between US Generally Accepted Accounting Principles (US GAAP) and the International Financial Reporting Standards (IFRS).

The terms harmonization is also used to mean the process of increasing the capability of accounting practices by setting bounds to their degree of variation (Nobes at Parker, 2008). Distinction is often made between harmonization of rules (de jure) and harmonization of practices (de facto). It has been argued that de facto harmonization is more useful than de jure harmonization because de facto tends to stress uniformity (rather than comparability) of rules and invariably, practices. However, in principle, it is believed that harmony can be achieved through uniformity, and vice-versa.

Convergence in some form has been taking place for several decades, and efforts accelerated when the main standard setting body in the USA, the financial accounting standard board (the FASB), and the international accounting standards board (IASB), signed Memorandum of Understanding at their Norwalk meeting in 2002, to work towards making their existing and future financial reporting standards fully comparable. Although the 2002

MOU was updated in 2008, US are yet to make a decision whether to adopt, reject or incorporate IFRS. The delay has been largely attributed to three factors.

1. Fundamental differences still remain between US GAAP and IFRS.
2. The notion in US that GAAP is more robust set of standard than IFRS.
3. The concern in US of shifting or surrendering standard- setting authority from US SEC to the IASB.

The convergence or harmonization of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally and in particular the effort to reduce the differences between the US Generally Accepted Accounting Principles (US GAAP), and the International Financial Reporting Standards (IFRS).

Motivations for convergence include the belief that it will result in increased comparability between financial statements, which will benefit a variety of stakeholders. For example, the FASB believes that *"investors, companies, auditors, and other participants in the U.S. financial reporting system"* will benefit from converged standards because it will result in increased comparability between the financial statements of different firms. Convergence might also reduce inefficiency caused by companies having to operate under different rules of different jurisdiction, and might guard against competition by jurisdictions to attract companies by having the most lax rules.

A report by PricewaterhouseCoopers (PwC) in 2008 stated that convergence of accounting standards would contribute to the flow of international investment and benefit *"all capital markets stakeholders"* because it:

1. renders international investments more comparable to investors;
2. reduces the cost of complying with accounting requirements for global businesses;
3. potentially establishes a more transparent accounting system with greater accountability;
4. reduces "operational challenges" for accounting firms; and
5. Gives standard-setters the opportunity to "improve the reporting model".

Criticisms

The goal of and various proposed steps to achieve convergence of accounting standards has been criticized by various individuals and organizations. For example, in 2006 senior partners at PricewaterhouseCoopers (PwC) called for convergence to be "shelved indefinitely" in a draft paper, calling for the IASB to focus instead on improving its own set of standards.

In particular, senior academics have called the link between convergence and comparability "overblown", while the cost out-weighs the benefits and the pace of adoption have been cited as the most common criticism.

Nature of standards

Other criticisms center on the nature of the converged standards. For example, some critics are concerned that convergence will increase the use of fair value accounting.

Other critics have also respectively cited shortcomings with rules-based and principles-based standards as reasons. Principles-based standards allow for "different interpretations for similar transactions" and have also been described as "less precise", while rules-based standards contain more exceptions and use bright-line rules and specific details to deal with "as many potential contingencies as possible". The above-mentioned PwC senior partners expressed their concern that convergence will lead to an accounting system that is too rules-based for non-US listed companies, while other critics conversely criticize the principles-based nature of the IFRS as making it difficult for preparers of financial statements to defend against litigation.

Reasons for Harmonization

i. Investors and financial analyst need to be able to understand the financial statements of foreign firms whose shares they might wish to purchase.
ii. Various intergovernmental transnational bodies are interested, *inter alia* in protecting investors within their jurisdiction.
iii. Stock exchange regulators have listing requirements which include the demand for financial statements.
iv. Companies especially multinationals may require finance at lower cost from international capital markets through the issue of new shares. MNCS also want simplicity in the preparation of group accounts and reduction in cost of preparation.
v. International credit grantors such as the world bank face difficulties of comparison of financial statements
vi. International accounting firms are interested in harmonization because it is good for their Clients and for ease of transferability of their staff.
vii. Tax authorities throughout the world will want their work greatly facilitated through reduction in profit measurement.
viii. Government in developing countries will work an easier way of understanding and controlling the operations of multinationals in their jurisdiction.

Advantages of International Harmonization

i. Investors have greater comparability of financial statements which enables easier investment decisions. This is important in the context of global investment which has become more significant in the last decade.
ii. Governments will not have to develop accounting standards for their own countries, reducing bureaucracy and cost.
iii. Accounting firms with international practices will find it easier to deal with staff resourcing in countries experiencing boom or recessionary times due to common

accounting standards allowing staff transferability between countries with no major impact on services delivered.

iv. Companies:
   a. Management control of foreign subsidiaries will be different.
   b. Consolidation of financial statements of subsidiaries will be easier as they will operate under the same standards.
   c. Easier to comply with stock exchange reporting requirements.
   d. Investment more likely as investors will have a greater knowledge and reliance on the financial statements.

Obstacles to International Harmonisation

i. Different purposes of financial statements i.e. lFRS's aimed at investment decision-making, whereas many countries use financial statements for tax purposes;
ii. Nationalism - possible unwillingness to accept other countries' standards;
iii. Different legal systems whereby some countries require certain accounting practices and policies and others do not;
iv. Different users of financial statements. Countries vary in the importance they place on users' groups;
v. Lack of strong accountancy bodies. Many accountancy bodies in various countries are not independent or strong enough to press for harmonization of accounting standards in their jurisdiction;
vi. Language and cultural differences. Both of these can cause difficulties in the adoption of standards accounting standards.

It is important to note that the body that has been at the forefront in the struggle for harmonization of accounting is the international accounting standards board (IASB) which issues the international financial reporting standards (IFRS).

In the last few years, over 100 countries across the globe have adopted IFRS either through convergence, endorsement, or wholesome adaptation approach. Nigeria like most LDCs and EMs has since 2012 fully adopted the IFRS application by the large-scale companies operating in the country. It is expected that small and medium companies will adopt by 2014.

Other international bodies that have continued to play a role in the harmonization of accounting standards include the World Bank, international monetary fund (IMF), international organization of securities commissions (IOSCO), the Basel committee, the United Nations (UN) and organization for economic co-operation and development (OECD).

4.06 Accounting for Foreign Currency Transactions and Translations

An understanding of the following terms is important in the discussion of accounting for foreign currency transactions and translation.

1. **Translation: -** This involves the process of restating the financial data expressed in one currency in terms of another currency such as restating financial data expressed in dollars in terms of naira. Asset remains the same but the basis of measurement changes.
2. **Conversion: -** This involves the process whereby an asset is actually changed from one currency (such as naira) to another (such as dollar) usually in a bureau de change.
3. **Translation of transactions: -** This deals with the treatment of foreign currency transactions in the books of account and the financial statements of an individual company.
4. **Translation of financial statements:** - This deals with the preparation of the consolidated financial statement of a group of companies where the financial statements of the parent company and those of one or more of its subsidiaries are not denominated in the same currency.
5. **Functional currency: -** This is the currency of the primary economic environment in which the entity operates.
6. **Foreign currency: -** This is the currency other than the functional currency of the entity.
7. **Presentation currency:** This is the currency in which the financial statements are presented.
8. **Foreign transaction:-** This is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an entity:
    a. Buys or sells goods or services whose price is denominated in a foreign currency.
    b. Borrows or lends funds when the amounts payable or receivable are denominated in foreign currency
    c. Otherwise acquires or disposes assets or incur or settles liability, denominated in a foreign currency.

IAS 21 which deals with *the Effects of Changes in Foreign Exchange Rates* covers the following issues:

1. The definition of functional and presentation currencies;
2. Accounting for an entity individual transactions in a foreign currency;
3. Translation of the financial statements of a foreign subsidiary.

Functional and Presentation Currencies

The functional currency is the currency of the primary economic environment where the entity operates. In most cases the functional currency is the currency of the country in which the entity is situated and in which it carries out most of its transactions. In essence, it is the currency an entity uses in its day-to-day transactions.

IAS 21 states that the following factors should be considered when determining the functional currency of an entity:

a. The currency that mainly influences sales prices for goods and services (i.e. the currency in which prices are denominated and settled).
b. The currency of the country whose competitive forces and regulations mainly determine the sales price of goods and services.
c. The currency that mainly influences labour, material and other costs of providing goods and services.
d. The currency in which funding from issuing debt and equity is generated.
e. The currency in which receipts from operating activities are usually retained.

The first three points are seen as the primary factors in determining an entities functional currency.

Furthermore, if an entity is a foreign operation (i.e.: a subsidiary, associate; joint venture or branch whose activities are based in a country or currency other than those of the reporting entity), the following factors must also be considered:

a. Whether the activities of the foreign operation are carried out as an extension of the parent, rather than with a significant measure of autonomy/independence.
b. Whether transactions with the parent are a high or low proportion of the foreign operations activities.
c. Whether cash flows from the foreign operation directly affect the cash flows of the parent and are readily available for remittance to it
d. Whether cash flows from the activities of the foreign operation are sufficient to service existing debt obligations without funds being made available by the parent.

Where the indicators are mixed, management must exercise its judgment as to the functional currency to adopt that best reflects the underlying transactions.

Putting the above into context, if an entity operates abroad as an independent operation (generating income and expenses and raising finance, all in its own local currency), then its functional currency would be its local currency. On the other hand, if the entity was merely an overseas extension of the parent and only sells goods imported from the parent and remits all profits back to the parent, then the functional currency should be the same as the parent. In this case, the foreign entity would record its transactions in the currency of the parent and not its local currency.

Once the functional currency has been determined, it is not subsequently changed unless there is a change in the underlying circumstances that were relevant when determining the original functional currency.

The presentation currency is the currency in which the financial statements are presented. IAS 21 states that, whereas an entity is constrained by the above factors in determining its functional currency, it has a completely free choice as to the currency in which it presents its financial statements.

If the presentation currency is different from the functional currency, then the financial statements must be translated into the presentation currency. Therefore, if a parent entity has subsidiaries whose functional currencies are different to that of the parent, then these must be translated into the presentation currency so that the consolidation process can take place.

Accounting for Individual Transactions
When an entity enters into a contract where the consideration is denominated in a foreign currency, it will be necessary to translate that foreign currency into the entity's functional currency for inclusion in its accounts. Examples of such foreign transactions include:

a. Importing of raw materials;
b. Importing non-current assets;
c. Exporting finished goods;
d. Raising an overseas loan;
e. Investment in foreign shares / debt instruments.

When translating the foreign currency transaction, the exchange rate used should be either:

a. The spot exchange rate on the date the transaction occurred (the spot rate is the exchange rate for immediate delivery); or
b. For practical reasons, an average rate over a period of time, providing the exchange rate has not fluctuated significantly.

When cash settlement occurs, the settled amount should be translated using the spot rate on the settlement date. If the exchange rate has altered between the transaction date and the settlement date, there will be an exchange difference.

These exchange differences must be recognized as part of the profit or loss for the period in which they arise.

Example
Moshood Nig. Ltd has a year-end of 31st December. On 16th November, Moshood purchased goods from an American supplier for $125,000. On the 5th December, Moshood paid the American supplier in full.
The relevant exchange rates are:

16th November	₦1 = $1.35
5th December	₦1 = $1.31

<u>At the date of the transaction:</u>

$125,000 / $1.35 = ₦92, 593

Debit	purchases	₦92, 593
Credit	payables	₦92, 593

<u>At the date of settlement:</u>

$125,000 / $1.31 =		=₦95, 420
Debit	payables	₦92, 593
Debit	FX Loss (P/L)	₦2, 827
Credit	Cash	₦95, 420

The treatment of any foreign items remaining in the statement of financial position will depend on whether they are classified as monetary or non-monetary items.

<u>Monetary Items</u> are defined as money /cash and assets and liabilities to be received or paid in fixed or determinable amounts.

The main characteristic of <u>non-monetary items</u> is the absence of a right to receive fixed or determinable amounts.

The main characteristic of non-monetary items is the absence of a right to receive a fixed or determinable amount of money. They represent other items in the statement of financial position that are not monetary items.

Examples of each include:

Monetary items	Non-Monetary items
• Cash	• PPE
• Receivables	• Inventory
• Payables	• Investments
• Loans	• Prepayments
• Deferred Tax	• Intangibles
• Pensions	• Goodwill
• Provisions	

The rule for the treatment of these foreign items at the reporting date is as follows:

Monetary items: Re-translate using the closing rate of exchange (i.e. the spot exchange rate at the reporting date).

Non-monetary items: Do not re-translate Non-monetary items measured at cost less depreciation are translated and recorded at the exchange rate at the date of their acquisition items measured at fair value less depreciation should be translated and recorded at the exchange rate at the date of revaluation Exchange differences arising on the retranslation of monetary items at the reporting date must be recognized as part of the profit or loss for the period in which they arise.

Similarly, exchange differences arising on the subsequent settlement of these monetary items after the reporting date should be recognized as part of the profit or loss for the period in which they arise.

Example

Paul Ltd. purchases specialized machinery for use in its production process from a Ghanaian supplier on 18th September. The machine cost ₵300,000 and was paid for in full one month later. The year end is 31st December.

The relevant exchange rates are:

18 September ₦1 = ₵4.0

5th December ₦1 = ₵4.0

At the date of the transaction:

₵300,000/4 = ₦75, 000

Debit PPE ₦75, 000

Credit Payables ₦75, 000

At the date of settlement:

₵300,000/4.8 = ₦62, 500

Debit payables ₦75, 000

Credit FX Gain (P/L) ₦12, 500

Credit Cash ₦62, 500

No further transaction will occur. All depreciation charged on this asset will be based on ₦75, 000.

Example:

Jabir Nig Ltd entered into the following foreign transactions with Swiss-based suppliers and customers during the year ended 31st December 2013:

Date	**Details**	**Amount SwFR**
31st January	Purchase of PPE	300,000
9th April	Payment for the PPE Purchases on credit	300,000 150,000
30th June	Sales on credit	400,000
23rd September	Payment for the purchases	150,000
5th December	10 year loan taken out	500,000

The relevant exchange rates were:

Date	SwFr : ₦
31st January	1.5 : 1
9th April	1.8 : 1
30th June	1.6 : 1
23rd September	1.2 : 1
5th December	1.3 : 1
31st December	1.4 : 1

Required: Prepare Journal Entries to record the above transactions.

Solution

31st January 2013

SwFr300, 000 / 1.5 =		₦200, 000
Debit	PPE	₦200, 000
Credit	Payables	₦200, 000

9th April 2013

5wFr300, 000 / 1.8 N166, 667

SwFrl50, 000 / 1.8 = ₦83, 333

Debit	Payables	₦200, 000
Credit	Cash	₦166, 667
Credit	FX Gain (P/L)	₦33, 333
Debit	Purchases	₦ 83,333
Credit	Payables	₦ 83,333

30th June 2013

SwFr400, 000 / 1.6 =		₦250, 000
Debit	Receivables	₦250, 000
Credit	Sales	₦250, 000

23rd September 2013

SwFrl50, 000 / 1.2 = ₦125, 000

Debit	Payables	₦83333
Debit	FX Loss (P/L)	₦41, 667
Credit	Cash	₦125, 000

5th December 2013

SwFr500, 000 / 1.3 = ₦384, 615

Debit	Cash	₦384, 615
Credit	Loan	₦384, 615

In addition, at the year ended 31st December 2009, any outstanding monetary items must be re-translated at the closing rate. In this example, there are two such monetary items remaining:

- The Receivables arising from the sale of goods on 30th June
- The Loan taken out on 5th December

31st December 2013

SwFr400, 000 / 1.4 =₦285, 714 (Re-state the receivable to this amount)

SwFr500, 000 / 1.4 =₦357, 143 (Re-state the loan to this amount)

Debit	Receivables	₦35, 714
Credit	FX Gain (P/L)	₦35, 714
Debit	Loan	₦27, 472
Credit	FX Gain (P/L)	₦27, 472

Summary of FX Gains / Losses for the year ended 31st December 2013:

		₦
9th April	Gain	33,333
23rd September	Loss	(41,667)
31st December	Gain	35,714
31st December	Gain	27,472
Net Gain to P/L for year		54,852

Note that when the Receivable is received in 2014, a further exchange gain or loss will need to be calculated upon settlement and included as part of the profit or loss for the year ended 31st December 2014.

TRANSLATING THE FINANCIAL STATEMENTS OF FOREIGN OPERATION

Where a subsidiary entity's functional currency differs from the presentation currency of its parents, its financial statements must be translated into the parent's presentation currency prior to consolidation.

There are number of different methods that can be used to deal with the translation of foreign subsidiary. The method below outlines one such approach.

The following exchange rates should be used in the translation:

Profit or Loss /Statement of profit or loss and other comprehensive income:

Income:	average rate for the year
Expenses:	average rate for the year

Note that average rote for the year is used for expediency. Ideally, each item of income and expenditure should be translated at the rate in existence for each transaction. But if there has been no significant variance over the period, the average rate can be used.
Statement of financial Position

Assets & Liabilities.	Closing rate (i.e. the rate at the reporting date)
Share capital	historic rate (i.e. the rate at the date of acquisition)
Pre-Acquisition reserves:	historic rate
Post–Acquisition reserves:	Balancing figure

Exchange differences arise because items are translated at different points in time at different rates of exchange, for example, the profit or loss for the year forms part of the entity’s overall retained earnings in the statement of financial position. But, the profit or loss for the year is arrived at by using the average rate, whereas the reserves figure as a whole in the statement of Financial Position does not use the average rate all.

In the absence of such items as revaluations of property, plant and equipment, issues of shares for cash etc. the following accounting equation is true:

Opening net assets + retained earnings for a reporting period = closing net assets.
The exchange difference arising on translation of foreign currency accounts arises as follows:

Opening net assets	+ Retained Earnings for the year	= Closing net asset
In the previous year's financial statements, these were translated at last year's closing rate. For the purposes of this year's accounts, they are included within closing net assets at this year's closing Rate	Revenue and expenses are translated within the Profit or Loss at the average rate. However, the profit is included within this year's closing net assets at the closing rate	

Therefore, the exchange difference can be calculated as follows:

Opening net assets at this year's closing rate		X
Opening net assets at last year's closing rate	(X)	
		X/(X)
Profits for year at closing rate		X
Profit for year at average rate		(X)
		X/(X)
Total exchange gain / loss (multiplied by Group Share)	X/(X)	

For Example:

	Opening Net Assets	+	Retained Earnings	=	Closing Net Assets
Foreign currency	400		200		600
Exchange rates	5		4.50 (Average)		4
Euros	80	+	44.44	=	150

As can be seen, when translated in Euros, the equation does not work. A difference of 25.56 occurs. This is because of movements in the exchange rates used to translate the figures.

These differences can be explained as follows:

Translation difference 1

Opening net assets	400	
At opening rate 5	80	
At closing rate 4	100	
Difference		20.00

Translation difference 2

Retained earnings for year		200	
At average rate 4.50	44.44		
At closing rate 4.00	50.00		
Difference			5.56
Total translation difference			25.56

Goodwill on consolidation

Goodwill is calculated in the normal way, e.g. if using the proportion of net assets method:

Fair Value of consideration	X
Less: share of net assets acquired	(X)
Goodwill	X

Alternatively, if goodwill and NCI are to be arrived at using the fair value method, calculate as follows:

Fair values of consideration given	X
Fair values of NCI at acquisition	X
	X
LESS: Net assets at acquisition	(X)
Goodwill	X

However, either way, the goodwill is initially calculated in foreign currency.
Goodwill is then translated twice:

1. at the rate existing at the date of acquisition
2. at the rate existing at the reporting date

The exchange difference arising will form part of the total exchange difference disclosed as other comprehensive income and accumulated in other components of equity.

Non-Controlling Interest

Profit or Loss/Statement of profit or loss and other comprehensive income:
NCI is the share of the subsidiary's profit as translated for consolidated purposes

Statement of Financial Position:

NCI is calculated by reference to either the net assets of the subsidiary or the fair value at acquisition plus the share of post-acquisition profits.
In either case, the NCI is translated at the closing rate at the reporting date
Illustration:

On 1st June 2011, Nigeria Limited acquired 80% of Sweden Inc. whose functional currency in the Krona (KR). The financial statements at 31st May 2012 are as follows:

Profit or Loss

	Nigeria	Sweden
	₦	KR
Revenue	25,000	15,000
Operating Costs	(15,000)	(26,250)
Profit before tax	10,000	8,750
Tax	(8,000)	(7,450)
Profit for the year	2,000	1,300

Statement of Financial Position

	Nigeria	Sweden
	₦	KR
Investment in Sweden	5,000	
Non-current assets	10,000	3,000
Current assets	5,000	2,000
	20,000	5,000
Share capital	6,000	1,500
Retained earnings	4,000	2,500
	10,000	4,000
Liabilities	10,000	1,000
	20,000	5,000

Neither entity recognized any components of other comprehensive income in their individual accounts in the period.

The following information is applicable:

1. At the date of acquisition, the fair value of the net assets of Sweden was KR6, 000. The increase in the fair value is attributable to land that remains carried by Sweden at its historical cost.
2. Goodwill is translated at the closing rate.
3. During the year Nigeria sold goods on cash terms ₦1,000 to Sweden
4. On the 1st May 2010, Nigeria lent Sweden ₦400. The liability is measured by Sweden at the historic rate.
5. The non-controlling interest is valued using the proportion of net assets method.
6. Exchange rates to the

	₦	KR
1st June 2011	1.50	
Average rate		1.75
1st May 2012	1.90	
31st May 2012		2.00

Required:
Prepare the group statement of financial position, Profit or Loss and statement of profit or loss and other comprehensive income at 31st May 2012.

Solution

Step 1: Establish Group Structure

	Sweden
Group	80%
NCI	20%
	Subsidiary
	1 year

Step 2: Adjustments

2.1 Inter Company Loan

Sweden has recorded the loan at its historic amount. The monetary liability must be translated at the closing rate, with any gain/loss arising being included in the P/L for the year. Initially, the loan would have been recorded at ₦400 x 1.9 = KR760

At year end, the loan is retranslated at ₦400 X 2= KR800

Thus, there is a loss of KR40

		KR	KR
Debit	P/L Sweden	40	
Credit	Loan		40

Any gain or loss arising must be adjusted for in Sweden Profit or Loss, before translation. Remember to eliminate the inter-company loan on consolidation.

2.2 Revaluation at the Date of Acquisition

At acquisition, the fair value of Sweden net assets was KR6, 000

At that date:

	KR
Share capital	1,500
Pre-Acq. Reserves	1,200 (2,500 less 1,300 profit for the year)
	2,700
Fair Value	6,000
Increase	3,300

The increase is in respect of land. Thus,

		KR	KR
Debit	PPE	3,300	
Credit -	Revaluation Reserve		3,300

Step 3: Translate the Profit or Loss of Sweden, at the average rate for the year

	KR	Rate	₦
Revenue	35,000	1.75	20,000
Operating Costs	-	1.75	-
	26,250		15,000
FX loss on loan	(40)	1.75	(23)
Profit before tax	8,710		4,977
Tax	(7,450)	1.75	(4257)
Profit for the year	1,260		720

Step 4: Calculate Goodwill Arising on Acquisition

(i) Calculate goodwill in foreign currency
(ii) Translate goodwill at the spot rate at acquisition
(iii) Translate goodwill at the closing rate at year end
(iv) The difference represents either a gain or loss and is shown in reserves

			KR
Cost of investment	₦5, 000 x 1.5		7,500
Less:			
Net assets (given in question)		6,000	
Group share		80%	
			4,800
Goodwill in foreign currency			2,700
Translate at acquisition	2,700/1.5		1,800
Translate at reporting	2,700/2		
1,350			
Date			
Loss (to reserves)			450

Step 5: Translate the SOFP of Sweden

		KR	Rate	₦
Non-current assets		6,300	2	3,150
Current assets		2,000	2	1,000
		8,300		4,150
Ordinary share capital		1,500	1.5	1,000
Revaluation reserve		3,300	1.5	2,200
Reserves:	Pre-Acq	1,200	1.5	800
	Post-Acq (BAL fig)	1,260	(BAL fig)	(370)
		7,260		3,630

Liabilities	1.040	520
	8,300	4,150

Step 6: Prepare the Consolidated Profit or Loss and SOFP

Profit or Loss

	Nigeria	Sweden	Adjust.	Total
	₦m	₦m	₦m	₦m
Revenue	25,000	20,000	(1,000)	44,000
Opening costs	(15,000)	(15,000)	1,000	-
FX Loss	(23)			
Profit before tax	10,000	4,977		14,977
Tax	(8,000)	(4,257)		-
				12,257
Profit after tax	2,000	720		2,720

NCI: ₦720x20%=₦144

Nigeria Group

Consolidated Statement of profit or loss and other comprehensive income for the year ending 31st May 2012

	₦
Revenue	44,000
Operating costs	29,023
Profit before tax	14,977
Tax	-
(8,000+4,257)	12,257
Profit after tax	2,720
Other Comprehensive Income	
Loss on retranslation of Goodwill	(450)
Exchange loss on translation of financial statements (see below)	(1,090)
Total Comprehensive Income	1,180

Profit attributable as follows:	
Equity holders of parent	2,576
NCI	144
	2,720

Total Comprehensive Income attributable as follows:	
Equity holders of parent (2,576 - 872 - 450)	1,254.0
NCI (144-218)	(74.0)
	1,180.0

Nigeria Group

Consolidated Statement of Financial Position at 31st May 2012

	₦m	₦m
Assets		
Non-current Assets		
Intangibles: Goodwill		1,350
Tangibles (10,000 + 3,150)		13,150
Current Assets (5,000 +1,000-400)		5,600
		20,100
Equity and Liabilities		
Equity		
Share capital		6,000
Reserves (see below)		3,254
		9,254
NCI (see below)		726
		9,980
Liabilities (10,000 + 520 - 400)		10,120
		20,100

Note 1: NCI in SOFR

On translation of Sweden SOFP in Step 5 earlier, the net assets (capital and reserves) were translated as ₦3, 630 in total.

Thus, NCI is ₦3, 630 x 20% =₦726

Note 2: Consolidated Reserves

	₦m	₦m
Nigeria:		
Per SOFP		4,000
Loss on retranslation of goodwill		(450)
		3,550
Faraway:		
Group share of post-acq reserves		
80% x (370) = (296) [the post-acq reserves were Calculated as a balancing figure in the translation Of the SOFP of Faraway in Step 5)		
		(296)
		3,254

Note 3: Exchange Difference

In the Consolidated Accounts, the exchange difference will comprise:

(i) Exchange difference on translation of the financial statements

(ii) Exchange difference on retranslation of goodwill

The total exchange difference shall be disclosed as other comprehensive income.

There are two ways in which the exchange difference arising on the translation of the financial statements can be calculated.

Method 1:

	₦m
Opening reserves	800.0
Profit for year	720.0
	1,520.0
Closing reserves	430.0
Exchange difference	1,090.0

Group share ₦1, 090 x 80% =₦872

NCI share ₦1, 090 x 20% = ₦218

Method 2:

Opening net assets (1,500 + 3,300 + 1,200) = KR6, 000

		₦m
Opening net assets at last year's closing rate (1.5)		4,000
Opening net assets at this year's closing rate (2)		3,000
	Loss	1,000

Profit for year = KR1, 260

		₦m
Profit for year at average rate (1.75)		720
Profit for year at closing rate (2)		630
	Loss	90

Total Net Loss 1,000 + 90 + 1,090

Group share ₦1, 090 x 80% =₦872

NCI share ₦1, 090 x 20% =₦218

Illustration 2

Mahmud, a public limited company owns 75% of the ordinary share capital of Ramadan, a public limited company which is situated in a foreign country. Mahmud acquired Ramadan on 1st May 2011 for 120 million Krona (KR) when the retained profits of Ramadan were 80 million Krona. Ramadan has not revalued its assets or issued any share capital since its acquisition by Mahmud. The following financial statements relate to Mahmu and Ramadan.

Statements of financial position at 30th April 2012

	Mahmud	Ramadan
	₦m	₦m
Property, plant and equipment	297	146
Investment in Ramadan	48	-
Loan to Ramadan	5	-
Current assets	355	102
	705	248
Capital and reserves		
Ordinary shares of N1/1/1KR	60	32
Share premium account	50	20
Retained earnings	360	95
	470	147
Non-current liabilities	30	41
Current liabilities	205	60
	705	248

Statements of Comprehensive Income for year ended 30th April 2012

	Mahmud	Ramadan
	₦m	₦m
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 for the year	34	15

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

(a) During the financial year Ramadan has purchased raw materials from Mahmud and denominated the purchase in Krona in its financial records. The details of the transaction are set out below:

	Date of Transaction	Purchase Price	Profit Percentage on Selling Price
		€m	
Raw materials	1st February 2012	6	20%

At the year-end, half of the raw materials purchased were still in the inventory of Ramadan. The inter-company transactions have not been eliminated from the financial statements and the goods were recorded by Ramadan at the exchange rate ruling on 1st February 2012. A payment of €6 million was made to Mahmud when the exchange rate was 2.2 Krona to ₦1. Any exchange gain or loss arising on the transaction is still held in the current liabilities of Ramadan.

(b) Mahmud had made an interest free loan to Ramadan of ₦5 million on 1st May 2011. The loan was repaid on 30th May 2012. Ramadan had included the loan in non-current liabilities and had recorded it at the exchange rate at 1st May 2011.

(c) The fair value of the net assets of Ramadan at the date of acquisition is to be assumed to be the same as the carrying value. Goodwill is to be calculated using the traditional method of only calculating goodwill acquired by the parent i.e. the non-controlling interest is calculated as a proportionate share of the subsidiary's net assets with no goodwill allocated.

(d) Ramadan operates with a significant degree of autonomy in its business operations.

(e) The following exchange rates are relevant to the financial statements:

Krona to ₦	
30th April/1st May 2011	2.5
1st November 2011	2.6
1st February 2012	2
30th April 2012	2.1
Average rate for year to 30th April 2012	2

(f) Mahmud has paid a dividend of ₦8 million during the financial year.

Required:
Prepare a consolidated statement of profit or loss and other comprehensive income for the year ended 30th April 2012 and a consolidated statement of financial position at that date in accordance with International Financial Reporting Standards.

Solution

Step 1: Establish Group Structure

	Ramadan
Group	75%
NCI	25%
	Subsidiary
	1 year

Step 2: Adjustments

2.1 Intercompany Purchases

Ramadan purchased goods from Mahmud and paid for them prior to the year end. The FX rate between the date of purchase and date of settlement changed, giving rise to a gain or loss. This exchange gain or loss is still held in the current liabilities of Ramadan, according to the question.

Thus, calculate the FX gain/loss arising and treat it properly in the accounts.
Initially, the transaction was recorded at ₦6m x 2 = 12 million Krone. The cost of settlement was ₦6m x 2.2 = 13.2 million Krona
Thus, Ramadan suffered a loss of 1.2 million Krona. Adjust its Profit or Loss to reflect this loss before translating the financial statements.

		KR	KR
		M	m
Debit	P/L (Random)	1.2	
Credit	Current Liabilities		1.2

2.2 Inter Company Loan

The loan was made by Mahmud to Ramadan on the 1st day of the accounting period and repaid by Ramadan after the year end.
Thus, this monetary liability existed at the year end and as such, needs to be retranslated at the closing rate. Any gain or loss arising must be adjusted for in Ramadan's Profit or Loss, again, before translation.
Initially, the loan would have been recorded at ₦5m x 2.5 = 12.5 million krona.
At year end, the loan is retranslated at ₦5m x 2.1 = 10.5 million Krona
Thus, there is a gain of 2 million Krona

		KR	KR
		M	m
Debit	Loan Account	2	
Credit	P/L (Ramadan)	2	

Remember to eliminate the intercompany loan on consolidation.

		Nm	Nm
Debit	Non-Current Liabilities	5	
Credit	Loan to Ramadan		5

Therefore, Ramadan has generated a net FX gain of 2m - 1.2m = 0.8m Krone, in respect of both the loan and the purchases. This is adjusted for in its Profit or Loss, and subject to translation.

2.3. Inter Company Profit on Inventory

Mahmud sold ₦6m goods to Ramadan, includes margin of 20%. At year end, ½ the goods remain.

₦6m x 20% x ½ =₦0.6m

		₦m	₦m
Debit	P/L (reserves) Memo	0.6	
Credit	Inventory		0.6

Eliminate inter- company sales and cost of sales ₦6m in the consolidated Profit or Loss.

Step 3: Translate the Profit or Loss of Ramadan, at the average rate for the year

	KR m	Rate	₦m
Revenue	142.0	2	71.0
Cost of sales	(96.0)	2	(48.0)
Gross profit	46.0		23.0
Distribution and Administration	(0.6)	2	(10.0)
Interest payable	(2.0)	2	(1.0)
Net Foreign Exchange gain	0.8	2	0.4
Profit before tax	24.8		12.4
Income tax expense	(9.0)	2	(4.5)
Profit after tax	15.8		7.9

Step 4: Calculate Goodwill arising on acquisition

(i) Calculate goodwill in foreign currency

(ii) Translate goodwill at the spot rate at acquisition

(iii) Translate goodwill at the closing rate at year end

(iv) The difference represents either a gain or loss and is shown in reserves

		KR m
Cost of investment		120
Less:		
	Share capital	32
	Share premium	20
	Reserves at acquisition	80
		132
		75%
		(99)
Goodwill in foreign currency		21

		₦m
Translate at acquisition	21/2.5	8.1

Translate at reporting date	21/2/1	10.0
Gain (to reserves)		1.6

Goodwill at the Reporting Date in the Consolidated SOFP is ₦10m

Step 5: Translate the SOFP of Ramadan

	Ke m	Rate	₦m
Tangible noncurrent assets	146.0	2.1	69.50
Current assets	102.0	2.1	48.60
	248.0		118.10
Ordinary share capital	32.0	2.5	12.80
Share premium	20.0	2.5	8.00
Reserves: Pre-Acq	80.0	2.5	32.00
Post-Acq (BAL fig)	15.8	(BAL fig)	17.60
	147.8		70.40
Non-Current liabilities (41-2)	39.0	2.1	18.60
Current liabilities (60+1.2)	61.2	2.1	29.10
	248.0		118.10

Step 6: Prepare the Consolidated Profit or Loss and SOFP

Profit or Loss

	Mahmud	Ramadan	Adjust	Total
	₦m	₦m	₦m	₦m
Revenue	200.0	71.0	(6.0)	265.0
Cost of sales	(120.0)	(48.0)	6.0	(162.6)
Inventory profit	(0.6)			
Gross profit	79.4	23.0		102.4
Admin & Distribution	(30.0)	(40.0)		(40.0)
Interest receivable	4.0			4.0
Interest payable		(1.0)		(1.0)
FX gain		0.4		0.4
Profit before tax	53.4	12.4		65.8
Tax	(20.0)	(4.5)		(24.5)
Profit after tax	33.4	7.9		41.3

NCI: N7.9m x 25% =N1.975m, say N2m

Mahmud Group

Consolidated Statement of profit or loss and other comprehensive income for the year ending 30th April 2012

	₦m
Revenue	265.0
Cost of sales	(162.6)
Gross profit	102.4
Administration & Distribution expenses	(40.0)
Interest receivable	4.0
Interest payable	(1.0)
FX gain	0.4
Profit before tax	65.8
Tax	(24.5)
Profit for the year	41.3
Other Comprehensive Income	
Gain on retranslation of Goodwill	1.6
Exchange gain on translation of financial statements (see below)	9.7
Total Comprehensive Income	52.6
Profit attributable as follows:	
Equity holders of parent	39.3
NCI	2.0
	41.3
Total Comprehensive Income attributable as follows:	
Equity holders of parent (39.3 + 1.6 + 7.3)	48.2
NCI (2+ 2.4)	4.4
	52.6

Mahmud Group

Consolidated Statement of Financial Position at 30th April 2012

	₦m	₦m
Assets		
Non-current Assets		
Intangibles: Goodwill		10.0
Tangibles (297 + 69.5)		366.5
Current Assets (355 + 48.6 - 0.6)		403.0
		779.5

Equity and Liabilities	₦m	₦m
Equity		
Share capital		60.0
Share premium		50.0
Reserves (see below)		374.2
		484.2
NCI (see below)		17.6
		501.8
Non-current Liabilities (30 + 18.6 - 5)		43.6
Current liabilities (205 + 29.1)		234.1
		779.5

Note 1: NCI in SOFP

On translation of Ramadan's SOFP in Step 5 earlier, the net assets (capital and reserves) were translated as ₦70.4m in total.

Thus, NCI is ₦70.4m x 25% = ₦17.6m

Note 2: Consolidated Reserves

	₦m	₦m
Per SOFP	360.0	
Inventory profit	(0.6)	
Gain on retranslation of goodwill	1.6	
		361.0
Ramadan:		
Group share of post-acq reserves		
75% x 17.6 (17.6 was calculated in the		
Retranslated SOFP of Ramadan in Step 5)		13.2
		374.2

4.07. Analysis of Foreign Financial Statements

Analysis of foreign financial statements, according to Nobes and Parker (2008), could involve:

i. The analysis of the operations of a multinational company, where the financial statements result from a process of aggregation of underlying transactions that have been carried out in a number of countries and denominated in various currencies; or

ii. Transnational comparison between companies that are based in different countries but do not necessarily have multinational activities; or, by contrast,

iii. The geographical spread not of companies but of the users of corporate reports, where the analysis is carried out by residents of different countries – Italian investors, American bankers, or Japanese fund managers, for instance – with their own particular expectations about corporate activity.

Whilst each of these distinctive 'international' dimensions of financial statement analysis is important, the basic process of financial communication remains the same. In each case, the concern is essentially with financial information that has crossed national boundaries at some stage. In so doing, financial statistics are restated and financial terminology is translated. For instance, some of the information disclosed by a multinational has already been restated using an alternative set of accounting methods and translated into a different language and currency during the consolidation of financial statements. In the case of a transnational comparison of two or more companies, it is the financial analyst who is most likely to confront the problems of restating financial statistics and translating financial terminology. Indeed, some of the key issues in international financial analysis are concerned with the restatement and translation of financial reports that describe operations conducted in one environment but that are the subject of review and analysis in another.

In subsequent parts of this section, discussion will focus on the reasons for analyzing foreign financial statements, the common problems encountered in analyzing foreign financial statements, and possible solutions to the problems of analyzing foreign financial statements.

Reasons for Analyzing Foreign Financial Statements

The following are the reasons for analyzing foreign financial statements:

1. Foreign portfolio investment Decisions
    a. Investors can diversify away some risk by investing internationally.
    b. While stock returns in many countries are positively correlated, these correlations are far from perfect.
    c. International investors, including managers of international mutual fund, rely on foreign financial statements.

2. International mergers and acquisitions
    a. The frequency and size of international corporate mergers has increased in recent years.
    b. The purchaser of an international company needs to analyze the target company's financial statements to determine the acquisition price.

3. Other reasons
    a. Extending credit for foreign customers.
    b. Evaluating foreign vendors.
    c. Benchmarking against foreign competitors.

Problems Encountered in Analyzing Foreign Financial Statements

The following are the common problems usually encountered in analyzing foreign financial statements:

1. Data availability and accessibility
    a. Financial information is difficult to obtain in many countries.
    b. While databases of foreign financial statements do exist, these can contain errors and present information in a variety of formats.
    c. These databases also do not often contain complete disclosure notes.

2. Language understandability
    a. Many international companies do not produce financial statements in English.
    b. The financial statement user could hire a translator or develop foreign language capability.
    c. Since English is the language of business, companies in many foreign countries produce convenience translations of their financial statements in English.

3. Currency problem

    Many international companies produce their financial statements in a currency other than the reporting currency.

4. Terminology
    a. Differences in terminology exist between countries using the same language.
    b. For example, sales in the U.S. is normally called turnover in the UK.
    c. In cases of convenience translations, sometimes these include terminology unfamiliar to English speakers.

5. Format
    a. Some format differences are not problematic because the information is given, just in a different place. However, other format differences are a problem because the information is not provided.
    b. It is common in Europe not to provide cost of goods sold. This prevents an analyst from determining gross margin percentage and inventory turnover.
    c. German and other continental European companies often do not distinguish between current and noncurrent liabilities. This makes it difficult or impossible to compute a current ratio.

6. Extent and adequacy of disclosure
    a. Disclosure internationally tends to be limited compared to the U.S. where full disclosure is fundamental.
    b. Some of the most serious disclosure limitations are information on segments, asset valuation, foreign operations, interim statements, and reserves.
    c. Lack of disclosure contributes to the significance of format problems.

7. Timeliness
   a. Timeliness is one aspect of the relevance of information.
   b. This varies significantly internationally since filing deadlines differ from country to country.
   c. Among developed countries, the U.S. and Canada are the timeliest whereas continental Europe is the least.
   d. Requirements about the frequency of information also vary internationally from quarterly to annual reporting.

8. Differences in accounting principles
   a. Differences in accounting principles often result in significantly different income and other financial statement amounts.
   b. Some of the biggest problem areas are consolidations, fixed asset valuation and depreciation, and goodwill.
   c. These differences cause some investors to limit the scope of their investments.

9. Business environment differences
   a. Differences in culture and economic environments have an impact on the relevance of ratios. A study of companies in Japan, Korea, and the U.S. found significant differences due to business environment. For example, Japanese and Korean companies borrow much more on a short-term basis than U.S. companies, leading to lower current ratios.
   b. Debt ratios also tend to be higher in Japan and Korea because of the sources of financing.
   c. Lower profit margins in Japan, relative to U.S., can be partly explained by those companies focus on market share as opposed to profits.

In summary, an investor needs to be aware of these differences and not forgo potentially profitable investments.

Possible Solutions to the Problems of Analyzing Foreign Financial Statements

It is believed that with the adoption of IFRS by many countries across the globe, the problems of analyzing foreign financial statements will be highly minimized. However, some of the problems are likely to persist for obvious reasons. Therefore, the search for solutions to the problem must continue indefinitely. The following possible solutions to foreign financial statements analysis are relevant.

1. A likely solution to the language problem is for the financial statement user to hire a translator or develop foreign language capability. In addition, since English is the language of business, companies in non-English speaking countries should produce convenience translations of their financial statements in English.
2. Foreign currency translation is a possible solution to currency related problems. This

can be achieved by translating all balances at the exchange rate at the end of the current year. Also, to avoid distortions, the current exchange rate could be used for all previous years. In addition, analysis using ratios could be a solution since it is not usually distorted by different currencies. Finally, knowledge of the business and accounting environment can help alleviate some of these problems.

3. In order to address disclosure problem, it is generally believed that globalization of capital markets will enhance disclosure as companies attempt to attract investors.
4. The problem of differences in accounting principles are currently addressed using the following approaches:
    a. Restatement of results in accordance with internationally recognized accounting principles (i.e. IFRS).
    b. Reframing foreign financial statements to a more familiar GAAP. This is usually the case with most US investors since US SEC stipulates that foreign Registrants must file a set of financial statements prepared using US GAAP or reconciled to it. This still applies unless the registrant complies with IFRS.
    c. Another approach is to use a stripped down measure of earnings that excludes items most affected by diversity.
    d. Another coping mechanism is to base analysis on a measure of performance from which accounting issues have been removed, such as earnings before interest, taxes, depreciation and amortization (EBITDA).
5. A possible solution to the problem of data availability and accessibility is to obtain a copy of the foreign company's annual report as prepared using the functional currency.

An example of restatement involving the net income of some multinational companies operating in UK, France and Brazil is provided in Table 4.07.1 below.

Table 4.07.1: Restatement of Results of Multinational Companies

Company	Country/Local GAAP	Local GAAP Net Income (Loss) (millions)		US GAAP Net Income (Loss) (millions)		Difference US Dollars (millions)
		Local Currency	US Dollars	Local Currency	US Dollars	
Exxon Mobil	USA				$39,500	
BP	UK IFRS		$22,000		$21,114	($886)
Royal Dutch Shell	UK IFRS		$25,442		$24,797	($645)
Total	France IFRS	€11,768	$14,828	€11,400	$14,364	($464)
Petrobras	Brazil IFRS		$10,344		$10,344	0

As earlier noted, as the use of IFRSs becomes more widespread, many of these problems will abate.

Analysts must exercise caution in interpreting ratios calculated for foreign firms because what is considered to be good in one country may be considered otherwise in another country. Some of the reasons for this are:

a) Financial ratios can differ across countries as a result of differences in accounting principles

b) Financial ratios can also differ across countries as a result of differences in business and economic environments. Optimally, an analyst will develop an understanding of the accounting and business environments of the countries they wish to analyze.

4.08 Review Questions

1. One of the influential environmental factors that determine a country's accounting development is the country's economic environment.

Required:

Critically x-ray the two major economic factors that generally shape the development of accounting globally and pinpoint clearly how such factors have influenced accounting practice in Nigeria.

2. Is worldwide application of IFRS going to solve the problems of international financial analysis?

3. International transfer of accounting technology to LDCs and EMs has occurred through a number of non-formalized methods.

Required:

Outline seven of the non-formalized methods used in transferring accounting technology to LDCs and EMs and critically examine the effect of this transfer to the development of accounting systems of these countries.

4. On 1 January 20X1 Taye plc acquired 80% of the ordinary shares of a Singaporean company, Fastlink Ltd, for ₦6m when fastlink's retained earnings were $15.5m and the share premium was $0.8m. Fastlink's financial statements have been prepared in their functional currency of Singapore dollars and comply with lAS 2l. The summarised statements of income and financial position as at 31 December 20XI were as follows:

Statements of income for the year ended 31 December 20X1

	Taye	Faslink
	₦000	$000
Sales	200,000	50,000
Opening inventories	20,000	8,000
Purchases	130,000	30,000
Closing inventories	(40,000)	(6,000)
Cost of sales	110,000	32,000
Gross profit	90,000	18,000
Expenses	(15,000)	(6,500)
Profit before taxation	75,000	11,000
Taxation	(15,000)	(3,000)
Profit after taxation	60,000	8,500

Statement of financial position as at 31 December 20x1

	Taye	Faslink
	₦000	$000
Non-current assets	90,000	25,000
Investment in Fast link	6,000	-

Current assets:		
Inventories	40,000	6,000
Trade receivables	27,000	5,000
Cash	2,000	4,000
Total current assets	69,000	15,000
Current liabilities:		
Trade payables	35,000	11,000
Taxation	15,000	3,000
Total current liabilities	50,000	14,000
Total assets less liabilities	115,000	26,000
Share capital	20,000	1,000
Share premium		800
Retained earnings	95,000	24,000
	115,000	26,000

The following information is also available:

(i) The opening inventory was acquired when the exchange rate was ₦1=$2.6 and the closing inventory when the rate was ₦1= $2.2

(ii) Exchange rates were as follows

At I January 20x1	₦1= $2.5
Average for the year ending 31 December 20x4	₦1= $2.25
At 31 December 20x1	₦1= $2.0

Required:

(a) Prepare a consolidated statement of income.

(b) Prepare a consolidated statement of financial position:

  (i) Show the goodwill calculation

  (ii) Show the non-controlling interest calculation.

  (iii) Complete with retained earnings as a balancing figure.

(c) Reconcile the retained earnings figure showing exchange gains and losses.

MODULE 5

5.00 ANALYSIS, EVALUATION AND INTERPRETATION OF FINANCIAL STATEMENTS

5.01 Learning Outcomes

On successful completion of this Module, Students should be able to:

i. Apply ratios in analyzing financial statements generally, and statement of cash flows in particular.
ii. Critically appraise the uses and limitations of financial statements.
iii. Explain and evaluate the various methods of treating goodwill.
iv. Interpret financial statements and prepare reports thereon for different user groups.

5.02 Ratio Analysis

The ability to comprehend, assesses, interpret and criticise the financial statements and related information of different businesses is the quality above all others, which distinguishes the accountant from the bookkeeper. Complete mastery of accounts can be gained only as a result of wide experience, but whatever one's personal circumstances he can increase his understanding by careful and systematic reading of the financial columns of the daily press and by close attention to the professional journals.

The object of this module is to show you the method which must underlie all good reports and appraisals, and the way in which they should be drafted.

Subject Matter for Analysis

Analysis of accounts usually means the analysis of SOFPs and trading and income statements ('final accounts') or the equivalent. Such accounts may be of two types:

(a) Published accounts, i.e. those prepared for the information of shareholders, etc.

(b) Internal accounts, i.e. those prepared for the information of the directors and management.

The second type, being the accounts upon which the policy of the concern is based, is usually in much greater detail than the first.

In either case, greater reliance can be placed on accounts which have been audited by a professional firm of standing than on any others; in particular, accounts drawn up by a trader himself are always open to question.

Analysis of accounts (meaning final accounts) does not, therefore, include any other accounts which may appear in the books. It is not an audit of the books or an investigation into the way in which the books have been kept. So long as the SOFP and accounts are genuine, it does not matter whether the books have been well or badly kept.

Purpose of Analysis
The primary object of analysis of accounts is to provide information. Analysis which does not serve this purpose is useless.

The type of information to be provided depends on the nature and circumstances of the business and the terms as reference. Terms of reference means the specific instructions given by the person wanting the enquiry to the person making it. Of course, if the person making the enquiry is also the person who will make use of the information thus obtained, he will be aware of the particular points for which he is looking.

The position of the ultimate recipient of the information must be especially noted. Suppose you are asked by the debenture holder to comment on the SOFP of a company in which he is interested. It should be a waste of time to report at length on any legal defects revealed in the SOFP. You would naturally pay attention to points which particularly concern the debenture holder, e.g. the security for his loan to the company, and the extent to which his interest in the debentures is 'covered' by the annual profits.
This does not mean that legal defects should be ignored. It is very important that they should be mentioned (although briefly), for failure to comply with legal requirements may be indicative of more serious shortcomings, possibly detrimental to the security of the debenture holder.

This matter of approach is vital to the task of analysis. We shall now consider certain special matters in which various parties will be particularly interested. For the sake of illustration, we will deal with their positions in relation to the accounts for a limited company, but many of the points we are going to mention are relevant to the accounts of a sole trader or partnership.

INTERESTED PARTIES

Debenture Holders
These are interested in both the long- and short-term position of the company. In the long term they are interested in the company's ability to repay the sums lent by them (assuming they are redeemable). They would look to see whether a sinking fund has been created, and for the realisable value of the assets which form security for their loans. The basis of valuation of assets would therefore be important, and whether the depreciation provision is adequate.
In the short term the debenture holder will consider the company's ability to pay the loan interest and hence will examine the working capital (current assets less current liabilities).

Trade Payables
As a general rule, a trade creditor will rely on trade references or personal knowledge when forming an opinion on the advisability of granting or extending credit to a company. He is not often concerned with the accounts, which he rarely sees, but if he does examine the

accounts he will be as much concerned with existing liabilities as with assets. In particular, he will note the following:

a. Working capital position or ability of company to pay debts when they fall due.
b. Ease with which current assets can be converted into cash.
c. Prior claims to company's assets in the event of a liquidation, i.e. secured loans or overdrafts.
d. Earnings record and expansion programme.

Bankers

Before making a loan or granting an overdraft, the bank would consider:

a. The nature and purpose of the loan.
b. The duration of the loan (bankers prefer the short- or medium-term loan to those for longer periods).
c. The arrangements for repayment.
d. The prospects of repayment.
e. Security and prior rights to the assets of the company on liquidation.
f. Financial policies of the company, and calibre of management.

Shareholders

The average shareholder is interested in the future dividends he will receive. Future profits are of secondary importance, so long as they are adequate to provide the dividend.
Past dividends provide the basis on which future dividends may be estimated, just as past profits afford a similar indication as to future profits. Estimates may, however, be upset because of radical changes in the nature of trade production methods, general economic conditions, etc.

If the shares are listed on an inventory exchange, it will be found that the market price varies more or less directly with the dividends declared. It is generally accepted that a company ought not to pay 'out more than two-thirds of its distributable profits each year in the form of dividend.

Cover is a vital factor in respect of any shares carrying fixed dividend rights, e.g. preference shares. The coefficient of cover is determined by dividing the annual dividend into the amount of the annual profits.

With redeemable shares, attention will be paid to the ability of the company to redeem on the due dates. There may be a sinking fund created for this purpose.
Overall, the shareholder would be concerned with whether the company still provides the best home for his investment or whether his money would be better utilised elsewhere.

Directors and Management

These are interested in the actual results, to enable them to:

i. Compare with competitors.
ii. Compare with budgeted or expected results.
iii. See whether capital has been utilised in the best way and profits maximised.

Potential Takeover Bidders

In a takeover situation, the buying company may see hidden potential in another company in the form of under-value assets or under-utilised funds. It may therefore be able to make a successful offer to the shareholders, who may not be aware of their company's real value. Potential takeover bidders would consider:

i. Current value of assets as opposed to book values.
ii. The asset-stripping potential, i.e. can the assets be sold off for a profit and the company liquidated rather than bought as a going concern for continuation in the future?
iii. The effect of the directors' financial and dividend policies in fostering shareholders' loyalties (e.g. is there still feeling and aggravation at the annual general meeting?).

PROFITABILITY RATIOS

Control of all costs, direct and indirect, is essential if profit is to be maximised. In a broad and general fashion, excluding the advanced techniques of budgetary control and cost accounting, it is possible to watch total costs of each type, and to take action to reduce them when necessary.

This may be done by comparing manufacturing costs, administration costs, and selling and distribution costs with profit (gross or net) or with sales. The broad headings, manufacturing costs, etc. can, of course, be usefully" analysed into their constituent parts and similar comparison made with profit or sales: The trend of the ratio - whether there has been an increase or decrease in costs as compared with profit or sales - is the significant factor.

Income as a Percentage of Turnovers

Under this heading can be grouped the various profit margins:

(a) Gross Profit Percentage

This is: $\dfrac{\text{Gross Profit}}{\text{Sales}}$

(b) Net profit Percentage before Tax

This is: $\dfrac{\text{Pre-Tax Profit}}{\text{Sales}}$

(c) Net Profit Percentage after Tax

This is: $\dfrac{\text{After-Tax Profit}}{\text{Sales}}$

Each one will lend itself to comparison with previous years' results or with the appropriate margins of another company.

Like so many aspects of ratio analysis, these figures can only provide a rough measure and care must be taken not to read too much into each. Consider the following example:

	Production A		Production B		Production C	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
	₦	₦	₦	₦	₦	₦
Sales	80,000	100,000	40,000	50,000	120,000	150,000
Operating profit	10,000	18,000	8,000	7,000	18,000	25,000
Margin P/S	12.5%	18%	20%	14%	15%	16.6%

Normally only totals would be studied and, as you can see, the company has increased sales and increased total profits; its margin has also increased from 15% to between 16% and 17%.

Notice that to leave the matter-with only totals would have ignored important underlying factors. Product A has /increased its profit margin but Product B has become less efficient, despite increased sales.

The same sort of distorting factors can be seen in a situation where any final, total figures are made- up of different products each having a different margin of profit. This is called the product mix and means that a total profit margin can change, even if efficiency has remained the same, because there has been a change in the proportion of sales taken by component products. You can see this important point illustrated in the following example:

	Year 1		Year 2	
	Sales		₦	
	Sales		₦	
	Product X	30,000	Product X	70,000
	Product Y	60,000	Product Y	220,000
		90,000		290,000

Profit margins for X and Y for both years are 7% and 15% respectively.

We can calculate profit and profit margins:

	Year 1		Year 2
	₦		₦
X Profit	21,000	X Profit	4,900
Y Profit	9,000	Y Profit	33,000
Total Profit	11,100	Total Profit	37,900
Total Margin	12.3%	Total Margin	13.1%

Although margins have increased from 12.3% to 13.1% the company has not become any more efficient. The reason for the better figures in Year 2 is because product Y, with a much better margin of profit, has taken up a much larger share of total sales than has product X. Even this illustration is itself an oversimplification and you must always approach profit margins with caution. For instance, it is important to think about accounting policies. An example would be the treatment of development expenditure, which can be capitalised and amortised, provided the criteria in IAS 38 are met.

Net Income Related to Capital Employed

This is widely used but unfortunately the formula for capital employed is not widely agreed. The ratio is used because it attempts to relate income generated to the resources employed.

The meaning of capital employed can be approached from two angles - the finance and the asset approaches:

(a) Finance Method

Income is related to total funds invested in the business and this involves taking the total of all shareholders (proprietors' if sole trader or partnership) funds plus future and current liabilities as shown in the SOFP.

(b) Assets Method

Income is Related to assets employed, being fixed assets and current assets as shown in the SOFP. Thus the values placed on non-current and current assets will reflect directly on this ratio. To capitalise brands, for example, is thought to strengthen a SOFP. But you can also appreciate what it does to the return on capital employed, with the increase in assets it provides.

We are really talking about the same figure, as a SOFP must balance. The difference between the two will concern the assets or funds to be counted. Are all funds/assets included in the figure for capital employed, whether employed during the year or not? Is working capital to be counted, or only fixed capital?

There is no easy answer to these questions and again the wisest approach will be one of caution. Generally, however, total funds or total assets will be favoured since investors expect all resources to be used. In any case, all resources have an opportunity cost, i.e. alternative uses.

Net Income Related to Shareholders' Funds

This may be useful in showing how efficiently a particular section of company capital is being used and what is said: here in connection with shareholders' funds could equally apply to other types of funds, loan capital, etc.

Various Expenses Related to Turnover

Using this ratio, wages, departmental expenses, selling expenses can all be related to sales. Comparisons can be made p": over periods of time and at the same time within the firm.

Value Added Per Employee

This is the amount added to the cost of materials consumed to cover labour charges, expenses and gross profit, divided H by the number of employees. Thus a guide is obtained to the output per employee.

Sales per Employee

This is obtained by dividing the value of sales for a period by the average number of persons employed during that p period. Expressed on its own it is of relative insignificance, but it is normally used in comparison with previous periods.

Times Covered for Interest and Dividends

This may be used to show how many times over a company could pay the demands on it in terms of interest and/or dividends. Alternatively it can show how far income would have to fall before dividend/interest was put at risk. It is calculated by the formula:

$$\frac{\text{Net Trading Income}}{\text{Rate of Interest x Loans, etc outstanding}}$$

This can be applied to preference shares, loan inventory and debentures.

LIQUIDITY RATIOS

Current Ratio

Current assets are compared with current liabilities. Generally speaking, the larger the former in relation to the latter the more financially stable is the business. As a very general rule, total current assets should be at least twice total current liabilities.

The length of time an asset is held or a liability is outstanding determines the category into which it falls i.e whether current or non-current. If an asset is to be held for up to a year, not longer, or a liability is to be paid off within a year, then one is a current asset and the other a current liability. Non-current assets or 'non-current liabilities, e.g. loan capital, are of a permanent nature.

This ratio can also be referred to as the working capital ratio.
Consider the following example illustrating the current ratio:

Extract from SOFP

	₦	₦	₦
Current Assets			
Inventory	80,000		
Accounts Receivable	110,000		
Less Provision for Bad Debts	5,500	104,500	
Cash at Bank and in hand			200
			184,700
Less: Current Liabilities			
Bank Overdraft			20,000
Accounts Payable			40,000
			60,000
			124,700

Current ratio 184,700: 60,000 = 3 to 1 (approx.)
From the information given, therefore, it would appear that the current ratio is quite satisfactory. The following points should, however, receive attention before any conclusion is reached:
i. The type of trade carried on by the business. In particular, trade fluctuations, owing to seasonality of sales of the product and the like, are extremely important. If the selling season is a number of months away, the inventory carried may build up considerably (giving a larger total of current assets) and yet, for all practical purposes, from the point of view of liquid resources the position will have deteriorated.

ii. Having regard to what is stated in (i), you will see that it is not the total ratio which is of importance but rather the composition of the total assets and total liabilities. Referring to the figures in the example we may ask:

Is the inventory composed mainly of raw materials or finished goods? Is the inventory slow moving? The aim should be to predetermine a desirable relationship between the different types of inventory and follow it as closely as possible.

Will the receivables pay promptly?

Will the bank extend the overdraft or is there a danger of it being called in?

The real question is the rate at which money will be received into the business as compared with the rate of payments to cover current liabilities. There is nothing static about a business but, unfortunately, this is often the erroneous impression gathered from accounting ratios. A clear understanding of the underlying implications is essential if ratios are to be a useful tool of management.

Application

From what we have said, it should be clear that '2 to 1' is only an approximate guide. At times a tower or higher ratio may be regarded as normal, e.g. a 5 to 1 ratio may be present at certain times of the year and be quite acceptable.

Once an ideal ratio for the business has been established, the most important point, from a financial point of view, is to ascertain whether there is a rise or fall, for, generally speaking, the former may be regarded as a favourable trend and the latter an unfavourable one. Again, no hard and fast rule is possible for much depends upon the circumstances.

Working Capital and the Current Ratio

The working capital is the excess of current assets over current liabilities. There is therefore a direct connection between working capital and the current ratio. If working capital is inadequate, so that the business is unable to pay its way, it will, if the worst comes to the worst, have to close down. This state of affairs usually arises from over-trading, i.e. having a volume of turnover which, with available working capital, is far too large. Typical steps leading to over-trading are:

(i) Large quantities of materials are purchased.

(ii) Extra workers and staff are employed to deal with the additional production and sales.

(iii) There is a rise in all other operating costs.

Next, after a time, the length of which depends upon the production and sales cycles, extra revenue from sales is received. Often a number of months will have elapsed before this extra cash is received. There has, however, been immediate payment of wages and salaries and only a limited period of credit will normally be allowed by payables. Possibly a bank overdraft will be obtained to accommodate immediate needs. If not, or when the limit of the overdraft is reached, an anxious creditor may apply for a petition, and the business may then be forced into bankruptcy or liquidation.

Even if a business does manage to survive, it will not, for a considerable period, be able to take advantage of a new market, the development of new ideas or a similar project. There is thus a second danger of being forced out of business, this being brought about by the competition of more progressive rival concerns.

In the circumstances outlined, only the availability of cash can avert the dangers. This is thus of the greatest possible importance to any business; without cash it is unlikely to survive. Inventories form part of the working capital and these, in the short term, are of limited value. It may be possible to attract cash customers by giving a discount, but this will mean that less profit is earned.
Because of the importance of paying payables promptly, it is advisable to fix a period of time within which accounts have to be settled. Following normal commercial practice, this may be taken as one month. If the business cannot meet its obligations within each month, then that is a danger sign, which indicates that prompt remedial action should be taken. The next ratio greatly assists in maintaining adequate cash or near cash resources.

Liquidity Ratio (Acid Test or Quick Ratio)
The liquidity ratio is the relationship which exists between liquid assets (cash and good receivables) and liquid liabilities (trade payables). Any inventory, work-in-progress or other current assets which are not cash or near cash do not enter into the comparison. There is thus a direct measure of solvency.

It is advantageous to keep this ratio in balance, as during the normal course of business events revenue from receivables will usually be required to pay payables. This helps to maintain inventories at a stable level and profits earned can be used to increase liquid resources.

If the liabilities are to be met, the ratio must clearly be at least 1 to 1, i.e. liquid assets must be equal to payables. Any falling short indicates that additional cash has to be obtained. The trend of the ratio will be a very helpful guide, for under stable trading conditions it should remain steady, without appreciable movement either way. A sharp fall in the liquid assets available without a similar fall in payables will show that immediate action is necessary.

Ratio of Current to Non-Current Assets
Current assets are compared with non-current assets and the ratio established. Owing to differences in types of business, and conditions under which they operate, it is virtually impossible to state a desirable ratio which can be applied generally. For the individual business it should be possible to establish the ideal ratio. Comparing ratios within an industry will usually show that the stronger businesses have the larger proportion of current assets. There is nothing to be gained by comparing ratios for concerns in different industries.

We've already explained the term 'current assets'. Non-current assets are properties, machines, equipment and other possessions held in the business permanently for the purpose of earning profit. Examples are land and buildings, plants and machinery, office furniture and machinery, motor vehicles and loose tools. The significant fact to remember is that these assets are not held in the normal course of business, but are retained so that materials may be converted to finished goods and. the latter then sold.

Ratio of Shareholders' to Payables' Equity

Liabilities in a company SOFP can be divided into two parts:

(a) Capital, reserves and undistributed profits owned by the shareholders (the net worth of the business)

(b) Sums due to payables and lenders of loan capital (payables' equity)

The two are compared to give the ratio of shareholders' to payables' equity. A strong business will have the largest proportion of its total liabilities composed of the net worth. Weaker concerns are those which are dependent upon payables and thus any adverse interference from them may lead to serious consequences. The strong company is fully ruled by shareholders without interference from payables.

Factors Affecting Liquidity

Three key factors influence the level of liquidity in a company, namely receivables, payables, inventory.

(a) Receivables

The earlier payment is received from receivables; the better is the liquidity position. A rough measure of time taken by receivables to pay is possible by using the ratio:

$$\frac{\text{Receivables (end of year)}}{\text{Sales}} \times 365$$

This gives the number of days taken to pay, which can be very useful in terms of credit control. This is illustrated by the following figures:

	Year 1		Year 2
	₦		₦
Sales	₦ 80,000	Sales	₦ 120,000
Receivables	8,000	Receivables	20,000
$\frac{₦8,000}{₦80,000}$ x 365 =	36 days	$\frac{₦20,000}{₦120,000}$ x 365 days = 61 days	

Clearly credit control has been lax, and action is needed.

It is very important to remember that money owed by receivables is company money that has alternative uses. Of course normal commercial courtesy demands that sometime be given to pay, but any unreasonable time means one company's rightful funds in another company's bank account.

(b) Payables

The same reasoning applies here - the higher the payables figure, the higher the temporary liquidity. For other reasons, however, too high a figure may mean danger. The calculation for this is:

$$\frac{\text{Payables (end of year)}}{\text{Purchases}} \times 365$$

This gives the number of days the company is being allowed to pay its payables.

(c) Rate of Inventory Turnover

From the purely financial angle inventory levels are important because high inventory levels may indicate the danger of tying up too much money in inventories (over stocking) or a sudden slowing down in the inventory turnover. Neither of these reasons for high inventory figures in the SOFP is healthy.

Inventory levels can be measured in the following ways:

(i) Inventory Turnover = $\frac{\text{Cost of goods sold}}{\text{Average inventory (i.e. average of opening and closing inventory)}}$

To show rate at which inventory turns over:

(ii) Inventory Levels= $\frac{\text{Closing inventory}}{\text{Sales}}$ as a %

This percentage can be measured against previous levels and comparisons can be made with other firms and departments.

Of course there is rarely one SOFP item called "inventory" and you will have to deal with the different types of inventory - raw materials, work in progress, finished goods.

INVESTMENT RATIOS

In addition to the management ratios, investors frequently need to assess the merits of particular investments. The following ratios are commonly used, and can be illustrated by using the summarized accounts of a limited company which follow.

Income Statement for the year ending 31st December

	₦	₦
Net profit		100,000
Corporation tax (say) 25%		25,000
		75,000
Balance 1st January		21,000
		96,000
Proposed dividends:		
Preference shares 10%	3,000	
Ordinary shares 20%	30,000	33,000
		63,000

SOFP as at 31st December

	₦	₦
Non-Current Assets		180,000
Current Assets:		
Inventory	71,000	
Accounts receivables	164,000	
Cash at bank and in hand	5,000	
		240,000
		420,000
Capital and Reserves:		
Called up Share Capital:		
30,000 ₦1 Preference Shares		30,000
600,000 Ordinary 25K Shares		150,000
		180,000
General Reserve	79,000	
Profit and Loss	63,000	
		142,000
Current Liabilities:		
Accounts payable	65,000	
Proposed dividends	33,000	
		98,000
		420,000

The shares were quoted on the Inventory Exchange on 31 December at the following prices:

Preference shares	90k
Ordinary shares	60k

We will use these summarized accounts as the basis for illustrating the investment ratios.

Dividend Yield

This is the actual dividend payable for a year, including both interim and final, expressed as a percentage of the quoted share price. It is calculated as:

$$\frac{\text{Dividend paid}}{\text{Quoted share price x No. of Shares}} \times 100 = \text{Dividend yield}$$

In our example it will therefore be:

(a) Preference Shares

$$\frac{3{,}000}{₦0.9 \times 30{,}000} \times 100 = 11.1\% \text{ approximately}$$

(b)

$$\frac{3{,}000}{₦0.6 \times 600{,}000} \times 100 = 8.3\% \text{ approximately}$$

The dividend yield is a measure of the income return on an investment, and ignores retained profits. Normally, the higher the dividend yields on ordinary shares, the greater the risk, though this is not always true. Preference shares tend to have a higher dividend yield than ordinary shares, mainly to offset the fact that there is little scope for capital appreciation.

Dividend Cover

This ratio represents the extent to which the distributable profits compare with the dividend payable. Distributable profits represent the profits after corporation tax and any other appropriations have been deducted. It is calculated in the following way:

$$\frac{\text{Distributable profits}}{\text{Dividend}} = \text{Dividend cover}$$

In our example this will be:

(a) Preference Shares

$$\frac{75,000}{3,000} = 25.0 \text{ times covered}$$

(b) Ordinary Shares

In this case it will be necessary to adjust distributable profits for the interest paid to the preference shareholders. The adjusted distributable profits will therefore be:

	₦
Profits after taxation	75,000
Less Preference dividend	3,000
Available for ordinary shares -	72,000
The cover for ordinary shares is thus:	$\frac{72,000}{30,000}$ = 2.4 times

Dividend cover is a test of a company's ability to maintain its dividend level.

Earnings Yield

This is the profits available for distribution to the ordinary shareholders, expressed as a percentage of the quoted market value of the ordinary share capital. It is computed as follows:

$$\frac{\text{Distributable profits (less Preference dividends)}}{\text{Number of ordinary shares x Market value}} \text{ x } 100 = \text{Earnings yield}$$

In our example the earnings yield will thus be:

$$\frac{72,000}{600,000 \text{ x } 0.60} \times 100 = 20\% = \text{Earning yield}$$

The earnings yield gives the true rate of return on an investment, assuming that all the profits available for distribution are paid out as dividends. In the majority of cases a proportion of the profits are retained, and it is the dividend yield that enables an investor to determine his income.

The earnings yield can also be expressed as earnings per ordinary share, which is the distributable profit earned at one share. This is:

$$\frac{\text{Distributable Profit}}{\text{Number of shares}} = \text{Earnings per ordinary share}$$

From our example accounts it will be:

$$\frac{72,000}{600,000} = ₦0.12 \text{ or } 12K \text{ per share}$$

Price Earnings Ratio (or P/E Ratio)

This is the number of times the earnings per ordinary share will divide into the quoted price for the share. The formular is:

$$\frac{\text{Quoted share price}}{\text{Earnings per shape}} = \text{P/E Ratio}$$

The P/E ratio is significant insofar as it establishes the number of years it will take for the capital invested to be repaid out of earnings. In our example it will be:

$$\frac{0.60}{0.12} = 5 \text{ times}$$

It will therefore take 5 years, in this case, to recover from dividends the sum of money originally invested. It can be compared with the payback period of assessing a capital product. Similar to the dividend yield, the P/E ratio can be an indicator of risk; in this case, the higher the rate the lower the risk, though this is not an absolute rule.

LIMITATIONS OF RATIO ANALYSIS

It must be emphasized that accounting ratios are only a means to an end; and not an end in them. By comparing the relationship between figures, only trends or significant features are highlighted. The real art in interpreting accounts lies in defining the reason for the features and fluctuations. In order to do this effectively, the interested party may need further information and a deeper insight into the business's affairs. The following points should also be borne in mind:

The date to which the accounts are drawn up. Accurate information can only be obtained from up-to-date figures. Seasonal trends should not be forgotten, as at the end of the peak season the business presents the best picture of its affairs.

The arrangement of certain matters can be misleading and present a more favourable position, i.e. making the effort to collect debts just before the year-end in order to show more cash and lower receivables than is usual; ordering goods to be delivered just after the year-end so that inventories and payables can be kept as low as possible.

Management interim accounts should be examined wherever possible to obtain a clearer idea of trends. Comparison with similar businesses should also be made.

OTHER MEASURES OF BUSINESS OPERATIONS

The ratios we have outlined are the more common measures of company performance. Attention should, however, be paid to the gearing of the company, i.e. the capital structure and the way the company finances its assets. The word 'capital' here is used in a wider sense than share capital.

The lenders of funds to the company fall into two groups:

(a) Least Risk

Debenture holders: Those who have first claim on money from a company in the event of a winding-up.

Payables: Who are unsecured but can sue for their debts.

(b) Most Risk

Ordinary shareholders: Who are only repaid in the event of liquidation, when the least-risk group has been fully repaid?

Gearing is the relationship of ordinary shareholders' funds (sometimes called equity interest) to preference shares and debentures (called fixed-return capital).

If a company is low-geared it means-that the proportion of preference shares and debentures is tow compared with ordinary shares. Hence the preference shareholders and debenture holders have greater security for payment of dividends/loan interest and the ordinary shareholders are not liable to such violent changes in return on their investment, as there is less to pay before they receive their entitlement.

High gearing, on the other hand, means a high proportion of preference shareholders and debenture holders to ordinary shareholders. Here there is greater risk for the ordinary shareholders as a greater proportion of the profit as to be paid out to a fixed return capital, before they receive their entitlement.

WORKED EXAMPLES

Example 1

Calculate the following ratios for Angle Plan Ltd and comment on your answers:

(a) Return on capital employed

(b) Gross profit margin

(c) Net profit margin

(d) Rate of inventory turnover

(e) Current ratio

(f) Acid test ratio

(g) Average debt collection period

(h) Average credit period allowed by suppliers

(j) Dividend per share

(k) Dividend covers

Jabir Plan Limited Income Statement for the Year Ended 31 December

		₦	₦
Sales			70,000
Less: Opening inventory		6,000	
Add: Purchases		34,000	
		40,000	
Less: Closing Inventory		8,000	
Cost of goods sold			32,000
Gross profit			38,000
Less: Expenses:	Selling	15,000	
	Administration	4,000	
	Other	2,000	(21,000)
Net profit			17,000
Add: Balance brought forward			3,000
			20,000
Less: Appropriations			
Transfer to general reserve		5,000	
Dividends - ordinary shares		8,000	(13,000)
Balance, being inappropriate profit carried forward			7,000

SOFP as at 31st December

	₦	₦
Non-current assets		
Freehold land and buildings		38,000
Plant and machinery		6,000
		44,000

Current assets		
Inventory	8,000	
Accounts receivable	10,000	
Cash at bank and in hand	2,000	20,000
		64,000
Capital and Reserves		
Authorised and called-up share capital		
40,000 ordinary N1 shares		40,000
General reserve	5,000	
Income statement	7,000	12,000
		52,000
Non-current liabilities		
Debenture loans		4,000
Current liabilities		
Accounts payable		8,000
		64,000

Solution

All the conclusions drawn are very tentative. We do not know anything about the history, the stage of development the objects of Angle Plan Ltd, nor do we know anything about the industry in which it operates.

(a) **Return on Capital Employed**

$$\frac{\text{Net Profit}}{\text{Capital Employed}} \times 100 = \frac{17{,}000}{56{,}000} \times 100 = 30.4\%$$

Comment

Irish industry produces a wide range of returns and it would seem that a return of 30.4%, assuming the figures be accurate, is very good indeed.

(b) **Gross Profit Percentage**

$$\frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{38{,}000}{70{,}000} \times l00 = 54.3\%$$

Comment

Subject to all the qualifications laid down, this seems a very good average.

(c) **Net Profit Percentage**

$$\frac{\text{Net Profit} \times 100}{\text{Sales}} \quad \frac{17{,}000}{70{,}000} \times 100 = 24.3\%$$

Comment

Following on from (b) above this would appear to be satisfactory. The question makes no mention of taxation.

(d) **Rate of Inventory Turnover**

$$\frac{\text{Cost of goods sold}}{\text{Average of opening and closing inventory}} = \frac{32{,}000}{(6{,}000 + 8{,}000) / 2} = 4.6 \text{ times}$$

(e) **Current Ratio**

Current assets: Current liabilities (Payables: amounts failing due to within one year)

= 20,000:8,000 = 2.5:1

Comment

This seems quite adequate (almost more than adequate)

(f) **Acid Test Ratio**

(Current assets – inventory): Current liabilities

(20,000: 8,000): 8,000 = 12,000: 8,000 = 1.5:1

Comment

This seems to be adequate, i.e. if no more inventories were sold Angle Plan Limited could still pay their way.

(g) **Average Debt Collection Period**

$$\frac{\text{Receivables}}{\text{Credit Sales}} \text{ X } 365 = \frac{10{,}000}{70{,}000} \text{ x } 365 = 32 \text{ days}$$

Comment

From this we can conclude that on average receivables are taking 52 days to pay. Whether this is a long time (i.e. credit control is too loose) depends on the terms. Note: It is assumed all sales are on credit.

(h) **Average Period of Credit Allowed by Suppliers**

$$\frac{\text{Payables}}{\text{Credit Purchases}} \text{ x } 365 = \frac{8{,}000}{34{,}000} \text{ x } 365 = 86 \text{ days}$$

Comment

In spite of their successful trading and solvency position, Angle Plan Limited are taking much too long to pay their payables and the time involved should be reduced in order to ensure suppliers do meet rush orders should they occur.

(i) **Dividend per Share**

$$\frac{\text{Ordinary dividend paid}}{\text{Number of ordinary issued shares}} = \frac{8,000}{40,000} = 20K \text{ per share}$$

This would appear to be a very satisfactory return on investment to the shareholders but, as with all ratios, should be viewed not on its own but in conjunction with prior years and competitors.

(j) **Dividend Cover**

$$\frac{\text{Profit available to pay ordinary dividend}}{\text{Ordinary dividend for the year}} = \frac{20,000}{8,000} = 2\tfrac{1}{2} \text{ times}$$

Comment

Note that both the net profit for the year and the balance of unappropriated profit are available for appropriation and the result shows that, whilst a fair proportion of profit is retained, the ordinary shareholders are receiving a fair return.

Other ratios cannot be calculated as the market price per share (not available from the final accounts) is not given.

Example 2

The following are financial statements provided by Tunde Associates Nig Plc.

Comparative Income Statements

	Yr 2	Yr 3
	₦	₦
Gross sales	1,091,400	1,604,125
Less: Discounts	21,400	39,125
	1,070,000	1,565,000
Cost of goods sold:		
Opening inventory	50,500	65,000
Raw materials	225,000	293,000
Direct labour	485,000	795,000
Factory overhead	64,000	117,000
Depreciation	50,000	60,000
Closing inventory	(65,500)	(105,000)
	809,500	1,225,000
Gross margin	260,000	340,000
Selling expenses	(84,500)	(121,000)
General and administrative expenses	(64,930)	(73,310)
Operating profit	111,070	145,690
Other income (expenses)	(20,000)	5,675
Taxation	(40,982)	(68,114)
Net profit	50,088	83,251

Comparative SOFPs as at end of Year

	Yr 2	Yr 3
	₦	₦
Current assets:		
Cash	1,000	11,500
Receivables	52,500	95,000
Inventory	65,000	105,000
Prepaid expenses	4,000	6,000
	122,500	217,500
Non-current assets	485,000	544,000
Less: Depreciation	(342,000)	(402,000)
	143,000	142,000
Other assets	20,000	15,000
Goodwill	50,000	50,000
	70,000	65,000
	335,500	424,500
Current liabilities:		
Payables	35,000	78,000
Bank overdraft	16,000	-
Accrued expenses	40,000	60,750
Dividends payable	2,000	3,000
Taxes due	1,500	6,499
	94,500	148,249
Bills of exchange	40,000	-
Provision for claims	10,000	10,000
Reserve for asset replacement	40,000	65,000
	90,000	75,000
Net worth:		
Preference shares	4,000	4,000
Ordinary shares	26,000	28,000
Capital surplus	5,000	10,000
Earned surplus	116,000	159,251
	151,000	201,251
	335,500	424,500

Reconciliation of Surplus in Year 2 and Year 3

	Yr 2	Yr 3
	₦	₦
Earned surplus	90,912	116,000
Add: Net Profit	50,088	83,251
	141,000	199,251
Less:		
Dividends	5,000	15,000
Addition to reserve for asset replacement	20,000	25,000
	116,000	159,251

Tunde Associates Nig Plc. seeking additional finance, which your company is considering providing. You are required:

(a) Using ratio analysis, to advise your company and

(b) To state, with reasons, what additional statements you would ask for.

Solution

The following points arise from an examination of the financial statements provided by Tunde Associates Nig.

Sales and Profits

Yr 3 indicates an increase in turnover of 47% in money terms arising either from an increase in selling price or an increase in sales volume, or from a mix of the two. This has involved a reduction in the gross margin (from 24.3% to 21.7%) although the operating profit as a percentage of sales has reduced by a smaller sum - down by only 1.1%. The net operating margin of 9.3% does, leave some room to cover interest on any loan that we might make.

Turning to return on capital employed the earnings before tax against net worth is 56.9% for Yr 3, an increase of 9.2% over the prior year.

The return is based on an assessment of non-current assets, which are presumably stated at historic cost, as being fairly aged (this being indicated by depreciation being some 75% of cost).

Working Capital and Liquidity

Expenditure on fixed assets has been approximately covered by the retentions for depreciation made during the year. Retained profit after dividend has been taken almost exclusively into working capital. This has led to some improvement of the current and liquidity ratios, which are still low:

	Year 2	Year 3
Current ratio	0.85:1	1.3:1
Liquidity ratio	0.40:1	0.71:1

Looking at the constituents of working -capital, the inventory turnover does appear to have increased a little but, without knowledge of the finished inventory figures, this is impossible to tell with any accuracy.

Receivables again cannot be accurately calculated as the sales trend over Yr 3 is unknown. It appears that they are taking a little longer credit, though.
Trade suppliers' credit has doubled and therefore does indicate a lengthening period of credit taken.

Summary

More information is needed, as shown below, before any recommendation can be made. What I can say though is that trading seems to be well managed, with a substantial increase having been possible without any large reduction in margins or any great increase in the value of inventory and receivables.
Non-current assets need replacing, which is presumably behind the request for finance. The company has a reserve of N65, 000 for this purpose - and accumulated depreciation - but these reserves and provisions are not in an immediately liquid form. Indeed, liquidity is low and no indication is made as to whether payables are pressing.
There is likely also to be pressure from shareholders for increased dividends, the present level being covered almost four times by available earnings.

Ratios Supporting Interpretation

Sales and Operating Profit

	Yr 2		Yr 3		movement
	₦'000	%	₦'000	%	%
Net sales	1,070.00	100.00	1,565.00	100.00	46
Gross margin	260.00	24.3	340.00	21.7	-2.6
Selling and administrative	149.43	13.9	194.31	12.4	-1.5
Costs	111.07	10.4	145.69	9.3	-1.1

Return on Capital Employed

This is defined (in this instance) as:
Operating profit plus/ (minus) other income/ (expenses) as a percentage of net worth plus fixed asset replacement reserve:

Year 2

$\frac{₦91,070}{191,000} \times 100 =$ 47.7%

Year 3

$\frac{₦151,365}{266,251} \times 100 =$ 56.9%

9.2% increase

Working Capital

(i) Current ratio

Current assets: Current liabilities, bills and provisions

Yr2	Yr3	Movement
0.85:	11.3:1	Increase 0.45 times

(ii) Liquidity ratio

Current assets excluding inventories: Current liabilities, bills and provisions

Yr 2	Yr 3	Movement
0.40:1	0.71:1	Increase 0.31 times

(iii) Inventory turnover (as far as this is available for data given).

$$\frac{\text{Cost of sales}}{\text{Average of opening/closing inventory}}$$

	Yr 2	Yr 3	Movement
Times turned over	14.02	14.41	Increase 0.39 times

(iv) Receivables turnover

Yr 2	**Yr 3**	**Movement**
$\frac{₦52,500}{1,565,000} \times 52$	$\frac{₦95,000}{1,070,000} \times 52$	
= 2.5 weeks	= 3.15 weeks	Increase 0.65 weeks

(b) Additional Statements Needed

(i) Accounts for Yr 0 and Yr 1 too, to enable the trend of results and cash flows to be investigated.

(ii) Data to enable closer analysis of inventory and receivables to be made.

(iii) Analysis of sales in units and money terms.

(iv) Breakdown of costs to assess whether any changes in processes have been made. In Yr 3 the following increases are apparent |raw materials 30%; direct labour 64%, factory overheads 83%.

(v) Reasons why the finance is needed, including forward budgets.

(vi) Details of security or guarantees.

5.03 Cash Flows Analysis

Statements of cash flows – their benefits

As far back as 1991 Professor Arnold wrote in a report by the ICAEW Research and Board ICAS Research Advisory Committee "The Future Shape of Financial Reports":

Little attention is paid to the reporting entity's cash or liquidity position. Cash is the lifeblood of every business entity. The report …advocates that companies should provide a cash flow statement . . . preferably uses the direct method.
Statements of cash flows are now primary financial statements and as important as statements of comprehensive income:

The emphasis on cash flows, and the emergence of the statement of cash flows as an important financial report, does not mean that operating cash flows arc a substitute for, or arc more important than, net income. In order to analyse financial statements correctly we need to consider both operating cash (lows and net income."

They are now primary financial statements because the financial viability and survival prospects of any organisation rest on the ability to generate positive operating cash flows. These are necessary in order to be able to pay the interest on loans and repay the loans, finance capital expenditure to maintain or expand operating capacity, and reward the investors with an acceptable dividend policy. If there is still a positive cash flow after this, it will help to reduce the need for additional external loan or equity funding.

The message is that, independent of reported profits, if an organisation is unable to generate sufficient cash, it will eventually become insolvent and fail.

Solvency is a money or cash phenomenon. A solvent company is one with adequate cash to pay its debts; an insolvent company is one with inadequate cash. Any information that provides insight into the amounts, timings and certainty of a company's future cash receipts and payments is useful in evaluating solvency. Statements of past cash receipts and payments are useful for the same basic reason that statements of comprehensive income are useful in evaluating profitability: both provide a basis for predicting future performance.

Applying IA7 (revised) Statements of cash flows

The cash flows are analysed under three standard headings to explain the net increase/ decrease in cash and cash equivalents and the effect on the opening amount of cash and cash equivalents. The headings are:

- Net cash generated by operating activities
- Cash flows from investing activities
- Cash flows from financing activities.

The two methods of preparing cash flows from operating activities

In the quote from The Future Shape of Financial Reports above, reference was made to the direct method. This preference was expressed because there are two methods, both of which are permitted by IAS 7. These are the direct method and the indirect method.

The direct method reports cash inflows and outflows directly, starting with the major categories of gross cash receipts and payments. This means that cash flows such as receipts from customers and payments to suppliers are stated-separately within the operating activities.

The indirect method starts with the profit before tax and then adjusts this figure for non-cash items such as depreciation and changes in working capital.

Statements of cash flows illustrated using the direct method

The following shows the statement of cash flows for Taye Ltd. Ltd for the period ended 31.3.2004.

Cash flows from operating activities	₦000	₦000
Cash received from customers (note (a)	11,740	
Cash paid to suppliers and employees (note (b)	(11,431)	
Cash generated from operations	309	
Interest paid (expense + (closing accrual — opening accrual)	(20)	
Income taxes paid (expense + (closing accrual - opening accrual)	(220)	
Net cash (used in) generated by operating activities		
69		
Cash flows from investing activities		
Purchase of property, plant and equipment	(560)	
Proceeds from sale of equipment	241	
Net cash used in investing activities		(319)
Cash flows from financing activities		
Proceeds from issue of shares at a premium	300	
Redemption of loan	(50)	
Dividends paid	(120)	
Net cash from financing activities		130
Net increase in cash and cash equivalents		(120)
Cash and cash equivalents at beginning of period		72
Cash and cash equivalents at end of period		(48)

Notes:

(a) Cash received from customers

	₦000
Sales	12,000
Receivables increase	(260)
	11,740

(b) Cash paid to suppliers and employees

	₦000
Cost of sales	10,000
Payables decreased	140
Inventory increased	900
Depreciation	(102)
Profit on sale	13
Distribution costs	300
Administration expenses	180
	11,431

Statements of cash flows illustrated using the indirect method

The two methods provide different types of information to the users. The indirect method applies changes in working capital to net income. In our illustration, for example, the cash generated from operations would he calculated as follows:

Cash flows from opera ting activities		₦000
Profit before tax		1,500
Adjustments for non-cash items:		
Depreciation		102
Profit on sale of plant	(13)	
Adjustments for changes in working capital:		
Increase in trade receivables	(260)	
Increase in inventories		(900)
Decrease in trade payables	(140)	
Interest expense (added back)		20
Cash generated from operations		309

Appraising the use of the direct method

The direct method demonstrates more of the qualities of a true cash flow statement because it provides more information about the sources and uses of cash. This information is not available elsewhere and helps in the estimation of future cash flows.

The principal advantage of the direct method is that it shows operating cash receipts and payments. Knowledge of the specific sources of cash receipts and the purposes for which cash payments were made in past periods may be useful in assessing future cash flows. Disclosure of cash from customers could provide additional information about an entity's ability to convert revenues to cash.

When is the direct method beneficial?

One such time is when the user is attempting to predict bankruptcy or future liquidation of the company. A research study looking at the cash flow differences between failed and non-failed companies established that seven cash flow variables and suggested ratios captured statistically significant differences between failed and non-failed firms as much as five years prior to failure. The study further showed that the research findings supported the use of a direct cash flow statement, and the authors commented:

An indirect cash flow statement will not provide a number of the cash flow variables for which we found significant differences between bankrupt and non-bankrupt companies. Thus, using an indirect cash flow statement could lead to ignoring important information about creditworthiness.

The direct method is the method preferred by the standard but preparers have a choice. In the UK the indirect method is often used; in other regions (e.g. Australia) the direct method is more common. It has been proposed in a review of IAS 7 that the direct method should be mandated and the alternative removed and this is the likely requirement in a new standard to eventually replace IAS 7.

Appraising the use of the indirect method

The principal advantage of the indirect method is that it highlights the differences between operating profit and net cash flow from operating activities to provide a measure of the quality of income. Many users of financial statements believe that such reconciliation is essential to give an indication of the quality of the reporting entity's earnings. Some investors and creditors assess future cash flows by estimating future income and then allowing for accruals adjustments; thus information about past accruals adjustments may be useful to help estimate future adjustments.

Preparer and user response

The IASB indicates that the responses to the discussion paper were mixed with the preparers tending to prefer the indirect method and the users having a mixed response. There was a view that the direct method would be improved if the movements on working capital were disclosed as supplementary information, and the indirect method would be improved if the cash from customers and payments to suppliers was disclosed as supplementary information; i.e., both are found useful.

Cash equivalents

IAS 7 recognised that companies' cash management practices vary in the amount of cash and range of short- to medium-term deposits that are held. The standard standardised the treatment of near-cash items by applying the following definition when determining whether items should be aggregated with cash in the statement of cash flows:

Cash equivalents are short-term, highly liquid investments which are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Near-cash items are normally those that are within three months of maturity at the date of acquisition. Investments falling outside this definition are reported under the heading of 'investing activities'. In view of the variety of cash management practices and banking arrangements around the world and in order to comply with IAS 1 Presentation of Financial Statements, an entity discloses the policy which it adopts in determining the composition of cash and cash equivalents.

Step approach to preparation of a statement of cash flows – indirect method

We will now explain how to prepare a statement of cash flows for Taye Ltd. taking a step approach. We have shown our workings on the face of the statements of financial position and income.

Step 1: Calculate the differences in the statements of financial position and decide whether to report under operating, investing or financing activities or as a cash equivalent.

Statements of financial position of Tyro Bruce as at 31.3.20X3 and 31.3.20X4

	20X3		20X4			
	₦000	₦000	₦000	₦000		
Non-current assets at cost	2,520	2,760				
Accumulated depreciation	452	2,068	462	2,298		
Current assets						
Inventory	800	1,700			900	Operating
Trade receivables	640	900			260	Operating
Securities maturing less than	—	20			20	Cash
equivalent						
3 months at acquisition						
Cash	80	10			70	Cash
equivalent						
	1,520	2,630				
Current liabilities						
Trade payables	540	400			140	Operating
Taxation	190	170			20	Operating
Overdraft	8	78			70	Cash
equivalent						
	738	648				
Net current assets	782	1,982				
	2,850	4,280				
Share capital	1,300	1,400			100	Financing
Share premium a/c	200	400			200	Financing
Retained earnings	1,150	1,150				
Profit for year	—	1,180				
10% loan 20x7	200	150			50	Financing
	2,850	4,280				

Step 2: Identify any items in the statement of income for the year ended 31.3.20X4 after profit before interest and tax (PBIT) to be entered under operating, investing or financing activities.

	₦000	₦000	
Sales		12,000	
Cost of sales		10,000	
Gross profit		2,000	
Distribution costs	300		
Administrative expenses	180	480	
PBIT		1,520	
Interest expense		(20)	Operating
Profit before tax		1,500	Operating
Income tax expense		(200)	Operating
Profit after tax		1,300	
Dividend paid		(120)	Financing
Retained earnings for year		1,800	

Step 3: Refer to the PPE schedule to identify any acquisitions, disposals and depreciation charges that a fleet the cash flows. The Taye Ltd. Ltd schedule showed:

Cost		₦000
As at 31 March 20X3		2,520
(i)	Additions	560
(iii)	Disposal	(320)
As at 31.3.20X4		2,760
Accumulated depreciation		
As at 31.3.20X3		452
(ii)	Charge for year	102
(iii)	Disposal	(92)
As at 31.3.20X4		462
NBV as at 31.3.20X4		2,298
NBV as at 31.3.20X3		2,068

Note: Disposal proceeds were ₦241, 000.

From Step 3 we can sec that there are four impacts:

(i) Additions: The cash of ₦560, 000 paid out on additions will appear under Investing.

(ii) The depreciation charge: This is a non-cash item and the ₦102, 000 will be added back as a non-cash item to the profit before tax in the operating activities section.

(iii) Disposal proceeds: The cash received of ₦241, 000 from the disposal was given in the Note and will appear under investing activities. If the note had provided you with the profit instead of the proceeds, then you would need to calculate the proceeds by taking the NBV and adjusting for any profit or loss. In this case it would be calculated as NBV of ₦228, 000 (320,000 - 92,000) + the profit figure of ₦13, 000 = ₦241, 000.

(iv) Profit on disposal: As the full proceeds of ₦241, 000 are included under investing activities there would be double counting to leave the profit of ₦13, 000 within the profit before tax figure. It is therefore deducted as a non-cash item from PBT in the Operating activities section.

The statement of cash flows

The cash flow items can then he entered into the statement of cash flows in accordance with IAS 7.

Cash flows from operating activities		₦000	₦000
Profit before tax			1,500
Adjustments for non-cash items:			
Depreciation	from Step 3 (ii)	102	
Profit on sale of plant	From Step 3 (iv)	(13)	
Adjustments for changes in working capital:			
Increase in trade receivables		(260)	
Increase in inventories			(900)
Decrease in trade payables		(140)	
Interest expense			20
Cash generated from operations			309
Interest paid (there are no closing Or opening accruals)		(20)	
Income taxes paid (expense + (Opening accrual — closing accrual)	200 + (190 - 170)		(220)
Net cash (used in) /generated by operating activities			69
Cash flows from investing activities			
Purchase of property, plant and equipment	From Step 3 (i)	(560)	
Proceeds from sale of equipment	From Step 3 (iii)		241
Net cash used in investing activities			(319)
Cash flows from financing activities			
Proceeds from issue of shares at a premium		300	
Redemption of loan			(50)
Dividends paid		(120)	
Net cash from financing activities			130
Net increase in cash and cash equivalents			(120)
Cash and cash equivalents at beginning of period	80 – 8		72
Cash and cash equivalents at end of period	(10 + 20) – 78		(48)

Note that interest paid and interest and dividends received could be classified either as operating cash flows or as financing (for interest paid) and investing cash flows (for receipts). Dividends paid could be presented either as financing cash flows or as operating cash flows. However, it is a requirement that whichever presentation is adopted by an enterprise should be consistently applied from year to year.

Additional notes required by IAS 7

As well as the presentation on the face of the cash flow statement, IAS 7 requires notes to the cash flow statement to help the user understand the information. The notes that are required are as follows.

Major non-cash transactions

If the entity has entered into major non-cash transactions that are therefore not represented on the face of the statement of cash flows, sufficient further information to understand the transactions should be provided in a note to the financial statements. Examples of major non-cash transactions might be:

i. The acquisition of assets by way of finance leases;
ii. The conversion of debt to equity.

Components of cash and cash equivalents

An enterprise must disclose the components of cash and cash equivalents and reconcile these into the totals in the statement of financial position. An example of a suitable disclosure in the case of Tyro Bruce is:

	20X4	20X3
Cash	10	80
Securities	20	
Overdraft	(78)	(8)
Cash and cash equivalents	(48)	72

Disclosure must also be given on restrictions on the use by the group of any cash and cash equivalents held by the enterprise. These restrictions might apply if, for example, cash was held in foreign countries and could not be remitted back to the parent company.

Segmental information

IAS 7 encourages enterprises to disclose information about operating, investing and financing cash flows for each business and geographical segment. This disclosure may be relevant. IFRS 8 does not require a cash flow by segment.

Analyzing statements of cash flows

Arranging cash flows into specific classes provides users with relevant and decision-useful information by classifying cash flows as cash generated from operations, net cash from operating activities, net cash flows from investing activities, and net cash flows from financing activities.

Lack of a clear definition

However, this does not mean that companies will necessarily report the same transaction in the same way. Although IAS 7 requires cash flows to be reported under these headings, it does not define operating activities except to say that it includes all transactions and other events that are not defined as investing or financing activities.

Alternative treatments

Alternative treatments for interest and dividends paid could be presented as either operating or financing cash flows. Whilst most companies choose to report the dividends as financing cash flows, when making inter-firm comparisons we need to see which alternative has been chosen. The choice can have a significant impact. If, for example, in the Tyro Bruce illustration the dividends of ₦120,000 were reported as an operating cash flow, then the net cash (used in)/generated by operating activities would change from an inflow of ₦69,000 to an outflow of ₦51,000.

The classifications assist users in making informed predictions about future cash flows or raising questions for further enquiry which would be difficult to make using traditional accrual-based techniques. We will briefly comment on the implication of each classification.

Cash generated from operations

In the Taye Ltd. example (Section 5.3.3) we can see that there hits been a significant increase in working capital of ₦1, 300,000 (₦260, 000 + ₦900, 000 + ₦140, 000).
The effect is to reduce the profit before tax from ₦1, 500,000 to the ₦309, 000 reported as cash flow from operations.

Lenders look to the cash generated from operations to pay interest and taxation, both of which are unavoidable - it is an indication of the safety margin, i.e. how long a business could continue to pay unavoidable costs.

Lenders in Taye Ltd. concerned with interest cover could see that there is sufficient cash available to meet their interest charges in the current year even though there has been a significant impact from the investment in working capital.

Interest cover

Interest cover is normally defined as the number of times the profit before interest and tax covers the interest charge: in the Taye Ltd. example this is 76 times (1,520/20). The position as disclosed in the statement of cash flows is a little weaker although, even so, the interest is still covered more than 15 times (309,000/20,000).

Cash debt coverage

In addition to interest cover, lenders want to be satisfied that their loan will be repaid. Failure to do so could lead to a going-concern problem for the company. One measure used is to calculate the ratio of cash flow generated by operating activities less dividend payments to total debt and, of more immediate interest, to loans that are about to mature.

The ratio can be adjusted to reflect the company's current position. For example, if there is a significant cash balance, it might be appropriate to add this on the basis that it would be available to meet the loan repayment. In our example the cash coverage in the current year is low due to the heavy investment in working capital and payment of a dividend.

Cash dividend coverage

The ratio of cash flow from operating activities less interest paid to dividends paid indicates the ability to meet the current dividend. If the dividend rate shows a rising trend, dividends declared might be used rather than the cash flow dividend paid figure. This would give a better indication of the coverage ratio for future dividends. In our example coverage is again reduced by the working capital investment.

Future cash flows from operations

We need to consider trends, the discretionary costs and the investment in working capital.

Trends

We need to look at previous periods to identify the trend. Trends are important with investors naturally hoping to invest in a company with a rising trend. If there is a loss or a downward trend, this is a cause for concern and investors should make further enquiries to identify any proposed steps to improve the position.

This is where narrative may be helpful, such as that proposed in the 1FRS Practice Statement Management Commentary, in the Strategic Review in the UK and in a Chairman's Statement. Reading these may give some indication as to how the company will be addressing the situation. For example, is the company planning a cost reduction programme or disposing of loss-making activities? If it is not possible to improve the trend or reverse the negative cash flow, then there could be future liquidity difficulties.

Discretionary costs

The implication for future cash flow is that such difficulties could have an impact on future discretionary costs, e.g. the curtailment of research, marketing or advertising expenditure; on investment decisions, e.g. postponing capital expenditure; and on financing decisions, e.g. the need to raise additional equity or loan capital.

Working capital

We can see the cash implication but would need to make further enquiries to establish the reasons for the change and the likelihood of similar cash outflow movements recurring in future years. If, for example, the increased investment in inventory resulted from an increase in turnover, then a similar increase could recur if the forecast turnover continued to increase. If, on the other hand, the increase was due to poor inventory control, then it is less likely that the increase will recur: in fact, quite the opposite as management addresses the problem. The cash flow statement indicates the cash extent of the change; additional ratios and enquiries are required to allow us to evaluate the change.

Evaluating the investing activities cash flows
These arise from the acquisition and disposal of non-current assets and investments.
It is useful to consider how much of the expenditure is to replace existing non-current assets and how much is to increase capacity. One way is to relate the cash expenditure to the depreciation charge; this indicates that the cash expenditure is more than five times greater than the depreciation charge, calculated as ₦540, 000/₦102, 000. This seems to indicate a possible increase in productive capacity. However, the cash flow statement does not itemise the expenditure, as the extract from the non-current asset schedule does not reveal how much was spent on plant - this information would be available in practice.

How capital expenditure requirement relates to replacing existing non – current assets
There has been a criticism that it is not possible to assess how much of the investing activities cash outflow related to simply maintaining operations by replacing non-current assets that were worn out rather than to increasing existing capacity with a potential for an increase in turnover and profits. The solution proposed was that investment that is merely maintained should be shown as an operating cash flow and that the investing cash flow should be restricted to increasing capacity. The IASB doubted the reliability of such a distinction but there is a view that such an analysis provides additional information, provided the breakdown between the two types of expenditure can be reliably ascertained.

Evaluating the financial cash flows
Additional capital of ₦300, 000 has been raised. After repaying a loan of ₦50,000 and payment of a dividend of ₦120,000, only ₦130,000 was left towards a net outflow of ₦250,000 (₦319,000 - ₦69,000).
This does not allow us to assess the financing policy of the company, e.g. whether the capital was raised the optimum way. Nor does it allow us to assess whether the company would have done better to provide finance by improved control over its assets, e.g. working capital reduction.

The indications are healthy in that the company is relying on earnings and equity capital to finance growth. It is lowly geared and further funds could be sought, possibly from the bank or private equity, particularly if it is required for capacity building purposes.

Free cash flows

This is a performance measure showing how much cash a company has for further investment after deducting from net cash generated by operating capital the amount spent on capital expenditure to maintain or expand its asset base. For example, Colt SA in its 2011 Annual Report states:

Free cash flow is net cash generated from operating activities less net cash used to purchase non-current assets and net interest paid.

Free cash flow is reported by many companies and emphasised for different reasons. There is, however, no standardised definition. For example, the Kingfisher Group's 2010 Annual Report defines it after cash used for investment activities:

The Group will maintain a high focus on free cash flow generation going forward to fund dividends to shareholders and increased investment in growth opportunities where returns are attractive.

However, Merck in its 2011 Annual Report states:
Free cash flow and underlying free cash flow are indicators that we use internally to measure the contribution of our divisions to liquidity.

The amount of free cash flow will be normally positive for a mature company and negative for a younger company.

Capital expenditure ratio

This is a ratio where the numerator is net cash flow generated by operating activities and the denominator is capital expenditures. This ratio measures the capital available for internal reinvestment and for meeting existing debt. We look for a ratio that exceeds 1.0, showing that the company has funds to maintain its operational capability and has cash towards meeting its debt repayments and dividends. The ratio would be expected to be lower for companies in growth industries as opposed to those in mature industries and more variable in cyclical industries, such as housing.

It should be recognised, however, that there is a risk if a company has significant free cash flow that its managers may be too optimistic about future performance. When they are not reliant on satisfying external funders there could be less constraint on their investment decisions. If there is negative free cash flow then the opposite applies and the business would require external finance.

Voluntary disclosures

IAS 7 (paragraphs 50-52) lists additional information, supported by a management commentary that may be relevant to understanding:

i. Liquidity, e.g. the amount of undrawn borrowing facilities;
ii. Future profitability, e.g. cash flow representing increases in operating capacity separate from cash flow maintaining operating capacity; and
iii. Risk, e.g. cash flows for each reportable segment, to better understand the relationship between the entity's cash flows and each segment's cash flows.

Critique of cash flow accounting

IAS 7 (revised) applies uniform requirements to the format and presentation of cash flow statements. It still, however, allows companies to choose between the direct and the indirect methods, and the presentation of interest and dividend cash flows. It can be argued, therefore, that it has failed to rectify the problem of a lack of comparability between statements.

An important point is that, in its search for improved comparability, IAS 7 (revised) reduced the scope for innovation. It might be argued that standard setters should not be reducing innovation, but that there should be concerted effort to increase innovation and improve the information available to user groups. The acceptability of innovation is a fundamental issue in a climate that is becoming increasingly prescriptive.

5.04 Critical Appraisal of Financial Statements

Improvement of information for shareholders

There have been a number of discussion papers, reports and voluntary code provisions from professional firms and regulators making recommendations on how to provide additional information to allow investors to form a view as to the businesses future prospects by (a) making financial information more understandable and easier to analyze and (b) improving the reliability of the historical financial data. This would help ensure the equal treatment of all investors and improve accountability for stewardship.

Making financial information more understandable

There has been a view that users should bring a reasonable level of understanding when reading an annual report. This view could be supported when transactions were relatively simple. It no longer applies when even professional accountants comment that the only people who understand some of the disclosures are the technical staff of the regulator and the professional accounting firms.

Statutory measure

Users need the financial information to be made more accessible. This is being achieved in part by initiatives such as the Strategic Report in the UK with the requirement to publish information on the past year, including a fair review of the company's business, a description of the principal risks and uncertainties facing the company, and a balanced and comprehensive analysis of the performance of the company's business during the financial year.

As regards the future, a description of the company's strategy, a description of the company's business model and the main trends and factors likely to affect the future development, performance and position of the company's business are also required.

In Nigeria, CAMA require companies to include a five-year financial summary in their published accounts.

Need to understand volatility

There is a need on the part of investors to understand the volatility that can arise as a result of a company's strategy, such as recognizing the short- and medium-term impact on earnings of R&D investment. There has been a view that investors are unhappy with an uneven profit trend and that companies have responded by smoothing earnings from year to year to maintain investor confidence.

The ICAEW report produced in 1999: “No Surprises: The Case for Better Risk Reporting” recognized the need for management to disclose their strategies and how they managed risk whilst stating that the intention was not to encourage profit-smoothing but rather a better management of risk and a better understanding by investors of volatility.

Making the information easier to interpret

Traditionally, individual investors have referred to financial data which have been paper-based. For further analysis, they have been dependent on analysts or access to the various commercial databases for further analysis.

An increasing number of companies, for example BP, BMW, Colgate, Dell, Lloyds TSB and Vodacom, have been addressing this by providing their annual report in multi-year downloadable Excel format.

A further advance is being achieved through the extensible Business Reporting Language (XBRL) which has been developed to allow information to be described uniformly and tagged. A demonstration website has been developed by Microsoft, NASDAQ PricewaterhouseCoopers.

Improving the reliability of financial information

Investors rely on the fact that annual reports are audited and so present a fair view of a company's financial performance and position. However, accounting scandals, like the ones in Enron, Satyam and the SEC probe in 2012 into the auditing of Chinese companies, have led to a feeling that auditors are not protecting investors' interests. The profession is aware of this view and of the existence of an expectation gap between what investors expect from an audit and what can reasonably be delivered.

Reliability of narrative information in the Annual Report

The following is an indication of the work carried out by an auditor.

i. Other information contained in the Annual Report is read and considered as to whether it is consistent with the audited financial statements.
ii. The other information comprises only the Directors' Report, the unaudited part of the Directors' Remuneration Report, the Chairman's Statement, the Operating and Financial Review and the Corporate Governance Statement.
iii. The implications for the audit report are considered if there is an awareness of any apparent misstatements or material inconsistencies with the financial statements.
iv. The responsibilities of the auditor do not extend to any other information.

Published financial statements - their limitations for interpretation purposes

Assuming that the financial statements have been audited and present a fair view, there remain limitations when attempting to analyze the statements. These can effectively be categorized under the following three headings.

Limitation 1 - Lack of detail

This limitation is due to the amount that corporate entities are required to disclose by the appropriate regulatory framework. Only that information that is required to be disclosed would be subject to objective external scrutiny through audit and that information is strictly limited. For example:

- When analyzing the profitability of a corporate entity, whether gross or net profit, the extent to which expenses can be broken down into categories is strictly limited. Most current frameworks require the disclosure of cost of sales and other operating expenses but do not require further analysis. Therefore, when, say, the gross margin shows a variation (either from one period to another for single-entity comparison or between entities) we cannot further investigate the components of gross margin because the published financial statements do not provide the required detail.

- Most frameworks require analysis of expenses into a number of headings but do not prescribe exactly where certain expenses (e.g. advertising) would fit. This means that when we compare the gross margin of one corporate entity with that of another we may not be comparing like with like, because one may have treated advertising as part of cost of sales and another may have treated equivalent costs as other operating expenses and the amount could be significant.

- Lack of detailed information prevents the computation of certain useful ratios in their 'purest' from. For example, one of the ratios we discussed in ealier was ‘payable days' - trade payables as a number of days' credit purchases. If we tried to compute this ratio from the published financial statements we would have a problem - credit purchases are not required to be disclosed in the published financial statements of corporate entities in most regulatory frameworks. It is possible to use cost of sales as a proxy for credit purchases. However, this ‘contrived’ ratio is not as useful as the ratio would be were credit purchases to be available.

Limitation 2 - The impact of unaudited information

There is a varying amount of information relating to areas such as strategy, risk and KPIs and an ongoing move for improvement. For example, an interesting report issued by the FRC in 1999, rising to the challenge: A Review of Narrative Reporting by UK Listed Companies, found the following:

i. For KPIs, the best companies linked KPIs to strategy and provided an explanation of each measure along with some targets, reconciliations, graphical illustrations of year-on-year comparatives and tables to link KPIs to strategy and targets or future intentions. How many reports still featured an isolated KPI table with no accompanying discussion or link to the remainder of the document?
ii. For principal risks, best-practice reports provided some context for the risk, indicating whether it was increasing or decreasing, and provided some idea of the impact of a risk crystallizing, supported by numbers. However, users would find it difficult to assess risk where there was too little detail or too many risks identified that obscured which were important.

Limitation 3 - Timeline of information

One of the factors that make financial information useful is its timeliness. However, the financial information published in the Annual Report is almost always backward-looking and there is an inevitable time lag between the year-end and the date the financial statement are authorized, for issue, which may well be up to four months after the year-end.

Possible ways of satisfying the timeliness criterion are to publish continuously, quarterly or half-yearly.

Continuous reporting

Technologically this is achievable, particularly with the adoption of XBRL, The advantages might be perceived as putting the investor in the same position as management. However, quite apart from the assurance considering, the reality is that the management has a contextual understanding of the information with an awareness of the probability of possible change. The result could well be that disclosure are deliberately bland.

Quarterly reporting
Here there is a distinct difference in the views of management and investor

Management might have a view that it is the quality of reporting that is important and increased frequency of reporting diverts management attention away from running the business. In addition, there is a view that it encourages speculative investor activity or short-termism.

Investors might have the opposite view, seeing these reports as essential to enable informed investment decisions. The degree of importance they attach to quarterly information could be influenced by the likelihood of an active investor response to receiving earlier information. Questions that influence their view at a particular point in time include those such as 'Is the company relatively stable?', 'Is the company highly geared when cash flow information might be relevant?', Is the company in a fast-changing market when information on product and segment performance might be important?' and 'Is the company subject to highly seasonal movements when an early indication of a change in the trend might be important?,

Half-yearly reporting
The EU Transparency Directive revised in 2012 proposes that listed companies should disclose annual and half-yearly financial reports and in the case of issuers of shares, interim management statements rather than quarterly reports.
An interim statement must include an explanation of material events and transactions in this period, their impact on the financial position of the issuer, and a description of their financial position and performance.

For half-yearly reports the Directive requires annual and half-yearly financial reports to include consolidated financial statements and management reports. EU listed companies will continue to publish management reports with an explanation of material events and transactions that occurred during the first six months of the financial year and their impact on the group's financial position.

Published financial statement – additional entity-wide, cash performance measures
When making inter-firm comparisons there is the problem that accrual accounting requires a number of subjective judgements to be made such as the non-cash adjustments for depreciation, amortization and impairment. Inter-firm comparison schemes overcome this by requiring member companies to restate their results using uniform policies such as restating non-current assets at current values and applying uniform depreciation policies.
External analysts are unable to achieve this and have, therefore, developed other performance measures, often described as non-GAAP, because they are not mandatory or

uniformly defined. These measures, discussed in this section, are becoming more frequently met in published annual reports to address specific user needs.

EBITDA

EBITDA is fairly widely used by external analysts. It stands for 'earnings before interest, "tax, depreciation and amortization'.

EBITDA more closely reflects the cash effect of earnings^ adding back depreciation and amortization charges to the operating profit. The figure can be derived by adding back the depreciation and amortization that is disclosed in the statement of cash flows.

By taking earnings before depreciation and amortization we eliminate differences due to different ages of plant and equipment when making inter-period comparisons of performance and also differences arising from the use of different depreciation methods when making winter-firm comparisons.

Note that there is no standard definition - for example some companies define it as earnings before interest, depreciation, tax, amortization, impairment and exceptional items.

EBITDA shows an approximation to the cash impact of earnings. It differs from the cash flow from operations reported in the statement of cash flows in that it is before adjustment for working capital changes.

EBITDA information is useful where an entity has a number of segments. It allows performance to be compared by calculating the EBITDA for each segment which provides a figure that is independent of the age structure of the non-current assets.

For example, the following is an extract from the Vodafone2011 Annual Report:

	EBITDA	EBITDA margin
	₦m	%
31 March 2011		
Nigeria	2,952	37.4
South Africa	2,643	46.2
Ghana	1,562	30.4
Kenya	1,233	23.4
Other Africa	2,433	
Africa	10,823	

Interestingly, the company states that it uses EBITDA as an operating performance measure which is reviewed by the Chief Executive to assess internal performance in conjunction with EBITDA margin, which is an alternative sales margin figure.

These include the following.

EV (Enterprise value)/EBITDA

EV is the value of the whole business calculated as the market capitalization of equity plus debt, non-controlling interest and preference shares less total cash and cash equivalents. Assuming for the current year an EV of ₦199, 283m and EBITDA of ₦29, 806m, the EV/EBITDA is 6.69. This is compared to the industry, average which is, say, 5.99 which indicates that the company is valued above the industry average. If the company ratio were significantly below the 5.99 it could invite the interest of a takeover. It would be normal to calculate the ratio for a period of say five years to note the trend.

Net debt/EBITDA

This ratio shows the number of years that it would take to 'pay off5 the net debt. For example the following is an extract from the AMEC 2011 Annual Report:

The group is currently in a net cash position. If debt is subsequently required, the long-term net debt is expected to be no more than two times EBITDA. The group may exceed this operating parameter should the business profile require it. However, it is expected that any increases would be temporary given the net operational cash flows of the group.

Debt service coverage ratio

This is defined as EBITDA/annual debt repayments and interest. This ratio is often used in setting debt covenants and by banks assessing a company's ability to repay debt on the terms being sought by the borrower.

EBITDA/interest

This shows the number of times interest is covered. This is also a ratio that banks set as covenant thresholds when agreeing bank credit limits. The following is an extract from the Wiesenberger 2011 Annual Report:

	2010	2011	Threshold
Net debt/EBITDA	1.8	1.7	<3.50
Operating EBITD A/interest	4.9	6.8	>3.75

EBITDAR

EBITDAR is a variant of EBITDA that has become popular with analysts in recent times. It stands for 'earnings before interest, tax, depreciation, amortization and rental expense’.

Adding this rental expense back allegedly makes performance comparisons between entities with different proportions of assets leased under operating leases more valid. It also removes the subjectivity introduced by lease classification as operating or finance.

The following is an extract from the J Sainsbury plc 2012 Annual Report:

Key financial ratios		
Adjusted net debt to EBITDAR	4.1 times	4.1 times
Interest cover	7.5 times	7.9 times
Fixed charge cover	3.1 times	3.1 times
Gearing	35.2%	33.4%

1. Net debt plus capitalized lease obligations (5.5% NPV) divided by EBITDAR.
2. Underlying profit before interest and tax divided by underlying net finance costs.
3. EBITDAR divided by net rent and underlying net finance costs.
4. Net debt divided by net assets.

EBITDAR is used as a comparator between companies. For example, Tesco plc in their 2012 Annual Report state that their fixed charge cover remained broadly flat due to increased rent offsetting their reduced interest and increase in operating cash flow. Their target was stated to be a level of cover in the band of 4 to 4.5 times. In its 2011 Annual Report Tesco plc had charted their EBITDAR against Salisbury's and Morrison's.

EBITDARM

EBITDARM stands for 'earnings before interest, tax, depreciation, amortization, and rental expense and management fees'. The rationale behind this measure is that management fees are extracted from different entities in different proportions. The following is an example from the healthcare sector:

	Care homes for the elderly	Mental health services
	₦	₦
Fee income	457m	76m
EBITDARM	132m	15m
% margin	28.8%	19.0%

Management charges may not always be totally representative of the services provided. Therefore management fees might sometimes be a form of profit extraction rather than a genuine expense and adding them back once again facilitates inter-entity comparison.

In addition to considering the range of cash-based earnings ratios, investors might also require a company to satisfy certain threshold ratios before making an investment.

The indices are compiled after:

- screening companies to confirm that their business activities are not prohibited (or fall within the 5% permitted threshold);
- calculating three financial ratios based on total assets; and
- Calculating a dividend adjustment factor which results in more relevant benchmarks, as they reflect the total return to an Islamic portfolio net of dividend purification.

Details are provided below.

The existence of a debt covenant has a number of potential implications for an entity and for analysis:

- An entity with a debt covenant that is close to its limit will be unable to raise funds by borrowing, so it will need to raise any required funds by an equity issue. Given the attitude of investors to risk, the return required by equity shareholders in a highly geared entity will be higher than that of an entity in which the gearing is lower. This will affect the overall amount of funding an entity can raise.

- Where a ratio of an entity subject to a debt covenant approaches the limit set out in the covenant, there is an inevitable temptation for the preparers to ensure the ratio is kept within the limit, leading to a potential temptation to misstate the financial statements.

  The potential existence of a debt covenant is a factor that should be borne in mind by external analysis. The problem is that the existence of such debt covenants is not normally a required disclosure by relevant regulatory frameworks. Therefore a concerned analyst would need to attempt to obtain this information from the management of the entity. The success or otherwise of this attempt will depend on the bargaining power of the analyst.

Affirmative and negative covenants

Lenders may require borrowers to do certain things by affirmative covenants or refrain from doing certain things by negative covenants.

Affirmative covenants may, for example, include requiring the borrower to:

- provide quarterly and annual financial statements;
- remain within certain ratios whilst ensuring that each agreed ratio is not so restrictive that it impairs normal operations:
- Maintain a current ratio of not less than an agreed ratio - say 1.6 to 1;
  Maintain a ratio of total liabilities to tangible net worth at an agreed rate say to greater than 2.5 to 1;
- maintain tangible net worth in excess of an agreed amount - say N1 million;'
- maintain adequate insurance.

Negative covenants may, for example, include requiring the borrower not to:

- grant any other charges over the company's assets;
- repay loans from related parties without prior approval;
- change the group structure by acquisitions, mergers or divestment without prior agreement.

What happens if a company is in breach of its debt covenants?

Borrowers will normally have prepared forecasts to assure themselves and the lenders that compliance is reasonably feasible. Such forecasts will also normally include the worst-case scenario, e.g. taking account of seasonal fluctuations that may trigger temporary violation with higher borrowing required to cover higher levels of inventory and trade receivable

If any violation has occurred, the lender has a range of options, such as:

- amending the covenant, e.g: accepting a lower current ratio; or
- granting a waiver period when the terms of the covenant are not applied or
- Renegotiating the credit facility and restructuring the finance, as in the following extract from the 2009 Annual Report of Sunshine Holding 3 Ltd.

Directors' report

While the directors fully expect to resolve the covenant issues with a restructuring and/or amendment to the facility agreements, these circumstances represent a material uncertainty regarding the Group's going concern status… the directors have a reasonable expectation that the Group will satisfactorily conclude its covenant issues and will have adequate resources to continue in operational existence for the foreseeable future. Therefore, the accounts have been prepared on a going concern basis.

In addition, companies may increase their equity capital, possibly by a right issue as the current shareholders have a greater incentive to provide additional capital than new investors.

For example, it was reported in 2012 that Lonmin planned an ₦800m rights issue to avoid possibly breaching its covenants. A rights issue is often made in these circumstances as existing shareholders have a greater incentive than new shareholders to inject further equity capital.

In times of recession a typical reaction is for companies to also take steps to reduce their operating costs, align production with reduced demand, tightly control their working capital and reduce discretionary capital expenditure.

Risk of aggressive earnings management

In 2001, before the collapse of Enron, there was a consensus amongst respondents to the UK Auditing Practices Board Consultation Paper Aggressive Earnings Management that aggressive earnings management was a significant threat and actions should be taken to diminish it. It was considered that aggressive earnings management could occur to increase earnings in order to avoid losses, to meet profit forecasts, to ensure compliance with loan covenants and when directors' and managements' remuneration were linked to earnings. It could also occur to reduce earnings to reduce tax liabilities, or to allow profits to be smoothed.

In 2004, as a part of the Information for Better Markets initiative, the Audit and Assurance Faculty commissioned a survey3 to check whether views had changed since 2001. This showed that the vulnerability of corporate reporting to manipulation is perceived as being always with us but at a lower level following the greater awareness and scrutiny by non-executive directors and audit committees.

The analysts interviewed in the survey believed the potential for aggressive earnings management varied from sector to sector, e.g. in the older, more established sectors followed by the same analysts for a number of years, they believed that company management would find it hard to disguise anything aggressive even if they wanted to. However, this was not true of newer sectors (e.g. IT) where the business models may be loss-making initially and imperfectly understood. This is illustrated by the developments in the business models for social networking with Facebook, YouTube and Twitter.[4]

Whilst analysts and journalists tend to have low confidence in the reported earnings where there are pressures to manipulate, there is a research report5 which paints a rather -more optimistic picture. This report aimed to assess the level of confidence investors had in different sources of company information, including audited financial information, when making investment decisions. As far as audited financial information was concerned, the levels of confidence in UK audited financial information amongst UK and US investors remained very high, with 87% of UK respondents having either a 'great deal' or a 'fair amount' of confidence in UK audited financial information.

The auditing profession continues to respond to the need to contain aggressive earnings management. This is not easy because it requires a detailed understanding not only of the business but also of the process management follow when making their estimates. ISA 540 Directors' report, Accounting Estimates, including Fair Value Accounting Estimates, and Related disclosures, requires auditors to exercise greater rigour and scepticism and to be particularly aware of the cumulative effect of estimates which in themselves fall within a normal range

While the directors fully expect to resolve the covenant issues but which, taken together, are misleading.

Audit implications when there is a breach of a debt covenant

Auditors are required to bring a healthy scepticism to their work. This applies particularly such as when there is a potential debt covenant breach. There may then well be to manipulate to avoid reporting a breach. This will depend on the specific covenant, e.g. if the current ratio is likely to fall below the agreed figure, management might be more optimistic when setting inventory obsolescence and accounts receivable provisions and assessing the probability of contingent liabilities crystallizing.

If there is a risk of bank covenants being breached, there can be a significant adverse effect on the share price. For example, it was reported in 2012 that Lonmin's share price dropped sharply by 4.6%, a new 52-week low for the company, following the announcement that it may be in the breach of its covenants with its financial lenders.

However, both the company and the lender might prefer to keep potential breaches private unless there is a risk that enforced disclosure is imminent.

If borrowings are high, it might be difficult to obtain additional loans to take advantage of new opportunities. For example, HSBC raised ₦12.5 billion in 2009 by a right issue on the basis that this would give the bank a competitive advantage over its rivals be restoring its position as having the strongest statement of financial position, i.e. high borrowing limit a company's flexibility.

Interest has to be paid even in bad years with the risk that loan creditors company into administration if interest is not paid.

The relationship is illustrated using data from the financial statements the year ended 31 December 20X9 presented.

	₦000
Total assets	4,587
Equity	3,353
Pre-tax profit	116
Tax	25
Sales	3,461

There were 3 million shares in issue. The effect on ROE and EPS is calculated as follows:

Pre-tax margin (3.35%) × Asset turnover (0.755) = Return on assets (2.53%)
(116/3,461) (3,461/4,587)

Return on assets (2.53%) x Leverage (1.37) × (1- tax rate) (0.785) = ROE (2.72)
(4,587/3,353) (1 - 0:215)

ROE (2.72) x Book value (1.12) = EPS (3.05)
(3,353/3,000)

PE

The PE ratio is computed as:

$$\frac{\text{Market value of a share}}{\text{Earnings per share}}$$

The PE ratio is a market-based measure and a high ratio indicates that investors are relatively confident in the maintainability and quality of the earnings of the entity. Entities in certain sectors (e.g. the retail sector) tend to have higher PE ratios than in other sectors (e.g. the construction sector). Higher PE ratios imply a greater level of market confidence, which usually means that (given the attitude an average investor takes to risk) the entity with a higher PE ratio operates in a sector which is less cyclical.

This is the reciprocal of the PE ratio. For example, a PE ratio of 10 becomes an earnings yield of 10% (1/10x100).

EPS

EPS is computed as:

$$\frac{\text{Profit attributable to the ordinary (equity) shareholders}}{\text{Weighted average number of ordinary shares in issue during the period}}$$

EPS could be said to be a more reliable indicator of the true trend in profitability than the actual profit numbers because the denominator of the fraction factors in any change in the issued capital during the period. The fact that the weighted average number is used removes the potential inconsistency that arises when dividing a 'period' number like profit by a ‘point of time’ number like the number of shares.

However, remember that its appropriateness as a performance measure is based on the reliability and subjectivity of the financial statements themselves. This is an important point to remember if directors' remuneration is based on the growth in EPS. Looking at calculation of the EPS of 3.05 (rounded) we can see that it is affected by the profit margin, the rate of asset turnover, the leverage, the tax rate and the number of shares — quite apart from the fact that reducing the discretionary expenditure and simply buying back one-sixth of the shares can lift the EPS by more than 10%. .

Dividend cover

$$\frac{\text{Profit for the period}}{\text{Dividends paid}} \quad \text{or} \quad \frac{\text{EPS}}{\text{Dividend per share}}$$

Dividend cover is a measure of the vulnerability of the dividend to a fall in profits. The legality of a dividend payment is normally based on cumulative profits rather than the, profits for a single period, but in practice an entity would wish the dividend declared for a particular period to be 'covered* by profits made in that period. Therefore this ratio is seen as a measure of the 'security' of the dividend.

An issue with this ratio is whether a high dividend cover is good or bad. In one sense a shareholder might be content with a high dividend cover, because this would mean that profits could potentially fall quite significantly without the dividend necessarily falling, and retained earnings are being employed profitably within the company. Alternatively, a shareholder might feel disgruntled that: the dividend itself is not higher. Therefore conclusions about whether a change in dividend cover is 'good' or 'bad' need to be made with caution - the trend and inter-firm comparators from the same industry need to be looked at. For example, some companies may target the rate of dividend cover as a key performance indicator as shown in die following extract from the Morrisons 2011 Annual Report.

Dividend yield

Dividend yield is computed as:

$$\frac{\text{Dividend per share}}{\text{Market value of a share}} \quad \text{(expressed as a percentage)}$$

This ratio measures the 'effective' current investment by the shareholder in the entity; because by deciding to keep the share rather than dispose of it the shareholder is forgoing an amount that would be available were the shareholder to make a disposal decision.

This ratio is a 'market-based' ratio, because it is influenced by the share price of the entity. We need to interpret any 'market-based' ratio with caution. In this case a high dividend yield could mean that the shareholder is receiving a very healthy dividend (which would be very positive) or that the share price was very low (which would clearly not be a desirable position either for the entity or for the shareholder).

Indeed, in times of disappointing prices on securities markets dividend yield often tend to be very high because entities are reluctant to cut their dividends for fear the share price will fall even further. A combination of a static dividend and falling share prices leads inevitably to a rise in dividend yields. This would become more apparent if dividend growth were considered in addition to dividend yield.

Determining value

There are three aspects to consider. One is to assess from an entity viewpoint whether adequate returns (EVA) are being generated, the other is to assess from a shareholders viewpoint the total shareholder (TSR), and the third is how either is used in setting director’s remuneration.

Economic Value Added (EVA)

Companies are increasingly becoming aware that investors need to be confident that the company can deliver above-average rates of return, i.e. achieve growth, and that communication is the key. This is why companies are using the annual report to provide shareholders and potential shareholders with a measure of the company's performance that will give them confidence to maintain or make an investment in the company. This is the view expressed in the 2009 Annual Report of Geveke NV Amsterdam:

A positive EVA indicates that over a specific period economic value has been created. Net operating profit after tax is then greater than the cost of finance (i.e. the company's weighted average cost of capital). Research has shown that a substantial part of the long-term movement in share price is explained by the development of EVA. The concept of EVA can be a very good method of performance measurement and monitoring of decisions.

Formula for calculating economic value added the formula applied by Geveke is as follows:

EVA measures economic value achieved over a specific period. It is equal to net operating profit after tax (NOPAT), corrected for the cost of capital employed (the sum of interest bearing liabilities and shareholders' equity). The cost of capital employed is the required yield (R) times capital employed (CE).

In the form of a formula: NOPAT - (R x CE) = EVA

We will illustrate the formula for Alpha NV, which has the following datu (in euros):

	31 March 20X3	31 March 20X4	31 March 20X5
NOPAT	10m	11m	12.5m
Weighted average cost of capital (WACC)	12%	11.5%	11%
Capital employed	70m	77m	96m

The EVA is:

	Percentage change
31 March 20X3: EVA = 10m - (12% of 70m) = 1.6m	—
31 March 20X4: EVA = 1 lm - (11.5% of 77m) = 2.145m	34%
31 March 20X5: EVA = 12.5m - (11% of 96m) = 1.94m-	(10%)

The formula allows weight to be given to the capital employed to generate operating profit. The percentage change is an important management tool in that the annual increase is seen as the created value rather than the absolute level, i.e. the 34% is the key figure rather than the 2.145 million. Further enquiry is necessary to assess how well Alpha NV will employ the increase in capital employed in future periods.

It is useful to calculate rate of change over time. However, as for all inter-company comparisons of ratios, it is necessary to identify how the WACC and capital employed have been defined. This may vary from company to company.

What are Z-scores!

Z-scores provide a single-value score to describe the combination of a number of key characteristics of a company. Some of the most important predictive ratios are weighted according to perceived importance and then summed to give the single Z-score. This is then evaluated against the identified benchmark.

The two best known Z-scores are Altman's Z-score and Toffler's Z-score.

The original Z-score equation was devised by Professor Altman in 1968 and developed further in 1977. The original equation is:

$Z = 0.012\ X_1 + 0.014\ X_2 + 0.033\ X_3 + 0.006\ X_4 + 0.999\ X_5$ where:

X_1 = Working capital/Total assets

(Liquid assets are being measured in relation to the businesses size and this may be seen as a better predictor than the current and acid test ratios which measure the interrelationships within working capital. For X, the more relative working capital the more liquidity).

X_2 = Retained earnings/Total assets

(In early years the proportion of retained earnings used to finance the total asset base may be quite low and the length of time the business has been in existence has been seen as a factor in insolvency. In later years the more earnings that are retained the more funds that could be available to pay creditors. X2 also acts as an indication of a company's dividend policy – a high dividend payout reduces the retained earnings with impact on solvency and creditors' position)

X_3 = Earnings before interest and tax (EBIT)/Total assets

(Adequate operating profit is fundamental to the survival of a business.)

X_4 = Market capitalization/Book value of debt

(This is an attempt to include market expectations which may be an early warning as to possible future problems. Solvency is less likely to be threatened if shareholders interest is relatively high in relation to the total debt.)

X_5 = Sales/Total assets

(This indicates how assets are being used. If efficient, then profits available to fail and payments are more likely. It is a measure that might have been more appropriate when Altman was researching companies within the manufacturing sector. It is a relationship that varies widely between manufacturing sectors and even more so within knowledge-based companies.)

Altman identified two benchmarks. Companies scoring over 3.0 are unlikely to fail and should be considered safe, while companies scoring under 1.8 are very likely fail. The value of 3.0 has since been revised down to 2.7 Z-scores between 2.7 and 1.8 falls into the grey area. The 1968 work is claimed to be able to distinguish between successes and failures up to two or three years before the event. The 1977 work claims an improved prediction period of up to five years before the event.

This was a model developed by Altman and Zeta Services, Inc. in 1977. It is the same as the Z-score for identifying corporate failure one year ahead but it is more accurate in identifying potential failure in the period two to five years ahead. The model is based on the following variables.

X_1 return on assets: earnings before interest and tax/total assets;
X_2 stability of earnings: normalized return on assets around a five – to ten-year trend;
X_3 interest cover: earnings before interest and tax/total interest;
X_4 cumulative profitability: retained earnings/total assets;
X_5 liquidity: the current ratio;
X_6 capitalization: equity/total market value;
X_7 size: total tangible assets.

Zeta is available as a subscription service and the coefficients have not been published.
The exact definition of Taffler's Z-score ' is unpublished, but the following components form the equation:
$Z = c_0 + c_1X_1 + c_2X_2 + c_3X_3 + c_4X_4$

Where
X_1 = Profit before tax/Current assets (53%)
X_2 = Current assets/Current liabilities (13%)
X_3 = Current liabilities/Total assets (18%)
X_4 = No credit interval = Length of time which the company can continue to finance its operations using its own assets with no revenue inflow (16%)

In the equation, c0 to c4 are the coefficients, and the percentages in brackets represent the ratios' contributions to the power of the model.

The benchmark used to detect success or failure is 0.2.14 Companies scoring above 0.2 are unlikely to fail, while companies scoring less than 0.2 demonstrate the same symptoms as companies that have failed in the past.

Taffler adapted the Z-score technique to develop the PAS-score. The PAS-score evaluates company performance relative to other companies in the industry and incorporates changes in the economy.

The PAS-score ranks all company Z-scores in percentile terms, measuring relative performance on a scale of 0 to 100. An f AS-score of X means that 100 - X% of the companies have scored higher Z-scores. So, a PAS-score of 80 means that only 20% of the companies in the comparison have achieved higher Z-scores.

The PAS-score details the relative performance trend of a company over time. Any downward trends should be investigated immediately and the management should take appropriate action.

The effectiveness of applying a failure prediction model is not restricted to large companies. This is illustrated by research16 conducted in New Zealand where such a model was applied to 185 SMEs and found to be useful. As with all models, it is also helpful to refer to other supplementary information that may be available, e.g. other credit reports, credit managers' assessments and trade magazines.

H-Score

An H-score is produced by Company Watch to determine overall financial health. The H-score is an enhancement of the Z-score technique in giving mare emphasis to the strength of the statement of financial position. The Company Watch system calculates a score ranging from 0 to 100 with below 25 being in the danger zone. It takes into account profit management, asset management and funding management using seven factors: profit from the statement of income; three factors from the asset side of the statement of financial position, namely current asset cover, inventory and trade receivables management and liquidity; and three factors from the liability side of the statement of financial position, namely equity base, debt dependence and current funding.

The factors are taken from published -financial statements which makes the approach taken by the IASB to bring off-balance-sheet transactions onto the statement of financial position particularly important.

The ability to chart each factor against the sector average and to 25 level criteria over a five-year period means that it is valuable for a range of user needs, from trade creditors considering extending or continuing to allow credit to potential lenders and equity investors and the big four accounting firms in reviewing audit risk. The model also has the ability to process ‘what-ifs’.

It appears to be a robust, useful and exciting tool for all user groups. It is not simply a tool for measuring risk. It can also be used by investors to identify companies whose share price might have fallen but which might be financially strong with the possibility of the share price recovering - it can indicate ‘buy’ situations. It is also used by leading firms of accountants for the purpose of targeting companies in need of turnaround. Further information appears on the company's website at www.companywatch.net which includes additional examples.
A-scores concentrate on non-financial signs of failure. This method sets out to quantify different judgmental factors.

The whole basis of the analysis is that financial difficulties are the direct result of management defects and strategic mistakes which can be evidenced by symptoms. A weighting is then attached to individual defects and mistakes.

Defects in operational management	*Weight*
The chief executive is an autocrat	8
The chief executive is also the chairman	4
The board is unbalanced, e.g. too few with finance experience	2
Defects in financial management:	
There are no budgets for budgetary control	3
Weak finance director	3
There is a poor response to change, e.g out-of-date Plant, old-fashioned products, poor marketing	15

To calculate a company A-score, different scores are allocated to each defect, mistake and symptom according to their importance. Then this score is compared with the benchmark values. If companies achieve an overall score of over 25, or a defect score of over 10, or a mistakes score of over 15, then the company is demonstrating typical signs leading up to failure. Generally, companies not at risk will score below 18, and companies which are at risk will score well over 25.

With an adverse A-score, symptoms of failure will start to arise. These are directly attributable to preceding management mistakes. Typical symptoms are financial signs (e.g. poor ratios, poor Z-scores); creative accounting (management might attempt to 'disguise’ signs of failure in the accounts); non-financial signs (e.g. investment decisions delayed; market share drops); and terminal signs (when the financial collapse of the company is imminent).

It is interesting to see the weighting given to the chief executive being an autocrat, which is supported by the experience in failures such as WorldCom in 2002 with the following comment:

5.05 Treatment of Goodwill

IFRS 3 *Business Combination* defines goodwill as: 'future economic benefits arising from assets that are not capable of being individually identified and separately recognised'. The definition effectively affirms that the value of a business as a whole is more than the sum of the accountable and identifiable net assets. Goodwill can be internally generated through the normal operations of an existing business or purchased as a result of a business combination.

Internally generated goodwill

Internally generated goodwill falls within, the scope of IAS 38 intangible assets which states that 'Internally Generated Goodwill (or "self-generated goodwill") shall not be recognized as an asset. If companies were allowed to include internally generated goodwill as an asset in the statement of financial position, it would boost total assets and produce a more favourable view of the statement of financial position, for example by reducing the gearing ratio.

Purchased goodwill

The key distinction between internally generated goodwill and purchased goodwill is that purchased goodwill has an identifiable 'cost', being the difference between the fair values of the total consideration that was paid to acquire a business and the fair value of the identifiable net assets acquired. This is the initial cost reported on the statement of financial position.

The accounting treatment of goodwill

Now that we have a definition of goodwill, we need to consider how to account for it in subsequent years. One might have reasonably thought that a simple requirement to amortize the cost over its estimated useful life would have been sufficient. This has been far from the case. Over the past 40 years, there have been a number of approaches to accounting for purchased goodwill, including:

(a) Writing off the cost of the goodwill directly to reserves in the year of acquisition;
(b) Reporting goodwill at cost in the statement of financial position (this was attractive to management as there was no charge against profits in any year);
(c) Reporting goodwill at cost, amortizing over its expected life; and
(d) Reporting goodwill at cost, but checking it annually for impairment.

The last (d) is now the treatment required by IFRS 3.

The current IFRS3 treatment

IFRS 3 prohibits the amortization of goodwill. It treats goodwill as if it has an indefinite life with the amount reviewed annually for impairment. If the carrying value is greater than recoverable value of the goodwill, the difference is written off.

Whereas goodwill amortization gave rise to an annual charge, impairment losses will rise at irregular intervals. This means that the profit for the year will become more volatile. This is why companies and analysts rely more on the EBITDA (earnings before interest, tax, depreciation and amortization) when assessing a company's performance, assuming that this is a better indication of maintainable profits.

This is illustrated by the following; extract from the 2012 Vodafone Annual Report which shows the volatile effect of impairment charges on maintainable profits:

	2012	2011	2010
	₦m	₦m	₦m
Revenue	46,417	45,884	44,472
Gross profit	14,871	15,070	15,033
Impairment losses	(4,050)	(6,150)	(2,100)
Operating profit	11,187	5,596	9,480

This illustrates the volatility when impairment charges are included when calculating operating profit or loss with a pre-impairment profit reporting a profit increase in 2012 of 100% instead of 30% and a fall in 2011 instead of an increase.

Identifying intangible assets to reduce the amount of goodwill

Because goodwill is reviewed annually for impairment under IFRS 3 and other intangible assets are amortized annually under IAS 38, standard setters wanted companies to identify any intangible assets that were acquired on an acquisition of another company and not to include them within a global figure of goodwill.

This has two effects: (a) there is greater transparency and control over assets by identifying the asset that the parent acquired; and (b) intangible assets are amortised rather than being reviewed annually for impairment, so reducing the volatility in the reported operating profits.

Examples of intangible assets that should be recognised and reported in the statement of financial position are set out in IAS 38. They include:

- **Marketing-related** intangible assets which are used primarily in the marketing or promotion of products or services such as trademarks, newspaper mastheads, internet domain names and non-compete agreements.
- **Technology related** intangible assets which rise from contractual right to use technology (patented and unpatented), database, Formular, designs and software, processes and recipes.

- **Customer and supplier related** intangible assets which rise from relationships with or knowledge of customers or suppliers such as licensing, royalty and standstill agreement, servicing contracts use right such as airport landing slots and customer lists.
- **Artistic-related** intangible assets which rises from the rise to benefits such royalty from artistic works such as plays, books, films and music, and from non-contractual copyrights protection.

Greater transparency should be achieved following the amendment in July 2009 to IFRS 3 which provides that if an intangible asset can be separately identified then it can be measured reliably, as the two conditions are interdependent. This will place further pressure on companies to properly consider the nature and value of any intangible assets they acquire.

Critique of various methods used to account for goodwill
Let us consider briefly the alternative accounting treatments

(a) Reporting goodwill uncharged at cost

It is (probably) wrong to keep goodwill unchanged in the statement of financial position, as its value will decline with time. Its value may be maintained by further expenditure, e.g. continued advertising, but this expenditure is essentially creating 'internally generated goodwill' which is not allowed to be capitalized. Sales of most manufactured products often decline during their life and their selling price falls. Eventually, the products are replaced by a technically superior product. An example is computer microprocessors, which initially command a high price and high sales. The selling price and sales quantities decline as faster microprocessors are produced. Much of the goodwill of businesses is represented by the products they sell. Hence, it is wrong to not amortize the goodwill.

(b) Writing off the cost of the goodwill directly to reserves in the year of acquisition
A buyer pays for goodwill on the basis that future profits will be improved. It is wrong, therefore, to write it off in the year of acquisition against previous years in the reserves. The loss in value of the goodwill does not occur at the time of acquisition but occurs over a longer period. The goodwill is losing value over its life, and this loss in value should be charged to the statement of comprehensive income each year. Making the charge direct to reserves stops this charge from appearing in the future income statements.

(c) Amortizing the goodwill over its expected useful life
Amortizing goodwill over its life could achieve a matching under the accrual concept with a charge in the statement of comprehensive income. However, there are problems (i) in determining the life of the goodwill and (ii) in choosing an appropriate method for amortizing.

i. What is the life of the goodwill?

Companies wishing to minimize the amortization charge could make a high estimate of the economic life of the goodwill and auditors have to be vigilant in checking the company’s justification. The range of lives can vary widely. For example, goodwill paid to acquire a business in the fashion industry could be quite short compared to that paid to acquire an established business with a loyal customer base.

ii. The method for amortizing

Straight-line amortization is the simplest method. However, as the benefit are likely to be greater in earlier years than in later ones, amortization could use 'actual sales; expected total sales' or the reducing balance method.

It could be argued that amortizing goodwill is equivalent to depreciating tangible fixed assets as prescribed by IAS 16 Property, Plant and Equipment and that the amortization approach appears to be the best way of treating goodwill in the statement of financial position and statement of comprehensive income. This is effectively following a 'statement of comprehensive income' approach to 'expense' (e.g. depreciation) with the expense charged over the life of the asset or in relation to the profits obtained from the acquisition'.

There are difficulties but these should not prevent us from using this method. After all accountants have to make many judgements when valuing items in the statement of financial position, such as assessing the life of property, plant and equipment, the value of inventory and bad debt provisions.

(d) An annual impairment check

IFRS 3 introduced a new treatment for purchased goodwill when it arises from a business combination (i.e. the purchase of a company which becomes a subsidiary). It assumes that goodwill has an indefinite economic life, which means that it is not possible to make a realistic estimate of its economic life and a charge should be made to the statement of income only when it becomes impaired.

This is called a ‘Statement of financial position' approach to accounting, as the charge is made only when the value (in the statement of financial position) falls below its original cost.

The IFRS 3 treatment is consistent with the Framework, which says: 'Expenses are recognised in the statement of comprehensive income when 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.'

Criticism of the 'statement of financial position' approach

However, there has been much criticism of the 'statement of financial position' approach of the Framework.

For example, if a company purchased specialised plant which had a resale value of 5% of its cost, then it could be argued that the depreciation charge should be 95% of its cost immediately after it comes into use. This is not sensible, as the purpose of buying the plant is to produce a product, so the depreciation charge should be over the life of the product. Alternatively, if the 'future economic benefit' approach was used to value the plant, there would be no depreciation until the future economic benefit was less than its original cost. So, initial sales would incur no depreciation charge, but later sales would have an increased charge.

This example shows the weakness of using impairment and the 'statement of financial position' approach for charging goodwill to the statement of comprehensive income - the charge occurs at the wrong time. The charge should be made earlier when sales, selling prices and profits arc high, not when the product becomes out of date and sales and profits are falling.

Why the impairment charge occurs at the wrong time

Although the IFRS 3 treatment of impairment appears to be correct according to the Framework, it could be argued that the impairment approach is not correct, as the charge occurs at the wrong time (i.e. when there is a loss in value, rather than when profits are being made), it is very difficult to estimate the future economic benefit of the goodwill and those ^.estimates are likely to be over-optimistic.

In addition, it means that the treatment of goodwill for IFRS 3 transactions is different from the treatment in IAS 38 Intangible Assets. This shows the inconsistency of the standards - they should use a single treatment, either IAS 38 amortization or IFRS 3 impairment.

Why does the IFRS 3 treatment of goodwill differ from the treatment of intangible assets in IAS 39?

The answer is probably related to the convergence of International Accounting Standards to US accounting standards and pressure from listed companies.

Convergence pressure

In issuing recent International Standards, the IASB has not only aimed to produce 'worldwide' standards but also standards which are acceptable to US standard setters. The IASB wanted their standards to be acceptable for listing on the New York Stock Exchange (NYSE), so there was strong pressure on the IASB to make their standards similar to US standards. The equivalent US standard to IFRS 3 uses impairment of goodwill as the charge against profits (rather than amortization). Thus, IFRS 3 uses the same method and it prohibits amortization.

Commercial pressure

A further pressure for impairment rather than amortisation comes from listed companies. Essentially, listed companies want to maximise their reported profit, and amortization reduces profit. For most of the time, companies can argue that the future economic benefit of the goodwill is greater than its original cost (or carrying value if it has been previously impaired), and thus avoid a charge to the statement of comprehensive income. Also, companies could argue that the 'impairment charge' is an unexpected event and charge it as an exceptional item. In Nigeria, companies publicize their profit after exceptional items and impairment.

Negative goodwill

Negative goodwill arises when the amount paid is less than the fair value of the net assets acquired. IFRS 3 says the acquirer should:

(a) reassess the identification and measurement of the acquiree's identifiable assets liabilities and contingent liabilities and the measurement of the cost of the combination in case the assets have been undervalued or the liabilities overstated; and

(b) Recognise immediately in the statement of comprehensive income any excess remaining after that reassessment.

The immediate crediting of negative goodwill to the statement of comprehensive income seems difficult to justify when, as in many situations, the reason why the consideration is less than the value of the net identifiable assets is that there are expected to be future losses or redundancy payments. Whilst the redundancy payments could be included in the 'contingent liabilities' at the date of acquisition, standard setters are very reluctant to allow a provision to be made for future losses (this has been prohibited in recent accounting standards). This means that the only option is to say the negative goodwill should be credited to the statement of comprehensive income at the date of acquisition. This result in the group profit being inflated when a subsidiary with negative goodwill is acquired.

In some ways, it would be better to credit the negative goodwill to the statement of comprehensive income over the years the losses are expected. However, the 'provision for future losses' (i.e. the negative goodwill) does not fit in very well with the Frameworks definition of a liability as being recognized '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'. It is questionable whether future losses are a 'present obligation' and whether they can be 'measured reliably', so it is very unlikely that future losses can be included as a liability in the statement of financial position.

Brands

We have discussed intangible assets and goodwill above but brands deserve a separate consideration because of their major significance in some companies. For example, the following information appears in the 2011 Dauda annual report:

	₦m	₦m
Total equity (i.e. net assets)		5,985
Intangible assets:		
Brands		4,805
Goodwill		418
Other intangible assets		1,138
Computer software		184
Total intangible assets		6,545

We can see that brands alone are 80% of total equity. It is interesting to take a look at the global importance of brands within sectors.

The importance of brands to particular sectors

It is interesting to note that certain sectors have high global brand valuations. For example, the Best Global Brands Report 2011 showed beverages (Coca-Cola $71,861m), computer services (IBM $69,905m), computer software (Microsoft $59,087m), Internet services (Google $55,317m), diversified (GE $42,808m), restaurants (McDonald's $35,593m) and electronics (Apple $33,492m). Even the hundredth exceeded $3,000 million (Harley Davidson $3,512m).

This indicates the importance of investors having as much information as possible to assess management's stewardship of brands. If this cannot be reported on the face of the statement of financial position then there is an argument for having an additional statement to assist shareholders, including the information that the directors consider when managing brands.

Justifications for reporting all brands as assets

We now consider some other justifications that have been put forward for the inclusion of brands as a separate asset in the statement of financial position.

Reduce equity depletion

For acquisitive companies it could be attributed to the accounting treatment required for measuring and reporting goodwill. Research in the UK has shown that a major aim of brand valuation has been to repair or pre-empt equity depletion caused by UK goodwill accounting rules.

Strengthen the statement of financial position

Non-acquisitive companies do not incur costs for acquiring goodwill, so their reserves are not eroded by writing off purchased goodwill. However, these companies may have incurred promotional costs in creating home-grown brands and it would strengthen the statement of financial position if they were permitted to include a valuation of these brands.

5.06 Interpretation of Financial Statements and Preparation of Reports Thereon

Overview of Techniques for the analysis of financial data

This might be described as 'identify your yardstick of comparison'. Analysis without comparison is meaningless. For example, if you were simply told that an entity generated revenue of N10 million and made a profit of N900,000 it would be difficult or impossible to assess whether that was 'good' or 'bad' without reference to factors such as:

i. The previous year's revenues and profits;
ii. The budgeted revenues and profits;
iii. The revenues and profits of competitors in the same industry; and
iv. The underlying expectations of the analyst based on their knowledge of relevant internal and external factors.

Methods of Interpreting Financial Statements

1. Item by item analysis of the contents of financial statements.
2. Ratio analysis (Computed via items in the financial statements).

Formula of Ratios

1. Profitability Ratios: These ratios assess or indicate the profitability of a company and some of them include:

a. Return on Capital Employed (ROCE)

$$\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

b. Return on Equity (ROE)

$$\frac{\text{Profit after Tax}}{\text{Equity/ Shareholders funds}} \times 100$$

c. Operating Profit margin

$$\frac{\text{Operating Profit}}{\text{Sales}} \times 100$$

d. Gross Profit Margin

$\frac{\text{Gross Profit}}{\text{Sales}} \times 100$

2. Liquidity Ratios: These ratios try to assess the liquidity position of a company. Some of them include:

   a. Current Ratio:

   $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

   b. Quick ratio /Acid-test:

   $\frac{\text{Current Assets - Stock}}{\text{Current Liabilities}}$

   c. Debtors Collection period:

   $\frac{\text{Average debtors}}{\text{Credit sales}} \times$ 365days/52wks/12months

   d. Creditors payment period:

   $\frac{\text{Average creditors}}{\text{Credit purchases}} \times$ 365days/52wks/12months

   e. Debtors Turnover:

   $\frac{\text{Credit Sales}}{\text{Trade Debtors}}$

3. Stability/Gearing/Debt Ratios: These ratios assess what percentage of total funds used to finance operations is generated from outside sources i.e. it assesses the stability of a company. It is also expressed as a relationship between debt and internal sources of finance.

   a. Debt ratio/ Gearing ratio/ Leverage ratio:

   $\frac{\text{Debt Capital}}{\text{Capital Employed}} \times 100$

   b. Debt/ Equity ratio

   $\frac{\text{Debt Capital}}{\text{Equity}}$

   c. Interest Cover:

   $\frac{\text{Operating Profit}}{\text{Interest Expense}}$

d. Proprietary ratio:

$$\frac{\text{Shareholders' Fund}}{\text{Total Assets}}$$

4. Investors/Shareholders/Stock Ratios: These ratios assess the return attributable to each share. They include:

   a. Earnings per Share:

   $$\frac{\text{Profit after tax}}{\text{No. of Ordinary shares in issue}}$$

   b. Dividend per Share:

   $$\frac{\text{Total Dividend}}{\text{No. of Ordinary shares in issue}}$$

   c. Price Earnings ratio:

   $$\frac{\text{Market price per share}}{\text{Earnings per share}}$$

   d. Earnings Yield:

   $$\frac{\text{Earnings per share}}{\text{Market price per share}} \times 100$$

   e. Dividend Yield:

   $$\frac{\text{Dividend per share}}{\text{Market price per share}}$$

   f. Dividend Cover:

   $$\frac{\text{Earnings per share}}{\text{Dividend per share}}$$

5. Activities Ratios: These ratios assess the efficient utilization of the company's resources by its management. Some of them include:

   a. Stock Turnover:

   $$\frac{\text{Cost of Sales}}{\text{Average Stock}} \times 365\text{days} \quad \text{OR} \quad \frac{\text{Sales}}{\text{Closing stock}} \times 365\text{days}$$

   b. Assets Turnover:

   $$\frac{\text{Sales}}{\text{Total assets/ fixed assets/ Net assets}}$$

c. Debtors collection period:

$$\frac{\text{Average Debtors}}{\text{Credit Sales}} \times \text{365days/ 52wks/ 12Months}$$

d. Creditors Payment period:

$$\frac{\text{Average Creditors}}{\text{Credit Purchases}} \times \text{365days/ 52wks/ 12Months}$$

e. Debtors Turnover

$$\frac{\text{Credit Sales}}{\text{Trade Debtors}}$$

Ratios of Banks

1. CAPITAL ADEQUACY: The standard set by BOFIA is 15% while the International Standard is 8% -BASEL.

a. Equity/ Total Assets:

$$\frac{\text{Equity}}{\text{Total Assets}} \times 100$$

b. Equity/ Loans and Advances:

$$\frac{\text{Equity}}{\text{Loans and advances}} \times 100$$

c. Permanent assets/ Equity:

$$\frac{\text{Fixed Assets}}{\text{Equity}} \times 100$$

2. ASSET QUALITY: These should not be less than 20%.

a. Classified loans/ Gross loans and advances:

$$\frac{\text{Classified loans}}{\text{Gross loans and advances}} \times 100$$

b. Classified loans/ Equity:

$$\frac{\text{Classified loans}}{\text{Equity}} \times 100$$

c. Loan loss reserve/ classified loans

$$\frac{\text{Loan loss reserve}}{\text{Classified loans}} \times 100$$

3. PROFITABILITY: The higher the better for the bank.

a. Pre-tax profit margin:

$$\frac{\text{Profit before tax}}{\text{Gross Earnings}} \times 100$$

b. Return on total asset:

$$\frac{\text{Profit before tax}}{\text{Total Assets}} \times 100$$

c. Net Interest Margin:

$$\frac{\text{Net interest}}{\text{Gross Earnings}} \times 100$$

d. Return on Equity:

$$\frac{\text{Profit after tax}}{\text{Equity}} \times 100$$

e. Interest income/ Loans and advances:

$$\frac{\text{Interest income}}{\text{Loans and Advances}} \times 100$$

f. Interest Paid/ Total deposit:

$$\frac{\text{Interest paid}}{\text{Total deposit}} \times 100$$

g. Operating expenses/ Total revenue

$$\frac{\text{Operating expenses}}{\text{Gross Earnings}} \times 100$$

h. Non-interest income/ Total revenue

$$\frac{\text{Non-interest income}}{\text{Total Revenue}} \times 100$$

4. LIQUIDITY: 40% is the standard while 20% is problematic.

a. Loans and advances/ Total assets

$$\frac{\text{Loans and Advances}}{\text{Total Assets}} \times 100$$

b. Cash and Bank advances/ Total liabilities

$$\frac{\text{Cash and bank balances}}{\text{Total Liabilities}} \times 100$$

c. Loans and advances/ Total deposits

$$\frac{\text{Loans and advances}}{\text{Total deposits}} \times 100$$

Illustration 1

The Managing Director of MEADOW Plc. a company in the leather industry has just received a statistical bulletin showing the performance of the industry as a whole for the year ended 30th September, 2014. He would like to assess the results of the company for the same period using these statistics for purposes of comparison. The accounts of MEADOW Plc. for the year ended 30th September, 2014 are given below:-

STATEMENT OF FIANCIAL POSITION

	N'000		N'000
Liabilities		Assets	
General Reserve	19,500	Trade Debtors	112,500
Ordinary Share Capital	75,000	Equipment at cost	39,000
Trade Creditors	71,250	Goodwill	18,750
Long-Term Loan	55,000	Cash at Bank	16,500
Provision for Dep. on Equip	20,000	Freehold Property at Cost	46,500
Profit and Loss Account	63,000	Stock	82,500
Provision for Taxation	12,000		
	315,750		**315,750**

PROFIT OR LOSS ACCOUNT

	N'000		N'000
Retained Profit c/d	63,000	Sales	632,000
Loan Interest	5,500	Retained Profit b/f	59,500
Administrative Expenses	46,500	Discount Received	500
Depreciation of Equipment	3,000		
Cost of Goods Sold	554,500		
Dividend Paid	7,500		
Company Taxation	12,000		
	692,000		**692,000**

The following ratios were extracted for the industry:-

Return on Capital Employed	10%
Stock Turnover	15 times
Current Ratios	1.8:1
Gross Profit Margin	10%
Gearing Ratio	33%
Quick Ratio	1.45:1

Required:

(a) Redraft the account in a form suitable for presentation to management.

(b) Calculate the above ratios for MEADOW Plc.

(c) Comment on the performance of MEADOW Plc. compared with the Industry.

Solution

MEADOW PLC

Statement of financial position as at 30th September, 2014

	N'000	N'000
Non-Current Assets		
Freehold Property at Cost		46,500
Equipment at Cost	39,000s	
Less Depreciation	20,000	19,000
Intangible Asset:		
Goodwill		18,750
		84,250
Current Assets:		
Stock	82,500	
Trade Debtors	112,500	
Cash at Bank	16,500	
	211,500	
Current Liabilities:		
Trade Creditors	71,250	
Provision for Taxation	12,000	
	83,250	
Working Capital		128,250
		212,500
Financed by:		
Ordinary Share		75,000
General Reserve		19,500
Profit and Loss Account		63,000
Long Term Liabilities:		
Long Term Loan		55,000
		212,500

MEADOW PLC

Profit or Loss Account for the Year Ended 30th September, 2014

	N'000
Sales / Turnover	632,000
Cost of Goods Sold	(554,500)
Gross Profit	77,500
Administrative Expenses	(46,500)
Depreciation of Equipment	(3,000)
Loan Interest	(5,500)
Discount Received	500
Profit before Tax	23,000
Taxation	(12,000)
Profit after Tax	11,000
Appropriation:	
Dividend Paid	(7,500)
Retained Profit for the Year	3,500
Retained Profit b/f	59,500
Retained Profit c/f	63,000

b) (i) Return on Capital Employed = $\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$

= $\frac{17{,}500 \text{ (i.e. Profit b/4 Tax minus Loans Interest)}}{295{,}750 \text{ (i.e. Fixed Assets + Current Asset)}}$

= 5.92% or 6%

(ii) Stock Turnover = $\frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$ or $\frac{\text{Sales}}{\text{Closing Stock}}$

= $\frac{N632{,}000}{N82{,}500}$ = 7.66 times

(iii) Current Ratio = $\frac{\text{Current Asset}}{\text{Current Liab}} = \frac{N211{,}500}{N83{,}250}$ = 2.54:1

(iv) Gross Profit on Sales = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100$

= $\frac{N77{,}500}{N632{,}000} \times 100$ = 12.26%

(v) Gearing Ratios = $\frac{\text{Debt Capital (Long term Debt)}}{\text{Capital Employed.}} \times 100$

= $\frac{N55{,}000}{N295{,}750} \times 100$

= 18.6% or 19%

(vi) Quick Ratio

$$\frac{\text{Current Assets – Stock}}{\text{Current Liabilities}}$$

$$= \frac{N211,500 – N\ 82,500}{N83,250} = \frac{N129,000}{N83,250}$$

$$= 1.55:1$$

c)

i. The Return on Capital employed of 6% is poor when compared with the industry average of 10%.
ii. Stock turnover of 7.66 times is also poor when compared with the industry average of 15 times.
iii. The current ratio of MEADOW Plc. is above that of the industry 2.54:1 as against 1.8:1 indicating that for every N1 owed to outsiders, there is N2.54k current asset available to take care of it. This is OK.
iv. The gross profit on sales of 12.26% of MEADOW is higher and better than the average of the industry of 10%. This is a good position.
v. The gearing ratio of 19% is better than the 33% of the industry. It implies that less of outsiders' money / fund are being utilized.
vi. The quick ratio of 1.55:1 is higher and better than the industry average of 1.45:1. This suggests more liquid assets available to take care of current liabilities.

Illustration 2

Jobach Nig. Ltd. is a manufacturer of Baby Foods. The balance sheet of the company is given below in line with format stated in CAMA.

Jobach Nigeria Ltd. statement of financial position as at 31st December 2010

	N	N
Assets Employed		9,350,000
Investment at cost		3,750,000
Current Assets		
Stock Balances	8,140,000	
Debtors & Prepayment	5,800,000	
Cash & Bank balances	4,920,000	
	18,860,000	
Less: Current Liabilities		
Creditors & Accrual	7,050,000	
Taxation	1,685,000	
	8,735,000	
		10,125,000

	<u>23,225,000</u>
Represented by:	
Share Capital	
Deposit for share	5,000,0000
Profit & Loss Account	10,075,000
	<u>8,150,000</u>
	<u>23,225,000</u>

Additional Information

a) Turnover represents 75% of net asset
b) Cost of sale represents 45% of the aggregate turnover
c) Trade Debtors represent 31% of the aggregate Debtors
d) Credit sales represent 1/5 of the aggregate sales
e) Credit purchases represent 1/3 of cost of sales.

Required:

a) Calculate the following ratios from the data above
   [i] Current ratio
   [ii] Liquidity ratio
   [iii] Debtors Turnover
   [iv] Average Collection Period
   [v] Creditor Turnover

b) State four *(4)* limitations of ratio analysis.

<u>Solution</u>

[a] i) Current Ratio = Current Assets ÷ Current Liabilities

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{18{,}860{,}000}{8{,}735{,}000} = \underline{\underline{2.2:1}}$$

ii) Liquidity Ratio

$$\frac{\text{Current Assets – Stock}}{\text{Current Liabilities}} = \frac{18{,}860{,}000 - 8{,}140{,}000}{8{,}735{,}000} = \frac{10{,}720{,}000}{8{,}735{,}000}$$

$$= \underline{\underline{1.2:1}}$$

iii) Debtors Turnover = $\frac{\text{Credit Sales}}{\text{Debtors}}$ = x times

Credit Sales = 1/5 of sales

: - Sales = 75% x 23,225,000 = 17,418,750

: - Credit Sales 1/5 of 17,418,750 = N3,483,750

Trade Debtors = 31% x 5,800,000 = N1,798,000

Debtors Turnover $= \frac{3,483,750}{1,798,000} = \underline{\underline{1.94}}$ times

iv) Average Collection Period

$$= \frac{\text{Average Debtors}}{\text{Credit Sales}} \times 365 \text{ days}$$

$$= \frac{1,798,000}{3,483,750} \times 365 \text{ days} = \underline{\underline{188}} \text{ days}$$

v) Creditors Turnover $= \frac{\text{Credit Purchases}}{\text{Creditors}}$

Credit Purchases = 1/3 of cost of sales

: - Cost of sales = 45% of 17,418,750

= N7,838,438

: - Credit Purchases = 1/3 x 7,838,438 = N2,612,813

: - Creditors Turnover $= \frac{2,612,813}{7,050,000} = \underline{\underline{0.37}}$ times

[b]

Limitations of Accounting Ratio Analysis

i. The difference in the methods adopted by two enterprises may distort the result of analysis and therefore misinform judgement. Examples of such difference,"X" company adopting first in first out stock valuation method whereas "Y" company used weighted average.

ii. The profit figures declared by the two companies may diverge, not as a result of varying levels of efficiency and effectiveness.

iii. There is inherent assumption that the historical data used for ratio analysis are inviolate, fixed and applicable under all situations. However, the dynamics of political and economic factors may prove such data as "out of date".

iv. Just as mathematics, which engages in "arm chair reasoning" and does not concern itself with what goes on in the empirical world, ratio analysis are not supposed to be ends in themselves. Useful as they ratio analysis should be considered along with other quantitative and indeed qualitative factors.

v. The issues, which crop up are:

- What is the suitable standard for comparison?
- What is the suitable industry standard?

5.07 Review Questions

1. The Profit or Loss Account and statement of financial position of ADEKING Plc. as at 31st December, 2013 and 2014 were as follows:

Profit or Loss Account

	2014	2013
	N'000	N'000
Turnover	2,713,285	3,089,973
Cost of sales	(1,907,419)	(1,954,626)
Gross profit	805,866	1,135,347
Operating expenses	(664,738)	(553,702)
Trading profit	141,128	581,645
Exceptional items	176,157	(5,848)
Other income	72,859	37,085
Interest charges	(105,976)	(80,273)
Profit on ordinary activities before tax	284,168	532,609
Taxation	(69,938)	(191,265)
Profit on ordinary activities after tax	214,230	341,344
Debenture Redemption Reserve	-	(10,000)
Dividend proposed	(132,875)	(199,313)
Retained profit for the year	81,355	132,031
Reserve at the beginning of the year	464,434	332,346
Transfer from redemption reserve	40,000	-
Retained profit C/F	585,789	464,377

Statement of financial position as at 31st December

	2014	2013
	N'000	N'000
Fixed Assets	260,739	248,609
Long-term investments	160	160

Current Assets:		
Stocks	1,456,182	1,387,073
Debtors	579,876	310,322
Bank & Cash Balance	525,574	792,059
	2,822,531	2,738,223
Creditors: (due within one year)	(1,479,217)	(1,557,347)
Net Current Assets	1,343,314	1,180,876
Creditors: (due after one year)	(10,795)	(8,700)
Provision for liabilities and charges	(285,701)	(179,713)
	1,046,818	992,463
Capital & Reserves		
Called-Up Share Capital @ 50k each	332,188	332,188
Reserves	714,630	660,275
	1,046,818	992,463
Market Price of shares	45k/share	6k/share

You are required to:

(a) Compute the following ratios for 2013 & 2014

i. Gross Profit Margin
ii. Return on Capital Employed
iii. Net Profit Margin
iv. Current ratio
v. Liquid ratio
vi. Debtors collection period
vii. Earnings per share
viii. Dividend per share
ix. Price earnings ratio

(b) Based on the ratios computed in (a) above comment on the company's profitability and liquidity position over the period.

Question 2

Kwall Ltd. has a capital base of N5,000,000 (shares of N100 each) as at 31st December 2003. The company's profit after tax for the same year stood at N700,000. Assume the market value of the company's share was N400 each and a dividend of 4% was declared for the year to 31/12/2003.

Determine the following in respect of the company;

i. Market value of the company's ordinary shares
ii. Price Earnings Ratio
iii. Earnings per share
iv. Dividend yield

v. Value of the retained profit

Question 3

Anan & Co. supplied you with the following statistics relating to its operation for the financial year ended 30th April, 2008

Gross Profit	-	25%
Average Inventory	-	N18,000
Inventory turnover	-	8 times
Net Profit/Revenue	-	15%
Collection period	-	50 days
Payment period	-	35 days
Current Asset: Current Liability	-	4:1
Net Profit/Net Asset	-	18%
Opening Inventory: Closing Inventory	-	1:2
Motor vehicles/furniture & fitting/loose tools	-	9:1:0.5
Drawings	-	N6,000

The payment and collection periods are based on year end Payables and Receivables. The current liabilities consist only of payables while current assets consist of inventory, receivables and cash. The non-current assets are motor vehicle, furniture and fittings and loose tools.

You are required to prepare in detailed form (much as the information above permits) an Income Statement for the year ended 30th April, 2018 and a Statement of Financial Position as at that date. Show all workings. Calculations should be made to the nearest whole number.

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Other Relevant Materials

Accounting Education	www.accountingeducation.com
Association of National Accountants of Nigeria (ANAN)	www.anan.org.ng
British Accounting Association	www.baa.group.shef.ac.uk
European Accounting Association	www.eaa-online.org
Financial Reporting Council of Nigeria	www.financialreportingcouncil.gov.ng
International Accounting Standards Board	www.iasb.org
International Federation of Accountants	www.ifac.org
United Nations Conference on Trade and Development	www.unctad.org
World Bank	www.worldbank.org
World Federation of Exchanges	www.world-exchanges.org