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Paper P7

Financial Accounting and Tax Principles

Relevant for **May & November 2005** examinations

Dak Patel & Colin Channer

CERTIFICATE | **MANAGERIAL** | STRATEGIC

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Managerial Level

Financial Accounting and Tax Principles

Dak Patel
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Introduction

Welcome to the new CIMA Exam Practice Kit which has been launched to coincide with a major change in the syllabus where new examinations will take place from May 2005.

This Kit has been designed with the needs of home study and distance candidates in mind. It is also ideal for fully taught courses or for students resitting papers from the old syllabus.

These hints, questions and answers have been produced by some of the best known freelance tutors in the United Kingdom who have specialised in their respective papers. The questions and topics selected are relevant for the May 2005 and November 2005 examinations.

The exam practice kits will complement CIMA's existing study manuals with the Q&As from May 2005 published in the next edition of the CIMA study manual and the Q&As from November 2005 examination published in the 2006 edition of the Exam Practice Kit.

Good luck with your studies.

About the Authors

Colin is a graduate in economics and a chartered accountant who, after qualifying with Deloittes, London (now part of PricewaterhouseCoopers), built a career in the private sector of accountancy training.

From 1974 to 1987, he was a lecturer, senior lecturer, partner and company director of ATC London (now part of FTC). During his time with ATC, he was head of the national tax team responsible for all tax study materials used by ATC and lectured on ICAEW professional examination courses in taxation, economics and financial accounting. After leaving ATC, he undertook ten years of freelance teaching, initially on ICAEW courses, but after 1991 increasingly ACCA and CIMA. In 1997, he re-joined ATC working for their overseas division, ATC International. Apart from teaching ACCA and CIMA courses in most countries of the former Soviet Union, he was responsible for writing and editing the tax material generated by ATCI. In 2002, he joined Emile Woolf Colleges in London, but left following the take-over by FTC in 2003. Colin has now resumed being a freelance teacher and writer both in the UK and abroad.

Dak Patel is the Principal of London School of Accountancy and Management. In 1991 he refurbished a major Accountancy college in Central London and started lecturing there on accountancy, taxation and management courses. In the late 1990s he became a co-founder for an Accountancy college where he was the managing director. In January 2004 he founded LondonSAM. The college has enrolled over 500 students studying full time, evening and on weekends. By 2007 he plans to have set up centres overseas notably China, Mauritius, India, Pakistan and Ghana where currently he has sole agencies in place. He has also lectured at Cambridge on the MBA and DMS programmes and trained staff members of the Essex Police and Fire Brigade.

Syllabus Guidance, Learning Objectives and Verbs

A The syllabus

The syllabus for the CIMA Professional Chartered Management Accounting qualification 2005 comprises three learning pillars:

1 Management Accounting pillar
2 Business Management pillar
3 Financial Management pillar.

Within each learning pillar there are three syllabus subjects. Two of these subjects are set at the lower 'Managerial' level, with the third subject positioned at the higher 'Strategic' level. All subject examinations have a duration of three hours and the pass mark is 50%.

Note: In addition to these nine examinations, students are required to gain three years relevant practical experience and successfully sit the Test of Professional Competence in Management Accounting (TOPCIMA).

B Aims of the syllabus

The aims of the syllabus are:

- To provide for the Institute, together with the practical experience requirements, an adequate basis for assuring society that those admitted to membership are competent to act as management accountants for entities, whether in manufacturing, commercial or service organisations, in the public or private sectors of the economy.
- To enable the Institute to examine whether prospective members have an adequate knowledge, understanding and mastery of the stated body of knowledge and skills.
- To complement the Institute's practical experience and skills development requirements.

C Study weightings

A percentage weighting is shown against each topic in the syllabus. This is intended as a guide to the proportion of study time each topic requires.

All topics in the syllabus must be studied, since any single examination question may examine more than one topic, or carry a higher proportion of marks than the percentage study time suggested.

The weightings *do not* specify the number of marks that will be allocated to topics in the examination.

D Learning outcomes

Each topic within the syllabus contains a list of learning outcomes, which should be read in conjunction with the knowledge content for the syllabus. A learning outcome has two main purposes:

1 to define the skill or ability that a well-prepared candidate should be able to exhibit in the examination;
2 to demonstrate the approach likely to be taken by examiners in examination questions.

The learning outcomes are part of a hierarchy of learning objectives. The verbs used at the beginning of each learning outcome relate to a specific learning objective, e.g. Evaluate alternative approaches to budgeting.

The verb 'evaluate' indicates a high level learning objective. As learning objectives are hierarchical, it is expected that at this level, students will have knowledge of different budgeting systems and methodologies and be able to apply them.

A list of the learning objectives and the verbs that appear in the syllabus learning outcomes and examinations follows:

Learning objective	*Verbs used*	*Definition*
1 Knowledge		
What you are expected to know	List	Make a list of
	State	Express, fully or clearly, the details of/facts of
	Define	Give the exact meaning of
2 Comprehension		
What you are expected to understand	Describe	Communicate the key features of
	Distinguish	Highlight the differences between
	Explain	Make clear or intelligible/State the meaning of
	Identify	Recognise, establish or select after consideration
	Illustrate	Use an example to describe or explain something

3 Application		
How you are expected to apply your knowledge	Apply	To put to practical use
	Calculate/compute	To ascertain or reckon mathematically
	Demonstrate	To prove with certainty or to exhibit by practical means
	Prepare	To make or get ready for use
	Reconcile	To make or prove consistent/compatible
	Solve	Find an answer to
	Tabulate	Arrange in a table
4 Analysis		
How you are expected to analyse the detail of what you have learned	Analyse	Examine in detail the structure of
	Categorise	Place into a defined class or division
	Compare and contrast	Show the similarities and/or differences between
	Construct	To build up or compile
	Discuss	To examine in detail by argument
	Interpret	To translate into intelligible or familiar terms
	Produce	To create or bring into existence
5 Evaluation		
How you are expected to use your learning to evaluate, make decisions or recommendations	Advise	To counsel, inform or notify
	Evaluate	To appraise or assess the value of
	Recommend	To advise on a course of action

Learning Outcomes, Syllabus Content and Examination Format

Syllabus outline

The syllabus comprises:

Topic and study weighting

A	Principles of Business Taxation	20%
B	Principles of Regulation of Financial Reporting	10%
C	Single Company Financial Accounts	45%
D	Managing Short-Term Finance	25%

Learning aims

Students should be able to:

- describe the types of business taxation rules and requirements likely to affect a company (in respect of itself and its employees);
- describe and discuss how financial reporting can be regulated and the system of International Accounting Standards;
- prepare statutory accounts in appropriate form for a single company;
- assess and control the short-term financial requirements of a business entity.

Assessment strategy

There will be a written examination paper of three hours, with the following sections.

Section A – 50 marks
A variety of compulsory objective test questions, each worth between 2 and 4 marks. Mini-scenarios may be given, to which a group of questions relate.

Section B – 30 marks
Six compulsory short answer questions, each worth 5 marks. A short scenario may be given, to which some or all questions relate.

Section C – 20 marks
One question, from a choice of two, worth 20 marks. Short scenarios may be given, to which questions relate.

A – Principles of business taxation – 20%

Learning outcomes

On completion of their studies students should be able to:

(i) identify the principal types of taxation likely to be of relevance to an incorporated business in a particular country, including direct tax on the company's trading profits and capital gains, indirect taxes collected by the company, employee taxation, withholding taxes on international payments;

(ii) describe the features of the principal types of taxation likely to be of relevance to an incorporated business in a particular country (e.g. in terms of who ultimately bears the tax cost, withholding responsibilities, principles of calculating the tax base);

(iii) describe the likely record-keeping, filing and tax payment requirements associated with the principal types of taxation likely to be of relevance to an incorporated business in a particular country;

(iv) describe the possible enquiry and investigation powers of taxing authorities;

(v) identify situations in which foreign tax obligations (reporting and liability) could arise and methods for relieving foreign tax;

(vi) explain the difference in principle between tax avoidance and tax evasion;

(vii) describe sources of tax rules and explain the importance of jurisdiction;

(viii) explain and apply the accounting rules contained in IAS 12 for current and deferred taxation.

Syllabus content

- Concepts of direct versus indirect taxes, taxable person and competent jurisdiction.
- Sources of tax rules (e.g. domestic primary legislation and court rulings, practice of the relevant taxing authority, supranational bodies, such as the EU in the case of value added/sales tax, and international tax treaties).
- Direct taxes on company profits and gains:
  - The principle of non-deductibility of dividends and systems of taxation defined according to the treatment of dividends in the hands of the shareholder (e.g. classical, partial imputation and imputation),
  - The distinction between accounting and taxable profits in absolute terms (e.g. disallowable expenditure on revenue account, such as entertaining, and on capital account, such as formation and acquisition costs) and in terms of timing (e.g. deduction on a paid basis, tax depreciation substituted for book depreciation),
  - The nature of rules recharacterising interest payments as dividends,
  - Potential for variation in rules for calculating the tax base dependent on the nature or source of the income (schedular systems),
  - The need for rules dealing with the relief of losses,
  - The concept of tax consolidation (e.g. for relief of losses and deferral of capital gains on asset transfers within a group).
- Indirect taxes collected by the company:
  - In the context of indirect taxes, the distinction between unit taxes (e.g. excise duties based on physical measures) and *ad valorem* taxes (e.g. sales tax based on value),
  - The mechanism of value added/sales taxes, in which businesses are liable for tax on their outputs less credits for tax paid on their inputs, including the concepts of exemption and variation in tax rates depending on the type of output and disallowance of input credits for exempt outputs.

- Employee taxation:
  - The employee as a separate taxable person subject to a personal income tax regime,
  - Use of employer reporting and withholding to ensure compliance and assist tax collection.
- The need for record-keeping and record retention that may be additional to that required for financial accounting purposes.
- The need for deadlines for reporting (filing returns) and tax payments.
- Types of powers of tax authorities to ensure compliance with tax rules:
  - Power to review and query filed returns,
  - Power to request special reports or returns,
  - Power to examine records (generally extending back some years),
  - Powers of entry and search,
  - Exchange of information with tax authorities in other jurisdictions.
- International taxation:
  - The concept of corporate residence and the variation in rules for its determination across jurisdictions (e.g. place of incorporation versus place of management),
  - Types of payments on which withholding tax may be required (especially interest, dividends, royalties and capital gains accruing to non-residents),
  - Means of establishing a taxable presence in another country (local company and branch),
  - The effect of double tax treaties (based on the OECD Model Convention) on the above (e.g. reduction of withholding tax rates, provisions for defining a permanent establishment),
  - Principles of relief for foreign taxes by exemption, deduction and credit.
- The distinction between tax avoidance and tax evasion, and how these vary among jurisdictions (including the difference between the use of statutory general anti-avoidance provisions and case law-based regimes).
- Accounting treatment of taxation and disclosure requirements under IAS12.

Note:

Examples of general principles should be drawn from a 'benchmark' tax regime (e.g. the UK, USA, etc.) or an appropriate local tax regime. Details of any specific tax regime will NOT be examined.

B – Principles of regulation of financial reporting – 10%

Learning outcomes

On completion of their studies students should be able to:

(i) explain the need for regulation of published accounts and the concept that regulatory regimes vary from country to country;

(ii) explain potential elements that might be expected in a regulatory framework for published accounts;

(iii) describe the role and structure of the International Accounting Standards Board (IASB) and the International Organisation of Securities Commissions (IOSCO);

(iv) explain the IASB's Framework for the Presentation and Preparation of Financial Statements;

(v) describe the process leading to the promulgation of an International Accounting Standard (IAS);

(vi) describe ways in which IASs can interact with local regulatory frameworks;
(vii) explain in general terms, the role of the external auditor, the elements of the audit report and types of qualification of that report.

Syllabus content

- The need for regulation of accounts.
- Elements in a regulatory framework for published accounts (e.g. company law, local GAAP, review of accounts by public bodies).
- GAAP based on prescriptive versus principles-based standards.
- The role and structure of the IASB and IOSCO.
- The IASB's *Framework for the Presentation and Preparation of Financial Statements*.
- The process leading to the promulgation of a standard practice.
- Ways in which IASs are used: adoption as local GAAP, model for local GAAP, persuasive influence in formulating local GAAP.
- The powers and duties of the external auditors, the audit report and its qualification for accounting statements not in accordance with best practice.

C – Single company financial accounts – 45%

Learning outcomes

On completion of their studies students should be able to:
(i) prepare financial statements in a form suitable for publication, with appropriate notes;
(ii) prepare a cash-flow statement in a form suitable for publication;
(iii) explain and apply the accounting rules contained in IAS's dealing with reporting performance, tangible fixed assets and inventories;
(iv) explain the accounting rules contained in IAS's governing share capital transactions;
(v) explain the principles of the accounting rules contained in IAS's dealing with disclosure of related parties to a business, construction contracts (and related financing costs), research and development expenditure, intangible fixed assets (other than goodwill on consolidation), impairment of assets, postbalance sheet events, contingencies, and leases (lessee only).

Syllabus content

- Preparation of the financial statements of a single company, including the statement of changes in equity (IAS 1).
- Preparation of cash-flow statements (IAS 7).
- Reporting performance: recognition of revenue, measurement of profit or loss, extraordinary items, prior period items, discontinuing operations and segment reporting (IAS 1, 8, 14, 18 and 35).
- Property, Plant and Equipment (IAS 16): the calculation of depreciation and the effect of revaluations, changes to economic useful life, repairs, improvements and disposals.
- Inventories (IAS 2).
- Issue and redemption of shares, including treatment of share issue and redemption costs (IAS 32 and IAS 39), the share premium account, the accounting for maintenance of capital arising from the purchase by a company of its own shares.

- The disclosure of related parties to a business (IAS 24).
- Construction contracts and related financing costs (IAS 11 and 23): determination of cost, net realisable value, the inclusion of overheads and the measurement of profit on uncompleted contracts.
- Research and development costs (IAS 38): criteria for capitalisation.
- Intangible Assets (IAS 38) and goodwill (excluding that arising on consolidation): recognition, valuation and amortisation.
- Impairment of Assets (IAS 36) and its effect on the above.
- Post-balance sheet events (IAS 10).
- Provisions and contingencies (IAS 37).
- Leases (IAS 17) – Operating and finance leases in the books of the lessee.

D – Managing short-term finance – 25%

Learning outcomes

On completion of their studies students should be able to:

(i) calculate and interpret working, capital ratios for business sectors;
(ii) prepare and analyse cash-flow forecasts over a 12-month period;
(iii) identify measures to improve a cash forecast situation;
(iv) compare and contrast the use and limitations of cash management models and identify when each model is most appropriate;
(v) analyse trade debtor information;
(vi) evaluate debtor and creditor policies;
(vii) evaluate appropriate methods of stock management;
(viii) identify alternatives for investment of short-term cash surpluses;
(ix) identify sources of short-term funding;
(x) identify appropriate methods of finance for trading internationally.

Syllabus content

- Working capital ratios (e.g. debtor days, stock days, creditor days, current ratio, quick ratio) and the working capital cycle.
- Working capital characteristics of different businesses (e.g. supermarkets being heavily funded by creditors) and the importance of industry comparisons.
- Cash-flow forecasts, use of spreadsheets to assist in this in terms of changing variables (e.g. interest rates, inflation) and in consolidating forecasts.
- Variables that are most easily changed, delayed or brought forward in a forecast.
- The link between cash, profit and the balance sheet.
- The Baumol and Miller-Orr cash management models.
- The credit cycle from receipt of customer order to cash receipt.
- Evaluation of payment terms and settlement discounts.
- Preparation and interpretation of age analyses of debtors and creditors.
- Establishing collection targets on an appropriate basis (e.g. motivational issues in managing credit control).
- The payment cycle from agreeing the order to making payments.
- Centralised versus decentralised purchasing.
- The relationship between purchasing and stock control.
- Principles of the economic order quantity (EOQ) model and criticisms thereof.

- Types and features of short-term finance: trade creditors, overdrafts, short-term loans and debt factoring.
- Use and abuse of trade creditors as a source of finance.
- The principles of investing short term (i.e. maturity, return, security, liquidity and diversification).
- Types of investments (e.g. interest-bearing bank accounts, negotiable instruments including certificates of deposit, short-term treasury bills and securities).
- The difference between the coupon on debt and the yield to maturity.
- Export finance (e.g. documentary credits, bills of exchange, export factoring, forfeiting).

Examination Techniques

Essay questions

Your essay should have a clear structure, i.e. an introduction, a middle and an end. Think in terms of 1 mark for each relevant point made.

Numerical questions

It is essential to show workings in your answer. If you come up with the wrong answer and no workings, the examiner cannot award any marks. However, if you get the wrong answer but apply the correct technique then you will be given some marks.

Reports and memorandum

Where you are asked to produce an answer in a report type format you will be given easy marks for style and presentation.

A *report* is a document from an individual or group in one organisation sent to an individual or group in another.

A *memorandum* is an informal report going from one individual or group to another individual or group in the same organisation.

You should start a report as follows:

To: J. SMITH, CEO, ABC plc

From: M ACCOUNTANT

Date: 31 December 200X

Terms of Reference: Financial

Strategy of ABC plc

Multiple choice questions – managerial level

From May 2005 some multiple choice questions will be worth more than two marks. Even if you get the answer wrong, you may still get some marks for technique. Therefore show all workings on such questions.

Introduction to the Principles of Business Taxation

1

Questions

1.1 In 1776, Adam Smith wrote in his book 'The Wealth of Nations' that there were four canons or key principles of a good tax – equity, certainty, convenience and efficiency.

Briefly explain the meaning of each of these terms.

(4 marks)

1.2 Which of the following statements most accurately explains the meaning of the term direct tax?

A A direct tax is a tax that falls directly on the person who is expected to pay it
B A direct tax is a tax where the person responsible for paying the tax is placed in direct contact with the relevant tax authority responsible for assessment and collection of the tax
C A direct tax is a tax where a person ends up bearing the cost of the tax as he, she or it cannot pass the burden on to another person
D A direct tax is a tax which is fair to different taxpayers because it takes into account the taxpayer's ability to pay

(2 marks)

1.3 Which of the following statements defines an hypothecated tax?

A The taxable person paying income to another person is required to deduct tax before making the payment
B The tax takes a decreasing proportion of income as the amount of income rises
C The relevant tax authority has the legal right to assess and collect tax
D The revenue raised by the tax is devoted to a specific type of government expenditure

(2 marks)

1.4 Explain the meaning of the term 'competent jurisdiction'?

(4 marks)

1.5 Differentiate, with the aid of examples, between a progressive or regressive tax structure?

(4 marks)

1.6 (i) Define the term 'tax base' and explain why most governments are keen to have a wide tax base?

(2 marks)

(ii) Identify *two* of the three principal classes of tax and their tax bases.

(2 marks)

(Total = 4 marks)

1.7 Identify *four* main sources of tax rules governing the operations of tax authorities.

(4 marks)

Answers

1.1 The key principles of a good tax

Equity – A tax should be perceived by the taxpayer as being a fair tax, i.e. it should reflect the taxpayer's ability to pay and not be avoidable by those to which it is intended to apply
Certainty – A tax should have a clear purpose and not have an arbitrary effect on taxpayers
Convenience – A tax can be easily assessed and collected
Efficiency – The costs of collection are small as a proportion of the revenue raised and it does not distort the economic behaviour of taxpayers, individuals or businesses.

1.2 Direct tax
A

B the definition of formal incidence of a tax. This is true for many direct taxes
C the definition of effective incidence of a tax. This is a common characteristic of most direct taxes
D the definition of equity. Most direct taxes attempt to have an equitable effect.

1.3 Hypothecated tax
D

A the definition of a withholding tax or deduction of tax at source
B the definition of a regressive tax
C the definition of tax jurisdiction.

1.4 Competent jurisdiction

The jurisdiction of a tax authority is its legal right to assess, collect and enforce the payment of a tax. Jurisdiction is conferred by the statutes of central or local government, clarified and extended by actions of the Courts and extra-statutory rules of the tax authority itself.

Jurisdiction is defined in terms of a territory (e.g. a country or part of a country such as a state, county, district or city). Taxable entities (e.g. individuals or businesses) become subject to the tax rules of a tax authority by being resident in that territory, by virtue of physical presence for a sufficient period of time or by being legally situated therein (e.g. through a company's incorporation) or by being controlled therein.

An individual or enterprise falls within the competent jurisdiction of a tax authority of a territory where he, she or it is obliged to apply its tax laws.

1.5 Progressive vs regressive taxes

A progressive tax is one where its rate structure results in an increasing tax yield as the value of the taxable source (e.g. income) increases; a regressive tax has the opposite effect.

In the UK, both income and corporation tax are progressive taxes; with multiple rates between 10 and 40% (income tax) and 0 and 30% (corporation tax). In contrast, Russia operates a flat rate 13% income tax which is basically regressive in nature since the rate does not increase in line with the taxpayer's ability to pay.

1.6 Tax base

(i) A tax base is something which is liable to tax. Governments prefer a wide tax base in order to increase overall tax revenues without resorting to high rates of tax.

(ii) The three principal forms of tax are income taxes, capital taxes and consumption taxes.

The main tax bases used for these taxes are:

For income taxes – profits from business enterprise; salaries and non-cash benefits in kind from employment; dividends, rents and interest from investment

For capital taxes – gains from the sale or gift of appreciating assets; gifts of accumulated wealth by individuals in their lifetimes or on death

For consumption taxes – either the value of sales of goods and services (i.e. for VAT and sales taxes) or the quantity of goods produced or sold (i.e. for excise duties).

1.7 Tax rules

The main sources of tax rules are:

(i) Domestic legislation (i.e. Finance Acts (in the UK) and Tax codes (other countries))
(ii) Extra-statutory guidelines issued by the tax authorities
(iii) Supranational regulations (e.g. EU directives on VAT)
(iv) Case law decisions made by domestic and supranational (e.g. the European Court) judicial bodies
(v) International tax treaties on double taxation.

Any four of the five sources mentioned will obtain full marks.

Direct Taxes on Profits and Gains of Enterprises

2

Questions

2.1 Which of the following statements best describes the tax base for determining the tax liability on corporate profits?

A The accounting profit calculated using international accounting standards adjusted for differences between the tax and accounting treatments accepted by all countries
B The accounting profit calculated using international accounting standards adjusted for differences between the tax and accounting treatments by reference to the tax law of the relevant tax jurisdiction
C The accounting profit calculated using the general accounting practice of the particular country as adjusted for differences between the tax and accounting treatments accepted by all countries
D The accounting profit calculated using the general accounting practice of the particular country as adjusted for differences between the tax and accounting treatments by reference to the tax law of the relevant tax jurisdiction

(2 marks)

2.2 A company will be assessed to corporate tax on total profits earned by that company.

Which of the following is *not* a reason for separately identifying for tax purposes the different types of income or gains making up these profits?

A Different bases of assessment – accruals, receipts, etc. – are used to determine the taxable amounts
B A particular taxable source may be eligible for a specific tax relief or be taxed at a different rate
C A source of profit may arise in a foreign tax jurisdiction
D The company is owned by another company resident in another tax jurisdiction

(2 marks)

2.3 The income statement of Company A for the accounting year ending 31 December 2004 discloses net profit before taxation as being $500,000. The following expenses and incomes were respectively charged and credited in arriving at this amount:

	$
Depreciation of tangible assets	50,000
Interest payable on a loan to purchase an investment property	80,000
Donation to trade association	5,000
Profit on the sale of a non-current asset used in the trade	60,000

The taxable trading income before tax depreciation for the year ended 31 December 2004 is:

A $550,000
B $575,000
C $570,000
D $490,000

(4 marks)

2.4 The income statement of Company B for the year ended 31 December 2004 shows a net loss of $90,000. The following amounts have been charged and credited in arriving at this figure of loss:

	$
Amortisation of leasehold building used in the trade	65,000
Cost of repairing the roof of a newly acquired factory. The damage, which existed at the date of acquisition had rendered the building incapable of trade use until the repair work was complete.	100,000
Amount received from the company's insurers in respect of flood damage to inventory sustained in the previous accounting period. An equivalent amount was treated as an allowable trading expense of this earlier period	80,000
Donation to a political party	10,000

The taxable or allowable amount before tax depreciation for the year ended 31 December 2004 is:

A A profit of $5,000
B A profit of $85,000
C A loss of $95,000
D A loss of $80,000

(4 marks)

2.5 Company C prepares accounts to 31 December each year. The income statement for the year ended 31 December 2004 shows the following amounts charged against and credited to net profit before taxation:

	$
Entertaining of customers	40,000
Staff Christmas party	8,000
Legal costs relating to a new share issue	60,000
Depreciation of tangible assets. This amount has been calculated using the rates and basis of computation prescribed by the tax authority	140,000

The amount to be added back in arriving at taxable trading income is:

A $248,000
B $100,000
C $108,000
D $40,000

(4 marks)

2.6 Company D conducts a trade of manufacturing and prepares annual accounts to 31 December. Its financial statements for the year ended 31 December 2004 show the following details about land and buildings used in its trade:

	Building 1	*Building 2*	*Building 3*
	$	$	$
Cost:			
At 1.1.04	1,600,000	700,000	
Additions in year			400,000
Disposals in year		(700,000)	
	1,600,000	0	400,000
Depreciation:			
At 1.1.04	400,000	210,000	
Charge for the year	40,000	0	10,000
Eliminated on disposals		(210,000)	
	440,000	0	10,000
Net book values	1,160,000	0	390,000

50% of the cost of each building is attributable to land which is not subject to depreciation.

The company's accounting policy for depreciation of buildings is 5% p.a. on a straight-line basis with a full charge in the year of acquisition and no charge in the year of disposal.

The sale proceeds of Building 2 were $650,000, of which $400,000 were attributable to the land.

The tax authority allows tax depreciation on a straight-line basis for 25 years from the date of first qualifying use on all buildings used in the trade of the taxpayer. If a building is disposed off during the 25-year period a balancing charge or allowance arises. Tax depreciation is not given in respect of the cost of the land on which buildings are located.

The tax written down value of Building 2 at 1 January 2004 was $182,000.

(i) The amount to be added to or deducted from accounting net profit to determine the taxable trading profit before tax depreciation for the year ended 31 December 2004 is:

A $50,000
B $(110,000)
C Nil
D $(210,000)

(4 marks)

(ii) The tax depreciation (or net balancing adjustment) for the year ended 31 December 2004 is:

A $(428,000)
B $40,000
C $12,000
D $(28,000)

(4 marks)
(Total = 8 marks)

2.7 Company E conducts a trade of manufacturing and prepares annual accounts for 31 December. A note attached to the financial statements for the year ended 31 December 2004 relating to non-current assets shows the following details:

	Plant and equipment	*Motor cars*	*Total*
	$	$	$
Cost:			
At 1.1.04	1,000,000	250,000	1,250,000
Additions in year	850,000	120,000	970,000
Disposals in year	(150,000)	(30,000)	(180,000)
	1,700,000	340,000	2,040,000
Depreciation:			
At 1.1.04	400,000	160,000	560,000
Charge for year	340,000	85,000	425,000
Eliminated on disposals	(90,000)	(20,000)	(110,000)
	650,000	225,000	875,000
Net book values	1,050,000	115,000	1,165,000

The company's accounting policy for depreciation of plant & machinery is a straight-line basis with a full charge in the year of acquisition and no charge in the year of disposal using the following rates:

	%
Plant and equipment	20
Motor cars	25

The sale proceeds (all less than original cost) of relevant assets during the year were:

	$
Plant and equipment	30,000
Motor cars	15,000

The tax authority allows tax depreciation on all types of plant and machinery calculated on a reducing balance basis at a rate of 25% p.a. by reference to totals of unrelieved expenditures for given classes of asset at the end of the chargeable period.

The tax written-down values brought forward on the pools of expenditures at 1 January 2004 were:

	$
Plant and equipment	680,000
Motor cars	110,000

(i) The amount to be added to accounting net profit to determine the taxable trading profit before tax depreciation for the year ended 31 December 2004 is:

A $425,000
B $450,000
C $560,000
D $670,000

(4 marks)

(ii) The tax depreciation for the year ended 31 December 2004 is:

A $395,000
B $291,250
C $428,750
D $353,750

(4 marks)
(Total = 8 marks)

2.8 Company F owns three assets which it sold in the year ended 31 December 2004. Relevant details are:

	Land and buildings	*Quoted shares*	*Motor car*
Date of sale	1.10.04	1.7.04	1.4.04
Date of purchase	1.11.90	1.2.99	1.12.01
	$	$	$
Purchase cost	500,000	100,000	20,000
Cost of extension to building on 1.5.96	200,000		
Gross sale proceeds	1,200,000	80,000	10,000
Incidental costs of sale	40,000	2,000	200

The tax authority applies the following rules in relation to capital gains:

(i) An allowance is given to offset the impact of inflation in respect of chargeable gains only, calculated as a percentage of each relevant cost (excluding incidental costs of disposal). The percentage is 2% p.a. for each complete year of ownership.
(ii) Neither gain nor loss can arise on the disposal of chattels with a gross value ≤$10,000, motor cars and government and corporate debentures and loan stocks.

The amount to be included in the tax computation of profits chargeable to corporate tax for the year ended 31 December 2004 is:

A $265,800
B $266,000
C $276,000
D $256,000

(4 marks)

2.9 In the context of the taxation of chargeable gains rollover relief means:

A The indefinite deferral of payment of the tax on an appropriate chargeable asset of a business sold at a gain

B The deferral of payment of the tax on an appropriate chargeable asset of a business sold at a gain where the proceeds of disposal are re-invested in another appropriate chargeable asset

C The exemption of gains and losses on the sale of appropriate chargeable assets of a business where sale proceeds are re-invested in other appropriate chargeable assets

D Paying, by instalments over a prescribed period, the tax due on a gain less losses arising on the sale of appropriate chargeable assets of a business.

(2 marks)

2.10 Which of the following statements best describes the concept of an imputation system for taxing dividends paid by a company to its shareholders?

A The corporate tax on the profits earned by the company is deemed to be the personal income tax payable by the shareholders on their dividends received

B The corporate tax attributable to the proportion of post-tax profits paid out as dividends is treated as fully discharging the personal income tax liabilities of the shareholders on their dividends received

C A proportion of the corporate tax attributable to dividends paid is treated as a tax credit to be set against the personal income tax liabilities of the shareholders on their dividends received

D Where a company distributes profits to its shareholders as dividends no corporate tax will be levied on the profits funding those dividends as the latter will be subjected to personal income tax in the hands of the shareholders

(2 marks)

2.11 Company G is resident in a tax jurisdiction operating the following rules for the assessment of corporate profits:

(i) companies are free to choose their accounting date, but once chosen must be applied for at least five consecutive accounting periods

(ii) corporate profits comprise all types of income and chargeable gains

(iii) capital losses can only be relieved against current or future capital gains of the same company

(iv) trading losses can be relieved in the same company as follows:

(a) against total taxable profits of the same accounting period and then against total taxable profits of the period of equal length preceding the accounting period of loss, and/or;

(b) against future taxable trading profits of the same trade of that company.

Recent results of the company were as follows:

	Year ended 31.12.03	*6 months ended 30.6.04*
	$	$
Taxable trading profit	300,000	
Allowable trading loss		(500,000)
Taxable investment income	100,000	120,000
Chargeable gain		50,000
Allowable capital loss	(60,000)	

For the year ended 30 June 2005, the company anticipates trading profits of $95,000 and investment income $90,000.

Assuming that the earliest relief is taken for all the losses, calculate the amount that will be unrelieved at 30 June 2005.

(10 marks)

2.12 Company H owns 100% of the ordinary share capital of Company J and 40% of the ordinary share capital of Company K. All the companies are resident in the same tax jurisdiction and all prepare accounts to 31 December annually.

For the year ended 31 December 2004, results were:

	H	*J*	*K*
	$	$	$
Taxable trading income	2,000,000	300,000	60,000
Taxable investment income	200,000	10,000	
Chargeable gain		60,000	

The tax authority applies the following rules for the assessment of corporate profits:

1 Tax rates

Taxable profits	*Rate*
	%
1–100,000	10
100,001–1,000,000	20
1,000,001 and more	30

2 Two companies are associated companies for tax purposes if one company controls the other company or both companies are under common control of another company or person. Where two or more companies are associated companies, the profit limits of $100,000 and $1,000,000 in (i) above are divided by the number of associated companies. Control for this purpose exists if one company owns more than 50% of the other company's issued share capital.

3 Taxable profits = all types of income + chargeable gains

Calculate the corporate tax liabilities of all three companies for the year ended 31 December 2004.

(5 marks)

2.13 In addition to the facts of Question 2.12, the results of Companies H, J and K for the year ended 31 December 2005 were:

	H	*J*	*K*
	$	$	$
Taxable trading income	1,800,000		180,000
Allowable trading loss		(300,000)	
Chargeable gains	100,000	400,000	
Allowable capital loss	(260,000)		

In addition to the rules already established in Question 2.12, the tax authority permits:

1 Trading loss relief as follows:
   (a) against total taxable profits of the same company of the same accounting period and then of the preceding 12 months, and/or;
   (b) against the first available trading profits of the same trade of the same company, and/or;
   (c) against total profits of the same accounting period of other companies in the same group of companies.
2 Capital loss relief as follows:
   (a) against chargeable gains of the same company in the current and then first available future accounting period, and/or
   (b) against chargeable gains of the same accounting period of other companies in the same group of companies.

The tax authority defines a group of companies for the purpose of both capital and trading loss relief as one comprising a parent company and its 75% subsidiaries where:

(a) the parent company has an effective 75% interest (i.e. directly or indirectly through another company) in the ordinary share capital of the subsidiary, and;
(b) all the companies party to a loss claim are resident in the same tax jurisdiction.

Calculate the corporate tax liabilities of all companies for the year ended 31 December 2005 assuming the capital and trading losses are relieved in the ways generating the greatest tax saving for the group as a whole.

(10 marks)

Answers

2.1 Tax base for assessing corporate profits
D

2.2 Classification of taxable incomes
D

2.3 Adjustment of trading profit
C

	–	+
	$	$
Net profit		500,000
Accounting depreciation		50,000
Interest payable on loan for non-trading purpose		80,000
Capital gain	60,000	
	60,000	630,000
		(60,000)
		570,000

A Profit only after adding back depreciation
B As for C, and donation wrongly added back
D As for C, except interest payable not added back.

2.4 Adjustment of trading profit
B

	–	+
	$	$
Net loss	90,000	
Accounting amortisation		65,000
Repairs to roof*		100,000
Donation to political party		10,000
	90,000	175,000
		(90,000)
		85,000

* The repair is capital expenditure because (i) the asset was incapable of being used for the trade prior to the work being completed, and (ii) the need for the repair to the building pre-dated its acquisition and it would be assumed that the purchase price had been discounted to reflect the poor condition of the asset.

A As for B, except insurance, proceeds wrongly treated as non-trade receipt
C As for B, except insurance, proceeds wrongly treated as non-trade receipt and repair wrongly treated as an allowable trading expense
D No adjustment made except for adding back the political donation.

2.5 Adjustment of trading profit
B

	–	+
	$	$
Entertaining		40,000
Legal costs relating to capital transaction		60,000
		100,000

A All items added back
C As for B with staff party costs wrongly disallowed
D Only entertaining added back

Note:

No point in adding back accounting depreciation because the same figure will be deducted for tax purposes.

2.6 Depreciation of buildings

(i) Accounts adjustment

B

		−	+
	$	$	$
Annual depreciation charge			50,000
Profit on sale of Building 2:			
Proceeds	650,000		
Depreciation to date	210,000		
	860,000		
Cost	(700,000)		
	160,000	160,000	
		160,000	50,000
		(50,000)	
		(110,000)	

A Ignores profit on sale of Building 2

C Ignores depreciation on disposal when calculating profit

	$	$
Annual depreciation charge		50,000
Proceeds	650,000	
Cost	(700,000)	
	(50,000)	(50,000)
		0

D Adds depreciation on disposal to cost when calculating profit

	$	$
Annual depreciation charge		50,000
Proceeds	650,000	
Cost + depreciation	(910,000)	
	(260,000)	(260,000)
		(210,000)

(ii) Tax depreciation

D

	1	*2*	*3*
	$	$	$
4% × 50% × $1,600,000	32,000		
4% × 50% × $400,000			8,000
Balancing adjustment on sale:			
Tax WDV @ 1.1.04		182,000	
Proceeds of building		(250,000)	
Balancing charge		(68,000)	

Total = $32,000 + 8,000 − 68,000 = (28,000)

A Uses full sale proceeds (including land) in calculating the balancing charge

	$	$
Annual charge		40,000
Balancing charge:		
Tax WDV	182,000	
Proceeds	(650,000)	
	(468,000)	(468,000)
		(428,000)

B Ignores the balancing charge

C Calculates the annual tax depreciation on the full cost, including land

	1 $	*2* $	*3* $
4% × $1,600,000	64,000		
4% × $400,000			16,000
Balancing adjustment on sale:			
Tax WDV @ 1.1.04		182,000	
Proceeds of building		(250,000)	
Balancing charge		(68,000)	

Total = $64,000 + 16,000 − 68,000 = 12,000

2.7 Tax depreciation on plant and machinery

(i) Accounts adjustment

B

	$	$	− $	+ $
Annual depreciation charge				425,000
Profit/(loss) on sale of assets:				
	Plant	*Cars*		
Proceeds	30,000	15,000		
Depreciation	90,000	20,000		
	120,000	35,000		
Cost	(150,000)	(30,000)		
(Loss)/profit	(30,000)	5,000		25,000
				450,000

A Only takes depreciation into account

C Ignores depreciation on disposals

	$	$	− $	+ $
Annual depreciation charge				425,000
Profit/(loss) on sale of assets:				
	Plant	*Cars*		
Proceeds	30,000	15,000		
Cost	(150,000)	(30,000)		
(Losses)	(120,000)	(15,000)		135,000
				560,000

D Treats depreciation as a deduction in calculating profit/loss on disposal

			–	+
	$	$	$	$
Annual depreciation charge				425,000
Profit/(loss) on sale of assets:				
	Plant	*Cars*		
Proceeds	30,000	15,000		
Depreciation	(90,000)	(20,000)		
Cost	(150,000)	(30,000)		
(Losses)	(210,000)	(35,000)		245,000
				670,000

(ii) Tax depreciation

C

	Plant	*Cars*	*Total*
	$	$	$
Tax WDV @ 1.1.04	680,000	110,000	
Additions	850,000	120,000	
Disposals – proceeds	(30,000)	(15,000)	
	1,500,000	215,000	
Annual allowance @ 25%	(375,000)	(53,750)	428,750
WDV c/f	1,125,000	161,250	

A Deducts cost of disposals instead of proceeds

	Plant	*Cars*	*Total*
	$	$	$
Tax WDV @ 1.1.04	680,000	110,000	
Additions	850,000	120,000	
Cost of disposals	(150,000)	(30,000)	
	1,380,000	200,000	
Annual allowance @ 25%	(345,000)	(50,000)	395,000
WDV c/f	1,035,000	150,000	

B Applies the tax depreciation rates to the accounting net book values

	Plant	*Cars*	*Total*
	$	$	$
Annual allowance:			
25% × £1,050,000	262,500		262,500
25% × £115,000		28,750	28,750
			291,250

D Applies the accounting depreciation rates to the tax values

	Plant	*Cars*	*Total*
	$	$	$
Tax WDV @ 1.1.04	680,000	110,000	
Additions	850,000	120,000	
Disposals	(30,000)	(15,000)	
	1,500,000	215,000	
Annual allowance @ 20%	(300,000)		300,000
@ 25%		(53,750)	53,750
WDV c/f	1,200,000	161,250	353,750

2.8 Chargeable gains

C

	Land and buildings	*Quoted shares*	*Motor car*
	$	$	$
The car is an exempt asset			0
Net sale proceeds:			
$(1,200,000 − 40,000)	1,160,000		
$(80,000 − 2,000)		78,000	
Costs:			
Original	(500,000)	(100,000)	
Extension	(200,000)		
	460,000	(22,000)	
Inflation allowance:			
On land and buildings:			
Original cost – 13 complete years			
2% × 13 = 26% × $500,000	(130,000)		
Extension – 8 complete years			
2% × 8 = 16% × $200,000	(32,000)		
	298,000	(22,000)	
	(22,000)		
	276,000		

A Ignores the exemption for the car

	$
Loss on car:	
Net SP $(10,000 − 200)	9,800
Cost	(20,000)
	(10,200)
Other net gains	276,000
	265,800

B Gives inflation relief for the loss on the shares

	$
Loss before inflation allowance	(22,000)
Inflation allowance:	
5 complete years 2% × 5 = 10% × $100,000	(10,000)
	(32,000)
Gain on land and building	298,000
	266,000

D Applies inflation allowance to the aggregate costs of the building from the date of acquisition

	$
Gain on building before inflation allowance	460,000
Inflation allowance:	
13 complete years 2% × 13 = 26% × $700,000	(182,000)
	278,000
Loss on shares	(22,000)
	256,000

2.9 Rollover relief of gains
B

2.10 Imputation system
C

2.11 Loss relief in the same company

As relief for the capital loss is limited to relief against gains of the same or future periods priority is given to the relief of this loss. Relief will be:

	$
Gain of the 6m/e 30.6.04	50,000
Loss b/f	(60,000)
Unrelieved loss c/f	(10,000)

Relief for the trading loss:	$	$	$
Loss – 6m/e 30.6.04			(500,000)
1 Relief in current period:			
Trading profit		0	
Investment income		120,000	
Gain (already relieved)		0	
Total profits		120,000	
Loss relief − lower of loss and profits		(120,000)	120,000
Taxable profits		0	
			(380,000)
2 Relief in preceding period of equal length:			
Trading profit		300,000	
Investment income		100,000	
Total profits		400,000	
Loss relief – lower of:			
(i) the unrelieved loss, and;	380,000		
(ii) $\frac{6}{12}$ × profits, i.e. $\frac{6}{12}$ × 400,000	200,000	(200,000)	200,000
Taxable profits		200,000	
			(180,000)
3 Relief in first available future periods:			
Y/e 30.6.05: Trading profit		95,000	
Loss relief − lower of loss or profit		(95,000)	95,000
		0	
Investment income		90,000	
Taxable profits		90,000	
Unrelieved amount c/f			(85,000)

Total amount c/f £10,000 + 85,000 = 95,000

2.12 Corporate tax liabilities in a group of companies

Tax computations – year ended 31.12.04

	H	*J*	*K*
	$	$	$
Trading income	2,000,000	300,000	60,000
Investment income	200,000	10,000	
Chargeable gain		60,000	
Taxable profits	2,200,000	370,000	60,000
Tax liabilities (W1):			
H Profits > $500,000			
30% × $2,200,000	660,000		
J Profits < $500,000 > $50,000			
20% × $370,000		74,000	
K Profits < $100,000			
10% × $60,000			6,000

Working

1 Tax status

H and J are associated companies as H controls >50% of J's issued share capital. Thus, the profit limits for both H and J are then divided by two (i.e. they become $50,000 and $500,000 instead of £100,000 and $1,000,000).

K is not controlled by H (or J). Thus it has no associated companies and the full profit limits apply.

2.13 Capital and trading loss relief in a group of companies

Tax computations – year ended 31.12.05

	H	*J*	*K*
	$	$	$
Trading income	1,800,000	0	180,000
Chargeable gains	100,000	400,000	
	1,900,000		
Loss relief (W1):			
(i) capital loss of H	(100,000)	(160,000)	
(ii) trading loss of J	(300,000)		
Taxable profits	1,500,000	240,000	180,000
Tax liabilities (W1):			
H Profits > $500,000			
30% × $1,500,000	450,000		
J Profits > $50,000 < $500,000			
20% × $240,000		48,000	
K Profits < $1,000,000 > $100,000			
20% × $180,000			36,000

Workings

1 Loss relief

Priority is given to the relief of the capital loss as the relief options are more limited.

The greatest tax saving for the group is obtained by relieving the capital and trading losses against the profits suffering the highest rates of tax before loss relief.

The tax rate profit limits are the same as in Question 2.12. Before loss relief, H pays tax at 30% on some of its profits (i.e. above $500,000) whilst J and K only suffer a highest rate of tax of 20% (i.e. J on profits above $50,000 and K on profits above $100,000).

The best arrangement for relief is to set off:

(i) the capital loss of H first against the gain of H (relief at 30%) and then against the gain of J which is in the same 75% group as H (relief at 20%)
(ii) the trading loss of J against the total profits of H (relief at 30%)

Indirect Taxes and Employee Taxation

3

? Questions

3.1 Contrast a multi-stage sales tax (MSST) with a value added tax (VAT).

(6 marks)

3.2 In the context of value added tax (VAT) contrast (i) taxable supply with (ii) an exempt supply and (iii) a supply outside the scope of the tax.

(6 marks)

3.3 Which of the following indirect taxes borne by a business is normally recoverable from the tax authority?

A Sales tax
B VAT
C Excise duty
D An annual duty on the capital value of property used as business premises

(2 marks)

3.4 Which of the following indirect taxes borne by a business may not normally be treated as an allowable cost for corporate profits tax purposes?

A Sales tax
B VAT
C Excise duty
D An annual duty on the capital value of property used as business premises

(2 marks)

3.5 (i) Distinguish a Wealth tax from an Inheritance or capital transfer tax.

(4 marks)

(ii) Why may the value of company shares or other business assets frequently be excluded in whole or in part from such taxes or taxed at a lower rate?

(2 marks)

(Total = 6 marks)

3.6 Which of the following is neither a condition for nor a feature of an effective excise duty?

A Calculation based on the value of the goods produced
B Inelastic demand for the commodity
C Low costs of collection
D Consumers cannot easily access close substitutes from outside the tax jurisdiction

(2 marks)

3.7 Which of the following items would not be treated as an allowable business expense of the employing company for corporate profits tax purposes?

A The cost of entertaining customers reimbursed to staff
B The employer's contributions into an approved occupational pension scheme set up by the company for past and present staff
C The input VAT included in the benefit value of goods or services purchased for the private use of an employee
D The employer's social security contributions calculated as percentage of the employee's salaries

(2 marks)

3.8 Which of the following amounts would not be taxed on an employee as earnings from their employment?

A The excess of the market value over the cost to the employee of shares in the employing company provided free of charge to the employee
B The payment by the employer of travel costs incurred between an employee's home and his normal work location
C The payment of a performance-related bonus after the cessation of an employee's contract of employment
D The reimbursement by the employer of business expenses incurred by the employee in the course of his work

(2 marks)

3.9 Deduction of tax at source is the normal practice in relation to the taxation of employment income.

Which of the following is not an advantage of deducting tax at source?

A It removes the need for a taxpayer to make an annual tax declaration or return
B It improves governmental cash flow by collecting tax earlier than would otherwise be the case
C It lowers the cost of tax collection because it passes the burden on to the employer
D It reduces the potential for the illegal evasion of tax by taxpayers

(2 marks)

3.10 A tax jurisdiction has the following rules for the taxation of employment income:

(i) Personal income tax is assessed for the tax year ended 31 December
(ii) Salaries, bonuses and expense allowances are assessed when received
(iii) Benefits in kind are assessed on the cash equivalent amount, which is either:
  (a) the cost to the employer of the asset or service purchased, or;
  (b) the appropriate annual value, if an asset owned by the employer is made available for the private use of the employee
(iv) A deduction is made from the amount otherwise assessable in respect of expenses incurred wholly, exclusively and necessarily in the course of undertaking the duties of employment

Brown is a professionally qualified accountant and employee of a trading company. During the year ended 31 December 2004, Brown's employment details were:

	$
Salary payable monthly on the last working day of each month	
To 30.9.04 at $42,000 per year	
From 1.10.04 at $45,000 per year	
Performance-related bonuses:	
Earned for the company's year ended 31.12.03, and received 1.4.04	10,000
Earned for the company's year ended 31.12.04, and received 1.4.05	12,000
Expense allowances:	
For year ended 31.12.03	8,000
For year ended 31.12.04	9,000

	Year ended 31.12.03 $	*Year ended 31.12.04* $
Benefits in kind:		
Cost of private medical insurance borne by the company:		
Actual payments	1,200	1,400
Cost if paid by Brown himself	1,500	2,000
Use of company car available to Brown since 1.5.04:		
The annual cash equivalent is calculated as 20% of the manufacturer's list price adjusted pro-rata to take account of business use (measured in kilometers travelled) and non-availability.		

Relevant details of the car are:

	$
Manufacturer's list price	30,000
Actual cost to employer	26,000
	Kilometres
Total use in period to 31.12.04	25,000
Business use in same period	11,250

Expenses of employment incurred by Brown:		
Hotels and meals whilst on business trips	4,000	4,200
Travel costs:		
Home to office	3,000	2,800
Office to clients	1,400	1,800
Professional subscription	300	350
Lunches on days at office	1,000	1,100

Calculate the total amount assessable as employment income in respect of Brown for the year ended 31 December 2004.

(10 marks)

Answers

3.1 Multi-stage sales tax vs Value added tax

(i) A MSST taxes a sale of goods and services at the each stage of the productive cycle, usually raw material extraction, manufacturing or farming, wholesale and retail. VAT basically taxes in the same way as an MSST, but because a purchaser who is also in business can usually recover the VAT charged, the tax is effectively only borne by the final consumer.

(ii) Under an MSST the customer is charged to tax at the point of sale, with the seller accounting for the tax collected to the tax authority. VAT has the same rules, except the seller accounts for the tax on sales – output tax – less the tax recoverable on purchases – input tax – to the tax authority.

(iii) Under an MSST for financial accounting purposes, the tax is excluded from revenue in the Income Statement of the seller but included in the cost of sales, expenses or relevant asset accounts of the purchaser because it is not recoverable from the tax authority. For VAT purposes, both output tax and recoverable input tax are excluded from the Income Statement and relevant asset accounts.

3.2 Types of supply for VAT purposes

(i) A taxable supply is a supply of goods or services made within a given tax jurisdiction by a taxable person (i.e. a sole trader, partnership or limited company) required to register for VAT. VAT is then charged at various rates from 0% (zero rate), lower, standard (minimum of 15% in the EU) or higher rate.

(ii) An exempt supply is a supply of goods or services made by a supplier whose business activity is excluded from the scope of VAT. The supplier does not have to register for VAT, and consequently neither charges output tax on sales nor recovers input tax on acquisitions. Examples of exempt supplies in the UK are transactions in residential land and buildings, postal, insurance and banking services.

(iii) A supply outside the scope of VAT is a particular supply made by a taxable supplier which is specifically excluded from the scope of the tax. Examples from the UK are gift of services for no consideration, the transfer of a business as a going concern (i.e. the sale of a business) and the export of services (i.e. where the service is conducted for a customer located outside the supplier's tax jurisdiction).

3.3 Recoverable indirect tax
B

3.4 Non-allowable cost for direct tax on profits
B

3.5 Wealth tax vs Inheritance tax

(i) A wealth tax is an annual (or less frequent) levy based on the capital value of an individual, including the value of company shares or business assets within the person's ownership.

An inheritance tax or capital transfer tax is a tax levied when an asset is transferred as lifetime gift or on occasion of death. Business assets and shares of companies are significant assets for this purpose.

(ii) Business assets, including shares of companies, may avoid tax or be taxed in a favourable way because of the difficulty in valuing such assets, particularly if a company is not a quoted company, and because the imposition of the taxes could result in economically viable business units being unnecessarily sold to pay the taxes.

3.6 Effective excise duty
A

3.7 Allowable costs of employment
A

3.8 Non-taxable employment income
D

3.9 Deduction of tax at source on employment income
A

3.10 Personal tax assessment on employment income

Personal income tax computation – year ended 31.12.04

	$	$
Salary – receipts basis $\frac{9}{12} \times \$42{,}000 + \frac{3}{12} \times \$45{,}000$		42,750
Bonus – receipts basis (1.4.04)		10,000
Expense allowance – receipts basis		9,000
Benefits in kind – cash equivalent basis:		
Private medical insurance – cost to employer		1,400
Use of company car – 20% × $30,000	6,000	
Less:		
(i) business use		
$\frac{11{,}250}{25{,}000} \times \$6{,}000$	(2,700)	
	3,300	
(ii) non-availability (January – April 2004)		
$\frac{4}{12} \times \$3{,}300$	(1,100)	
		2,200
		65,350
Less:		
Allowable expenses		
Hotels and meals	4,200	
Travel – office to clients	1,800	
Professional subscription	350	
		(6,350)
		59,000

Administration of Taxation

4

? Questions

4.1 What is the main reason for companies needing to retain detailed records relating to taxation matters for an appropriate period of time?

(2 marks)

4.2 What are the principal records that need to be kept by a taxable supplier for VAT purposes?

(4 marks)

4.3 Explain the difference between a system of (i) direct assessment and (ii) self-assessment?

(4 marks)

4.4 Identify *four* powers that a tax authority would typically possess to ensure compliance with tax rules?

(4 marks)

4.5 Explain and contrast the concepts of (i) tax evasion and (ii) tax avoidance?

(4 marks)

4.6 The scope for tax avoidance and tax evasion can be diminished by removing 'tax loopholes' in the legislation as they are identified, but this results in increasingly complex tax rules.

Identify *four* other ways available to a tax authority to secure the same objective?

(4 marks)

✓ Answers

4.1 Principal reason for retaining tax records

The main reason for companies needing to retain underlying records relating to tax matters is that the relevant tax authorities can, as and when required, satisfy themselves as to the validity of tax returns (or declarations) and the correctness of the amounts of tax paid to (or refunded by) them.

4.2 Records kept by taxable supplier for VAT purposes

The records that must be kept by a registered supplier for VAT purposes are:

(i) basic sales records – in particular delivery notes, customer invoices, credit notes, till rolls if VAT calculated on the basis of daily takings and export documentation
(ii) basic purchase records – in particular goods-received notes, purchase invoices and debit notes received from suppliers, and import documentation
(iii) books of prime entry – in particular sales, purchase and returns daybooks; and cashbooks
(iv) A VAT account in the general ledger – showing the overall amount owed to or by the tax authority.

4.3 Direct assessment vs self-assessment

(i) Direct assessment is where a company submits a completed tax return (or declaration), supported by a copy of the financial statements for the relevant chargeable period, which the tax authority uses to determine the correct amount of tax due. The company then pays the amount of tax demanded, subject to appeal against an incorrect tax demand.
(ii) Self-assessment is where a company submits a completed tax return, as for direct assessment, but instead calculates its own tax liability on the basis of the returned information and makes payment by the due date(s). Any errors in the self-assessment can be subsequently corrected.

4.4 Powers of a tax authority to enforce compliance with tax rules

The usual powers conferred on a tax authority by a government to ensure compliance with tax rules are the right to:

(i) conduct, as part of normal audit procedures, reviews of tax returns.
(ii) obtain additional returns from taxpayers where previous declarations prove inadequate.
(iii) examine the underlying records of the company in the course of a tax investigation.
(iv) enter the taxpayer's premises to seize and remove documents relevant to an investigation. This is often only done once a suitable search warrant has been obtained.
(v) exchange information with other tax authorities within the same jurisdiction, or, provided an agreement to do so is contained within an appropriate double tax treaty, with foreign tax jurisdictions.

Any four from the five mentioned will obtain full marks.

4.5 Tax evasion vs tax avoidance

Tax evasion is the illegal avoidance of tax by the deliberate falsification of tax returns either through an act of commission (e.g. understating declared incomes/gains or falsely claiming expenses and tax reliefs) or an act of omission (e.g. not declaring a source of income or gain).

Tax avoidance is the legal avoidance of tax by arranging a taxpayer's affairs to make the best use of the tax law. Although such arrangements are strictly legal, some schemes are viewed as contrary to the intended effect of the tax law, leading to anti-avoidance rules being passed to prevent their continuing use.

4.6 Methods that can be adopted by a tax authority to minimise tax avoidance (and evasion)

Suitable courses of action available to a tax authority to minimise tax avoidance, apart from passing specific anti-avoidance legislation, are:

(i) to ensure that tax law is perceived as fair and equitable as between different taxpayers.
(ii) to keep the tax rules simple. Recent fiscal policies adopted in many developed countries has seen reductions in marginal rates of tax accompanied by the elimination of complex forms of tax relief, so dissuading people from not wanting to pay tax and at the same time making it easier to determine the tax liabilities.
(iii) to apply deduction of tax at source when practicable.
(iv) to simplify procedures for making tax returns and maximising the use of third-party reporting.
(v) to impose an effective audit regime of tax returns and of tax collection at source to convince taxpayers and third-party tax collectors that evasion will be discovered.
(vi) to impose a suitably tough regime of penalties for non-compliance and fraud.
(vii) to ensure that government-run tax administrations are efficient and free from corruption.
(viii) for Courts to adopt an unsympathetic attitude towards artificial tax avoidance schemes (i.e. those whose primary purpose is to avoid tax rather than to achieve a legitimate commercial objective).

Any four from the eight listed will obtain full marks.

International Taxation 5

Questions

5.1 Describe the two tests commonly used by tax authorities to determine the place of residence of a company?

(4 marks)

5.2 Under what circumstances can the business profits of a trade conducted on behalf of a foreign company be taxed by the country in which the trade is located?

(4 marks)

5.3 From a tax perspective, why is it often more beneficial for a company undertaking a separate trade in another country to conduct it through a non-resident subsidiary instead of a foreign branch of the company?

(4 marks)

5.4 In the context of a company conducting a trade in a foreign tax jurisdiction, which of the following is not a 'permanent establishment'?

A A foreign branch
B An oil-well
C A construction site active for nine months
D A local agent of a non-resident company able to enter into contracts in the name of its principal

(2 marks)

5.5 Why should the following matters be potentially problems for a company considering setting up a subsidiary company in another country?

(i) Establishing the tax residence of the subsidiary
(ii) The transfer of chargeable assets from the parent company to the subsidiary
(iii) Relief for a trading loss of the subsidiary
(iv) The pricing policies used for the transfer of goods and services between the parent company and the subsidiary

(4 marks)

5.6 (i) Identify the three methods by which relief is given for double taxation (i.e. where the same profits are taxed in two different countries).

(3 marks)

(ii) Give *three* reasons why the tax credit relief is the most widely used.

(3 marks)

(Total = 6 marks)

5.7 In the context of double taxation relief, distinguish between a withholding tax and an underlying tax.

(4 marks)

5.8 Company L ('L'), resident in country X, conducts a trade in country Y through a subsidiary company M ('M'), resident in that country. L owns 75% of the issued share capital of M, and both companies prepare accounts to the same date.

M's Income Statement and statement of equity for the year ended 31 December 2004 show:

	$
Net profit before taxation	500,000
Less:	
Corporate profits tax	(100,000)
Distributable profit	400,000
Less:	
Dividends paid (before withholding tax)	(240,000)
Retained profits	160,000

The tax authority of country Y imposes a withholding tax on dividends paid to non-resident shareholders as follows:

	%
If ≥25% of issued share capital held	5
If <25% of issued share capital held	15

The tax authority of country X apply the following rules to the taxation of foreign profits:

(i) Foreign dividends are assessed on the amount received inclusive of foreign taxes potentially recoverable for double tax relief (DTR) purposes
(ii) Underlying tax on foreign dividends is recoverable for DTR purposes if the company resident in X possesses ≥10% of the voting rights of the foreign paying company

The amount of foreign dividends assessable in country X is:

A $300,000
B $236,842
C $280,000
D $225,000

(4 marks)

5.9 Company N ('N'), resident in country S, conducts a trade in country T through a subsidiary company P ('P') resident in that country. N owns 80% of the issued share capital of P, and both companies prepare accounts to the same date.

The dividend received by N from P assessable in S for the year ended 31 December 2004 is:

	$
Dividend received	180,000
Withholding tax in T	20,000
	200,000
Underlying tax in T	80,000
	280,000

N has taxable profits arising in country S of $2,000,000 for the year ended 31 December 2004.

The tax authority of S applies the following rules:

(i) Foreign profits are assessed inclusive of potentially recoverable taxes for double tax relief (DTR) purposes as part of the total profits of the enterprise resident in S
(ii) A single rate of corporate profits tax of 22% is applied to the total taxable profits of a chargeable period
(iii) DTR is given by way of a tax credit = the lower of the foreign tax(es) paid on the foreign profits and the corporate profits tax paid in S on the same amount

The corporate tax liability on the total taxable profits of N after DTR in country S is:

A $481,600
B $440,000
C $378,400
D $0

(4 marks)

✓ Answers

5.1 Tests of residence of a company

The two tests commonly used to determine the tax residence of a company are 'the place of effective management and control (EMC) test' and 'the place of incorporation test'.

The 'EMC test' states that a company will be resident in the country in which effective management and control is exercised over that company. For this purpose the OECD defines 'the place EMC' as the country in which the key management decisions relating to the conduct of the whole business are substantively taken. For this purpose, the location of the most senior director's meetings and the residence of a parent company able to exercise control over the affairs of a subsidiary are both relevant considerations.

The 'incorporation test' states that a company will be resident in the country under whose rules it was legally incorporated.

Some countries apply both tests (e.g. the UK).

If a company could be resident in two countries because it is incorporated in one but EMC is exercised in another, the OECD tax convention states residence will be decided by the EMC test.

5.2 Circumstances in which trading profits of a foreign company can be assessed in the country in which the business is located

Under OECD rules, the profits of a business enterprise can only be taxed in the country in which it is located if they arise either:

(i) in the hands of the company resident in that country, by virtue of either the 'effective management and control' or 'incorporation' tests, or;
(ii) from activities conducted by a 'permanent establishment' located in that country (i.e. either a fixed place of business (e.g. an office or factory or a local agent of a foreign company with a continuing right to contract in the name of its foreign principal)).

5.3 Tax benefits of conducting a foreign trade through a non-resident subsidiary as opposed to a foreign branch

The principal benefit of foreign trading through a non-resident subsidiary is that the parent company will only be taxed in its country of residence on the dividends remitted rather than the profits earned in the subsidiary's country of residence. The tax saving accruing from this principle is maximised where the subsidiary is resident in a foreign country with significantly lower tax rates than those operating in the parent's country (i.e. not only may a substantial tax liability be avoided in the parent's company's country but any foreign tax liability incurred will be small). To stop the significant loss of tax revenue which arises in this circumstance, some countries have introduced special anti-avoidance legislation (e.g. UK resident companies must calculate their UK corporate tax assessment on profits earned rather than remitted, unless they can satisfy one of several exclusion clauses).

A foreign branch is not a separate legal entity from the company which it forms a part of. Consequently, it will be resident in the country of the company itself, and the branch profits earned (not remitted) will be taxable in that country. Thus, in general, given the same level of profits the branch will be more heavily taxed in the country in which the owning company is resident.

5.4 Examples of a permanent establishment
C

Since a construction site will constitute only a permanent establishment if it operates for ≥1 year.

5.5 Tax issues for a foreign subsidiary

(i) If the local tax authority uses both the incorporation and the effective management and control (EMC) test to establish the residence of the subsidiary, local residence will only apply if the tax authority is satisfied that EMC is not exercised by the non-resident parent company.
(ii) A transfer of assets from a parent company to the subsidiary, where the two companies are resident in different tax jurisdictions, will represent a 'migration of a trade'. In this circumstance, gains arising on chargeable assets will be assessed in the tax jurisdiction of the transferor company.
(iii) Even if the parent and subsidiary form a group for loss relief between group members but the subsidiary is resident in another tax jurisdiction, a trading loss of the subsidiary will only be relievable against profits of the subsidiary itself.
(iv) Both tax authorities will usually insist that prices used to transfer goods and services between associated companies are 'fair market prices' (i.e. neither artificially high nor low) to prevent profits from being deliberately accumulated in the tax jurisdiction with the lowest tax rates.

5.6 (i) Methods of giving double tax relief

The three methods of giving double tax relief (DTR) are:

1 Exemption from tax in one of the two tax jurisdictions
2 Giving a tax credit for the lower of the two taxes against the tax liability of the country in which the company is resident
3 Deducting the foreign tax from the value of the foreign source for the purpose of determining the taxable amount in the country of the company's residence (i.e. the net rather than the gross amount of foreign income or gain is taxed).

(ii) Reasons why the tax credit method is the most popular

The tax credit method is the most popular method of giving DTR because:

1 it can be operated where no DT treaty exists
2 it does not oblige one company to totally give up its right to tax (i.e. compared to the exemption method)
3 it gives relief for the tax paid rather than a percentage of the tax paid (i.e. compared to the deduction method which gives relief for the foreign tax paid × the rate of tax used in the country of residence).

5.7 Withholding vs underlying tax

Withholding tax (WHT) is the tax deducted at source on a payment before it is made to a foreign resident person – individual or company. Payments include interest, royalties, rents, dividends and the proceeds of capital gains. Many DT treaties attempt to eliminate or reduce the need for WHT.

Underlying tax is the corporate income tax on the profits out of which dividends are paid by the foreign company. The underlying tax attributable to a dividend is usually determined by the formula:

$$\frac{\text{Gross dividend paid (before deduction of WHT)}}{\text{Distributable profits after tax}} \times \text{Underlying tax paid}$$

5.8 Taxable amount of foreign dividends
D

The amount of foreign dividend assessable in Country X is:

	$
Dividend received (before WHT of 5%)	
75% × $240,000	180,000
Add:	
Underlying tax:	
$\frac{180{,}000}{400{,}000} \times 100{,}000$	45,000
	225,000

A Uses 100% of the dividend instead of 75%

	$
Dividend (before WHT)	240,000
Add:	
Underlying tax:	
$\frac{240{,}000}{400{,}000} \times 100{,}000$	60,000
	300,000

B Treats dividends paid as net of WHT

	$
Dividend received (after WHT of 5%)	
75% × $240,000	180,000
Add:	
WHT 5/95 × 180,000	9,474
	189,474
Add:	
Underlying tax:	
$\frac{189{,}474}{400{,}000} \times 100{,}000$	47,368
	236,842

C Assumes underlying tax = the whole amount levied on the distributable profits

	$
75% × $240,000	180,000
Add:	
Underlying tax	100,000
	280,000

5.9 Corporate tax liability after DTR
B

		$
Corporation tax computation – year ended 31.12.04		
UK profits		2,000,000
Foreign dividends (including foreign taxes)		280,000
Taxable profits		2,280,000

	$	$
Tax at 22%		501,600
Less:		
DTR – lower of:		
(i) Country T taxes on foreign income:		
WHT	20,000	
Underlying tax	80,000	
	100,000	
(ii) Country S tax on the foreign income:		
22% × 280,000	61,600	(61,600)
		440,000

A Ignores underlying tax

Tax at 22%		501,600
Less:		
DTR – lower of:		
(i) Country T taxes on foreign income:		
WHT	20,000	(20,000)
(ii) Country S tax on the foreign income:		
22% × 280,000	61,600	
		481,600

C Ignores foreign profits in calculating taxable profits:

Corporation tax computation – year ended 31.12.04		
UK profits = taxable profits		2,000,000

	$	$
Tax at 22%		440,000
Less:		
DTR – lower of:		
(i) Country T taxes on foreign income:		
WHT	20,000	
Underlying tax	80,000	
	100,000	
(ii) Country S tax on the foreign income:		
22% × 280,000	61,600	(61,600)
		378,400

D Ignores the UK profits in calculating taxable profits

Corporation tax computation – year ended 31.12.04

Foreign Dividends (including foreign taxes) = taxable profits		280,000
	$	$
Tax at 22%		61,600
Less:		
DTR – lower of:		
(i) Country T taxes on foreign income:		
WHT	20,000	
Underlying tax	80,000	
	100,000	
(ii) Country S tax on the foreign income:		
22% × 280,000	61,600	(61,600)
		0

Taxation in Financial Statements

6

Questions

6.1 Explain, for the purposes of IAS 12 – Income taxes, the meaning of the terms:

(i) Taxable profit
(ii) Tax expense
(iii) Current tax

(3 marks)

6.2 A company prepares accounts to 31 December each year. For the year ended 31 December 2004 it:

		$
(i)	Paid the tax liability on profits of the year ended 31.12.03	100,000
(ii)	Paid interest on debentures (gross)	25,000
	This includes tax deducted at source at the rate of 15%	
(iii)	Received dividends (gross) from other companies.	30,000
	This includes tax deducted at source at the rate of 10%	
(iv)	The estimated tax liability on the profits of the year ended 31.12.04 is	150,000

At 1 January 2004, the balance on the tax payable account was $110,000, being the estimated tax liability for the year ended 31 December 2003.

The current tax expense for the year ended 31 December 2004 and the amount of tax payable at 31 December 2004 is:

A $150,750 and $160,000
B $140,750 and $150,000
C $139,250 and $150,000
D $138,000 and $150,000

(5 marks)

6.3 Describe the provisions of IAS 12 – income taxes – relating to the disclosure of current taxation in the financial statements of a company. Ignore the rules relating to the treatment of discontinued operations and for extraordinary items.

(4 marks)

6.4 Company R prepares its financial statements applying IAS. The company is resident in a tax jurisdiction which operates the following rules for taxing companies:

(i) Corporate income tax operates a partial imputation system whereby the full rate of tax is 25% but dividends received by shareholders – individuals and companies – are received net of 10% tax deducted at source.

(ii) Corporate income tax is charged upon total taxable profits. Taxable profits include gains and all investment income, except dividends received from other companies resident in the same tax jurisdiction. The tax credits attaching to these tax exempt dividends are recoverable.

(iii) Interest and royalties payable are tax allowable, but 10% tax is deducted at source and is accounted for by companies to the tax authority. Companies receiving these amounts are taxed upon them, but the tax suffered at source is treated as a tax credit against the total corporate tax liability of the relevant period.

For the year ended 31 December 2004, the income statement under IAS rules shows:

	$
Operating profit	610,000
Net finance cost (gross)	(40,000)
Income from investments (gross)	10,000
Profit before tax	580,000

The net finance cost is interest on $400,000 of 10% Debentures with interest due and payable annually on 1 July. Gross means the amount includes 10% tax withheld at source. The 10% debentures were issued to finance the purchase of new plant and machinery for the trade.

Investment income is dividends received from another company (not an associate) in the same tax jurisdiction, and were received on 1 October 2004. Gross means the amount is inclusive of a 10% tax credit.

Operating profit has been arrived at charging:

	$
Depreciation	50,000
Entertaining of customers	15,000

Tax depreciation is identical in all respects to accounting depreciation.

At 1 January 2004, the tax payable account showed a credit balance of $122,000, being the estimated current tax liability for the year ended 31 December 2003.

In respect of the year ended 31 December 2004:

(i) Calculate the adjusted trading profit for tax purposes.

(2 marks)

(ii) Calculate the corporate income tax liability on the total taxable profits.

(2 marks)

(iii) Show the necessary journal entries to record:

1 the payment of interest

(2 marks)

2 the receipt of the dividends

(2 marks)

3 the payment of the finally agreed 2003 tax liability amounting to $125,000

(2 marks)

4 the provision for the current year's tax liability.

(2 marks)

(iv) Write up the corporate income tax payable account showing the amount c/f at 31 December 2004.

(5 marks)

(v) State the amount of the net profit after tax disclosed in the Income Statement.

(3 marks)

(Total = 20 marks)

6.5 Differentiate between the terms 'taxable temporary difference' and 'deductible temporary difference' for the purposes of deferred taxation under IAS 12 – income taxes.

(4 marks)

6.6 Why is deferred tax irrelevant for permanent differences between the carrying value in the balance sheet and the tax base?

(2 marks)

6.7 When will a tax loss be recognised for deferred tax purpose?

(2 marks)

6.8 Company V prepares its annual financial statements for the year ended 31 December applying IAS. The following details relate to non-current assets:

	$
1.1.04 Purchased plant and machinery for	500,000
31.12.07 Sold this same equipment for	50,000

Accounting depreciation is 25% p.a. on cost provided the asset is in use at the end of each period.

The tax depreciation policy of the tax authority is:

In the year of purchase – an allowance = 40% of cost
In subsequent years – an annual allowance = 20% of the tax written down value at the end of each period

(i) For all the relevant years:

1 calculate the carrying values of the plant and machinery

(5 marks)

2 calculate the tax bases of the plant and machinery

(5 marks)

3 identify the temporary differences for deferred tax purposes

(3 marks)

4 calculate the deferred tax liabilities or assets at the end of each period, assuming a tax rate of 30% and a NIL deferred tax liability b/f at 1 January 2004.

(2 marks)

(ii) Comment on the overall effect of the above calculations.

(5 marks)

(Total = 20 marks)

6.9 Company S prepares its financial statements to 31 December each year applying IAS. The following balances appear at 31 December 2004 in the Balance Sheet:

(i) $10,000 provision for the cost of entertaining customers in the Christmas period and due for settlement in early 2005
(ii) $25,000 of dividends receivable at 31 December from companies in the same tax jurisdiction but not due for payment until early 2005
(iii) $50,000 of interest payable not due to be paid until March 2005
(iv) Net book value of plant and machinery = $500,000.

The tax rules applicable to each of these items are:

(i) Entertaining of customers is a disallowable expense
(ii) Dividends receivable are not taxable
(iii) Interest payable is tax allowable when paid
(iv) The written down value of plant and machinery for tax purposes at 31 December 2004 = $300,000 because tax depreciation is at a greater rate than accounts depreciation.

(i) The overall taxable temporary difference is:

A $250,000
B $150,000
C $175,000
D $140,000

(4 marks)

(ii) Given that as at 1 January 2004 the balance b/f on the deferred tax account was a liability of $12,000, and the tax authority applies a tax rate of 30%, the amount shown as the deferred tax expense in the Income Statement for the year ended 31 December 2004 is:

A $63,000
B $40,500
C $33,000
D $30,000

(4 marks)
(Total = 8 marks)

6.10

(i) Briefly describe the disclosure requirements for deferred taxation under IAS 12 – income taxes, ignoring the impact of extraordinary items and discontinuing operations.

(4 marks)

(ii) Company T prepares its annual financial statements to 31 December each year applying IAS.

For the year ended 31 December 2004 the following figures have been agreed or are yet to be finalised for inclusion in the accounts:

	$
Estimated current year tax liability	?
Over-provision for the previous year's current tax liability	15,000
Deferred tax liability at 1.1.04	30,000
Deferred tax expense for this year	?
Operating profit before taxation for this year	700,000
Investment income for this year	140,000

Additional information:

(i) Taxable trading profit for the current year is as follows:

	$
Operating profit per accounts	700,000
Add:	
Accounting depreciation	70,000
Less:	
Tax depreciation	(170,000)
	600,000

Tax depreciation comprises:

	$
Annual allowance	50,000
Special 100% allowance for certain type of expenditure	120,000
	170,000

(ii) Investment income is interest receivable, calculated as follows:

	$
Accrued interest receivable at 1.1.04	60,000
Interest received	160,000
Accrued interest receivable at 31.12.04	(80,000)
Credited to IS	140,000

Investment income is taxed when received.

(iii) Non-current assets:

	$
Carrying value at 31.12.04	800,000
Tax base at 31.12.04	550,000

In respect of the year ended 31 December 2004, show the relevant extracts from the financial statements – Income Statement, Balance Sheet and Notes to the Accounts prepared according to IAS, particularly IAS 12 (Income taxes).

(16 marks)
(Total = 20 marks)

✓ Answers

6.1 Definitions under IAS 12

(i) Taxable profit (or loss) is the profit for a period, determined in accordance with the local tax authority's rules, upon which income taxes are payable. IAS 12 refers to income taxes as any taxes levied on the profits and gains of an enterprise, including corporate income tax and capital gains tax.
(ii) Tax expense means the total amount of income tax for the period plus any charge for deferred tax.
(iii) Current tax means the amount of income tax payable (or recoverable) in respect of the taxable profit (or loss) for a period.

6.2 Accounting for the current tax liability
B

Tax expense account

Bank – Interest paid – tax at source 15% × $25,000	3,750	Tax payable – overprovision 2003	10,000
		Bank – Dividends received – tax at source 10% × $30,000	3,000
Tax payable – charge for year	150,000	Income statement	140,750
	153,750		153,750

Tax payable account

Bank	100,000	Balance b/d	110,000
Tax expense	10,000		
	110,000		110,000
Balance c/d	150,000	Tax expense	150,000
		Balance b/d	150,000

A Ignores the overprovision for 2003

Tax expense account

Bank – Interest paid – tax at source 15% × $25,000	3,750	Bank – Dividends received – tax at source 10% × $30,000	3,000
Tax payable – charge for year	150,000	Income statement	150,750
	153,750		153,750

Tax payable account

Bank	100,000	Balance b/d	110,000
Balance c/d	160,000	Tax expense	150,000
	260,000		260,000
		Balance b/d	160,000

C Deals with the tax on the interest paid as a credit instead of a debit and the tax on the dividends received as a debit rather than a credit to the tax expense account

Tax expense account

Dividends receivable – tax at source 10% × \$30,000	3,000	Tax payable – overprovision 2003	10,000
		Interest payable – tax at source 15% × \$25,000	3,750
Tax payable – charge for year	150,000	Income statement	139,250
	153,000		153,000

Tax payable account

Bank	100,000	Balance b/d	110,000
Tax expense	10,000		
	110,000		110,000
Balance c/d	150,000	Tax expense	150,000
		Balance b/d	150,000

D Uses the wrong rate of tax at source on interest paid (10%) and dividends received (15%)

Tax expense account

Bank – Interest paid – tax at source 10% × \$25,000	2,500	Tax payable – overprovision 2003	10,000
		Bank – Dividends received – tax at source 15% × \$30,000	4,500
Tax payable – charge for year	150,000	Income statement	138,000
	152,500		152,500

Tax payable account

Bank	100,000	Balance b/d	110,000
Tax expense	10,000		
	110,000		110,000
Balance c/d	150,000	Tax expense	150,000
		Balance b/d	150,000

6.3 IAS 12 rules of disclosure for current tax in financial statements

Income statement – current tax expense and any over/under-provision for previous period
Balance sheet – the current tax estimated liability of the period (under current liabilities)
Notes to accounts – an explanation of the difference between accounting and taxable profits.

6.4 Accounting for current year tax liability – comprehensive question

(i) Adjusted trading profit – y/e 31.12.04

	$
Operating profit per IS	610,000
Add:	
Entertaining	15,000
Less:	
Interest payable	(40,000)
Adjusted trading profit	585,000

Since the accounting and tax depreciation are identical, the net adjustment for these items is zero.

(ii) Corporate tax liability – y/e 31.12.04

	$
Trading profit	585,000
Investment income (dividends) – exempt	0
Taxable profits	585,000
Tax:	
At 25%	146,250

(iii) Journal entries

		Dr $	*Cr* $
1	Payment of interest (1.7.04) net of tax at source		
	Interest expense (net)	36,000	
	Tax expense (10%)	4,000	
	Bank		36,000
	Tax payable		4,000
2	Receipt of dividends (1.10.04) net of tax credit		
	Bank	9,000	
	Tax payable	1,000	
	Dividends received (net)		9,000
	Tax expense (10%)		1,000
3	Settlement of the 2003 liability		
	Tax payable	125,000	
	Bank		125,000
4	Estimated tax charge for 2004		
	Tax expense	146,250	
	Tax payable		146,250

(iv) Ledger account entries

Tax payable account

Bank	125,000	Balance b/d	122,000
		Tax expense	3,000
	125,000		125,000
Tax expense – tax credit on dividends	1,000	Tax expense – tax on interest	4,000
Balance c/d	149,250	Tax expense	146,250
	150,250		150,250
		Balance c/d (current liability at 31.12.04)	149,250

(v) Income statement – y/e 31.12.04

	$	$
Operating profit		610,000
Net finance cost		(40,000)
Investment income		10,000
Profit before tax		580,000
Less:		
Income tax		
Current year $(146,250 + 4,000 − 1,000)	149,250	
Underprovision for earlier year	3,000	
		(152,250)
Net profit		427,750

6.5 Temporary differences

A temporary difference (TD) is the difference between the carrying amount of an asset or liability in the balance sheet and its tax base.

The tax base is the equivalent for tax purposes of the carrying amount of the asset or liability determined by applying the tax rules of the local tax jurisdiction.

A taxable TD is a current difference which will result in a higher tax charge (i.e. a deferred tax liability) in a future period. A deductible TD is a current difference that will result in a lower tax charge (i.e. a deferred tax asset) in a future period.

6.6 No deferred tax on permanent differences

Permanent differences are ignored for deferred tax purposes, because the difference between the carrying value for accounts and tax base will never reverse (i.e. the taxable profit (or loss) will always remain higher or lower than the accounting profit (or loss)). Examples of permanent differences are disallowable expenses for tax purposes – entertaining, political donations, etc.

6.7 Tax losses and deferred tax

A tax loss will be recognised as giving rise to a deferred tax asset if there is a loss to be carried forward for relief and it is probable that relief will be obtained in a future period.

6.8 Deferred tax over several accounting periods

(i) Calculations

	31.12.04	*31.12.05*	*31.12.06*	*31.12.07*
	$	$	$	$
1 Carrying values				
Cost	500,000	500,000	500,000	500,000
Depreciation to date (W1)	(125,000)	(250,000)	(375,000)	(450,000)
Carrying values	375,000	250,000	125,000	50,000
2 Tax bases				
Cost	500,000	500,000	500,000	500,000
Tax depreciation to date (W2)	(200,000)	(260,000)	(308,000)	(450,000)
Tax bases	300,000	240,000	192,000	50,000
3 Temporary differences				
Carrying values	375,000	250,000	125,000	50,000
Tax bases	(300,000)	(240,000)	(192,000)	(50,000)
	75,000	10,000	(67,000)	0
At 30%	(22,500)	(3,000)	20,100	0
4 Deferred tax (liabilities)/assets				
	$	$	$	$
Balance b/f	0	(22,500)	(3,000)	20,100
(Charge) to/release from IS	(22,500)	19,500	23,100	(20,100)
Balance c/f	(22,500)	(3,000)	20,100	0

Workings

1 Accounting depreciation

	Annual depreciation	*Accumulated depreciation*
	$	$
Cost	500,000	
Year 1 25% × cost	(125,000)	125,000
	375,000	
Year 2 25% × cost	(125,000)	125,000
	250,000	250,000
Year 3 25% × cost	(125,000)	125,000
	125,000	375,000
Year 4 Disposal value (=proceeds)	(50,000)	
Under-depreciation	75,000	75,000
		450,000

2 Tax depreciation

	Accumulated depreciation $	*Annual depreciation* $
Cost	500,000	
Year 1 40% × cost	(200,000)	200,000
	300,000	
Year 2 20% × $300,000	(60,000)	60,000
	240,000	260,000
Year 3 20% × $240,000	(48,000)	48,000
	192,000	308,000
Year 4 Disposal value (=proceeds)	(50,000)	
Under-depreciation	142,000	142,000
		450,000

(ii) Comments

Over the useful life of the asset, both accounting and tax depreciation are the same in total but a timing difference arises due to the different rates and basis of computation. In year 1, the current tax liability is reduced by the excess of the tax depreciation over accounting depreciation (i.e. $200,000 − 125,000 = 75,000 × 30% = 22,500). In order to avoid overstating the company's distributable profits, a provision for deferred tax of $22,500 is created. Over the next three years, the relationship between accounting and tax depreciation is reversed. During this time, the deferred tax provision is adjusted and eventually eliminated on sale when accounting and tax depreciation become equal.

6.9 Taxable differences and deferred tax expense calculations

(i) Taxable temporary differences
B

	Carrying values $	*Tax bases* $	*Permanent differences* $	*Temporary differences* $
Non-current assets	500,000	300,000	–	200,000
Current assets:				
Dividends receivable	25,000	0	25,000	
Current liabilities:				
Interest payable	50,000	0		(50,000)
Other provisions	10,000	0	10,000	
				150,000

Notes

1 The tax bases for dividends receivable, interest payable and other provisions are all zero because the income and payments are taxed or allowable respectively on a receipts or payment basis.
2 Dividends receivable and other payables (i.e. entertainment costs) are permanent differences because the dividends are not taxable and the entertaining costs are not allowable, and the differences will never reverse.

3 The temporary difference on the NCA is a taxable difference because the future tax liabilities will be higher when accounting depreciation exceeds tax depreciation.
4 The temporary difference on the interest payable is a deductible difference because the future tax liability will be lower when the interest is paid.

A Treats the difference on the interest payable as a taxable (rather than a deductible) difference
i.e. $200,000 + 50,000 = 250,000

C Treats the difference on dividends as taxable temporary rather than a permanent difference (i.e. it ignores the fact that the income will never be taxable)
i.e. $200,000 + 25,000 − 50,000 = 175,000

D Treats entertaining as a deductible temporary difference rather than a permanent difference (i.e. it ignores the fact that the cost is never tax deductible)
i.e. $200,000 − 10,000 − 50,000 = 140,000

(ii) Deferred tax expense
C

	$
Deferred tax liability at 1.1.04	12,000
Deferred tax liability at 31.12.04 (30% × $150,000)	(45,000)
Deferred tax expense charged to IS (the balancing figure)	(33,000)

A Treats the balance at 31.12.04 as 30% × $250,000 = 75,000, making the IS charge $63,000
B Treats the balance at 31.12.04 as 30% × $175,000 = 52,500, making the IS charge $40,500
D Treats the balance at 31.12.04 as 30% × $140,000 = 42,000, making the IS charge $30,000

6.10 Current and deferred tax – disclosure in IAS financial statements

(i) Disclosure of deferred tax in the financial statements

IAS 12 requires the following disclosure of deferred taxation:

In the Income statement – the amount of the deferred tax expense or release in the period
In the Balance sheet – the amount of the overall deferred tax liability or asset shown under current liabilities (or current assets)
In the notes to the accounts – details relating to the nature of the temporary differences and the amounts thereof – deferred liabilities and assets – recognised in the accounts.

(ii) Income statement – year ended 31.12.04 (extract)

	$	$
Operating profit (Note 1)		700,000
Investment income		140,000
Profit before tax		840,000
Tax expense: (Note 2)		
Current tax (W1)	(228,000)	
Over-provision for earlier year	15,000	
Deferred tax (W2)	(69,000)	
		(282,000)
Net profit after tax		558,000

Balance sheet – at 31.12.04 (extracts)

	$	$
Non-current assets:		
Carrying value		800,000
Current assets:		
Interest receivable		80,000
Current liabilities:		
Tax liabilities:		
Current tax (W1)	228,000	
Deferred tax (W2)	99,000	
		(327,000)

Notes to the accounts – year ended 31.12.04 (extracts)

1 Operating profit

	$
This is arrived at after charging:	
Depreciation	70,000

2 Tax expense

Current taxation

Tax is levied at a rate of 30% on taxable profits. Taxable profits are the accounting profits after adjusting for the difference between the amounts provided in the accounts for depreciation and that allowed by the tax authority, including a special accelerated 100% allowance for certain types of capital expenditure.

Deferred taxation

The deferred tax liability at 31 December 2004 is the net temporary taxable difference for the year charged at 30%:

	$
Taxable differences being the excess of the carrying value over the tax base for the year in respect of:	
Non-current assets	250,000
Interest receivable	80,000
	330,000
At 30%	99,000

Workings

1 Current tax expense

	$
Taxable trading profit	600,000
Taxable investment income (receipts basis)	160,000
Total taxable profits	760,000
Tax at 30%	228,000

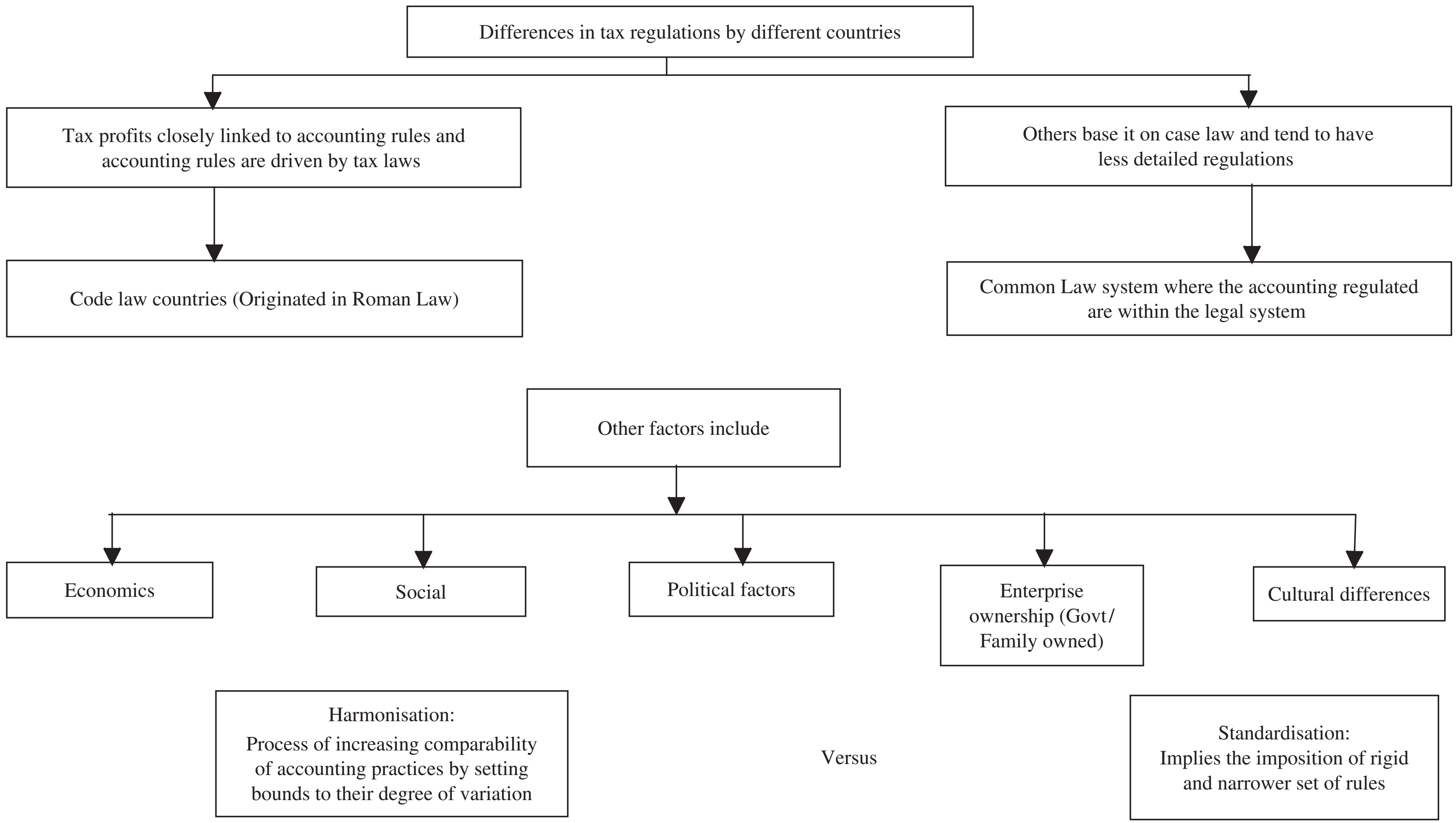
2 Deferred taxation

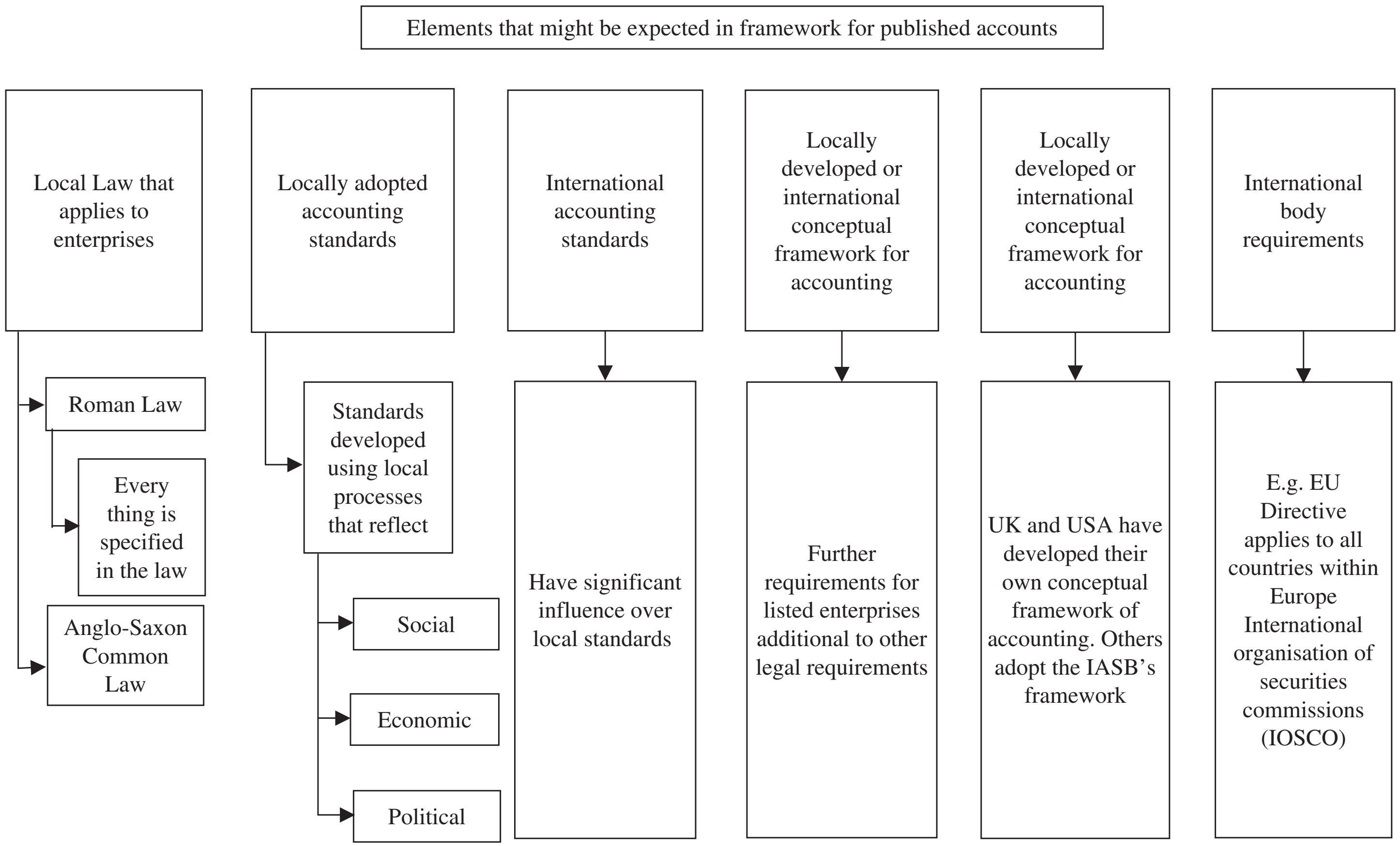
	Carrying value $	*Tax base* $	*Temporary difference* $
NCA	800,000	550,000	250,000
Interest receivable	80,000	0	80,000
			330,000
Liability at 1.1.04			30,000
Expense for year (balancing figure)			69,000
Liability at 31.12.04 ($330,000 × 30%)			99,000

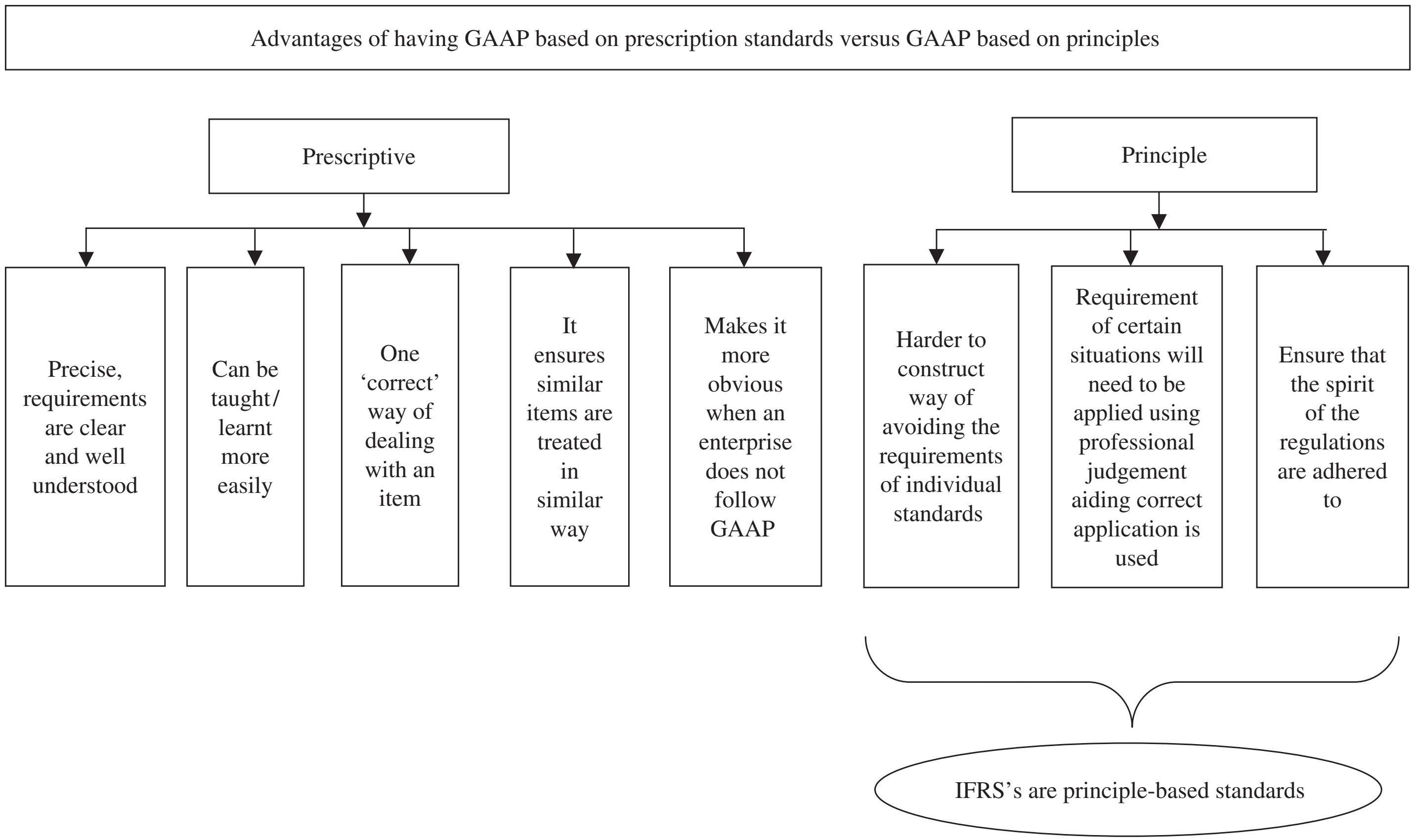
7

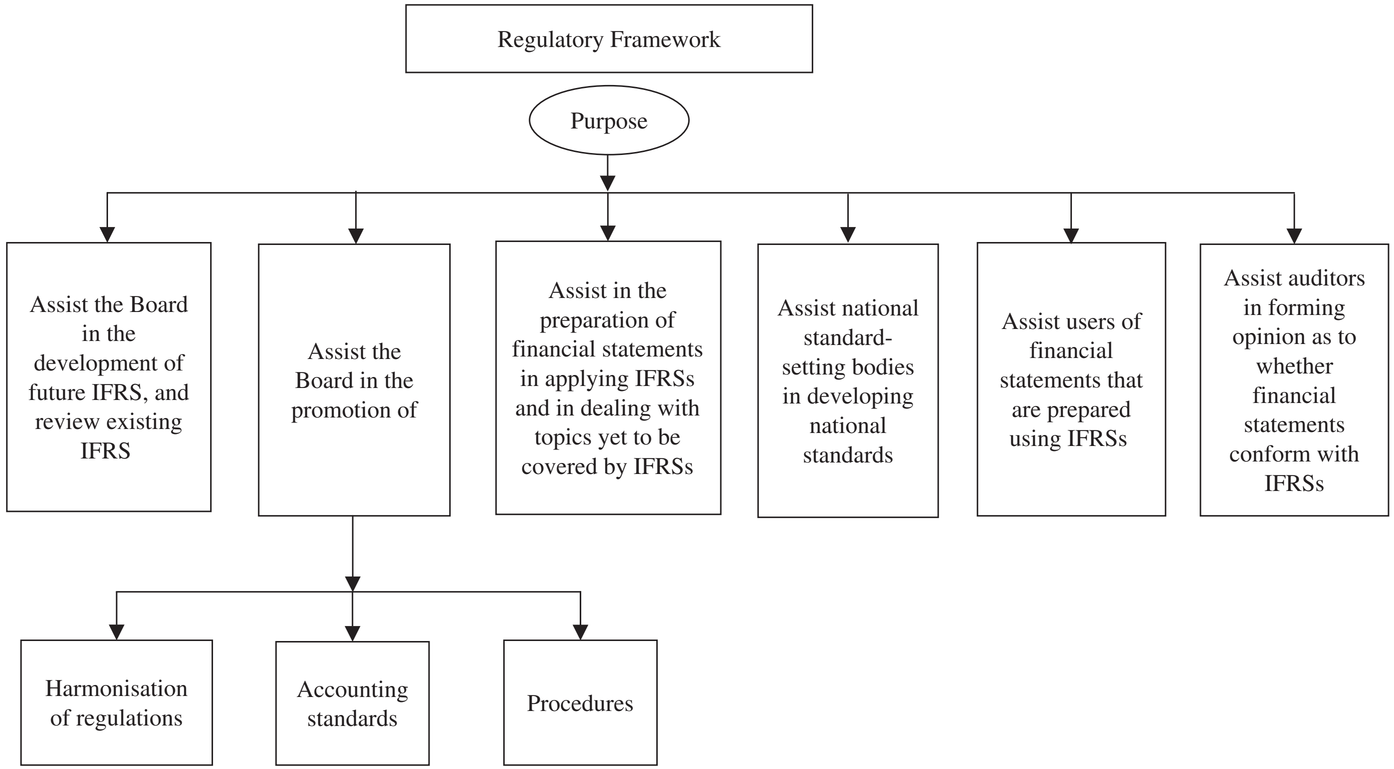
The IASC and Standard Setting Process

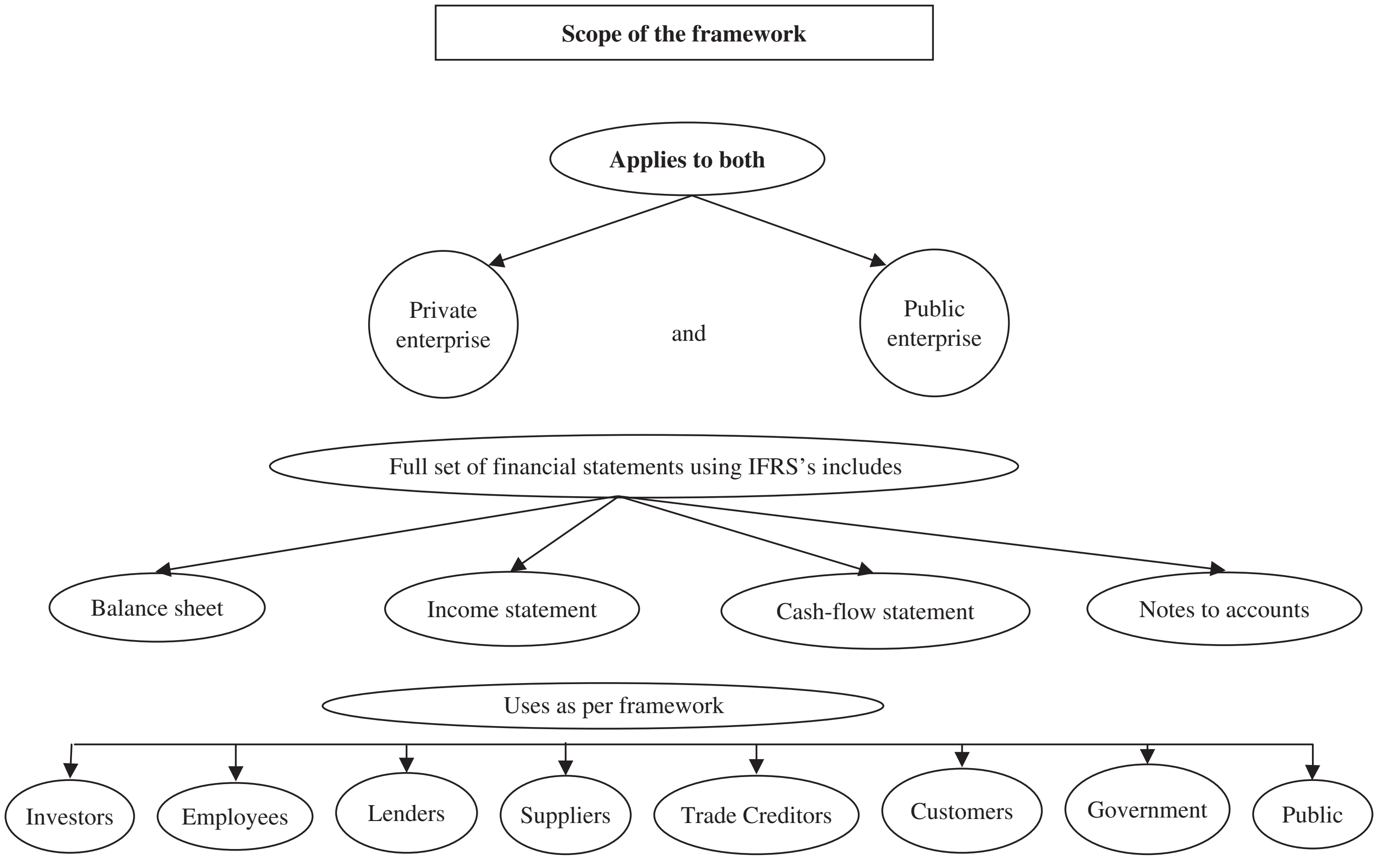
Need for regulating standard

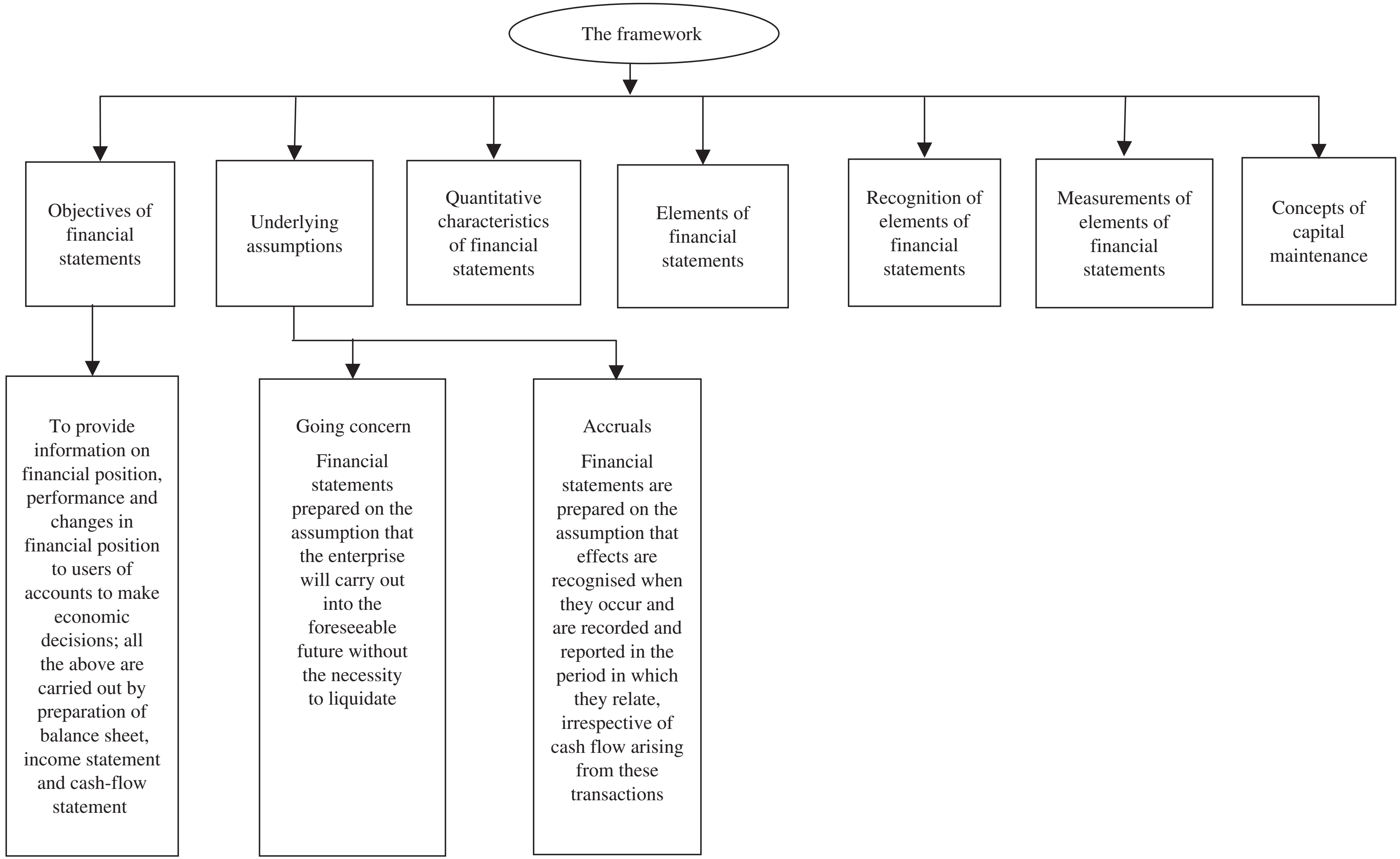


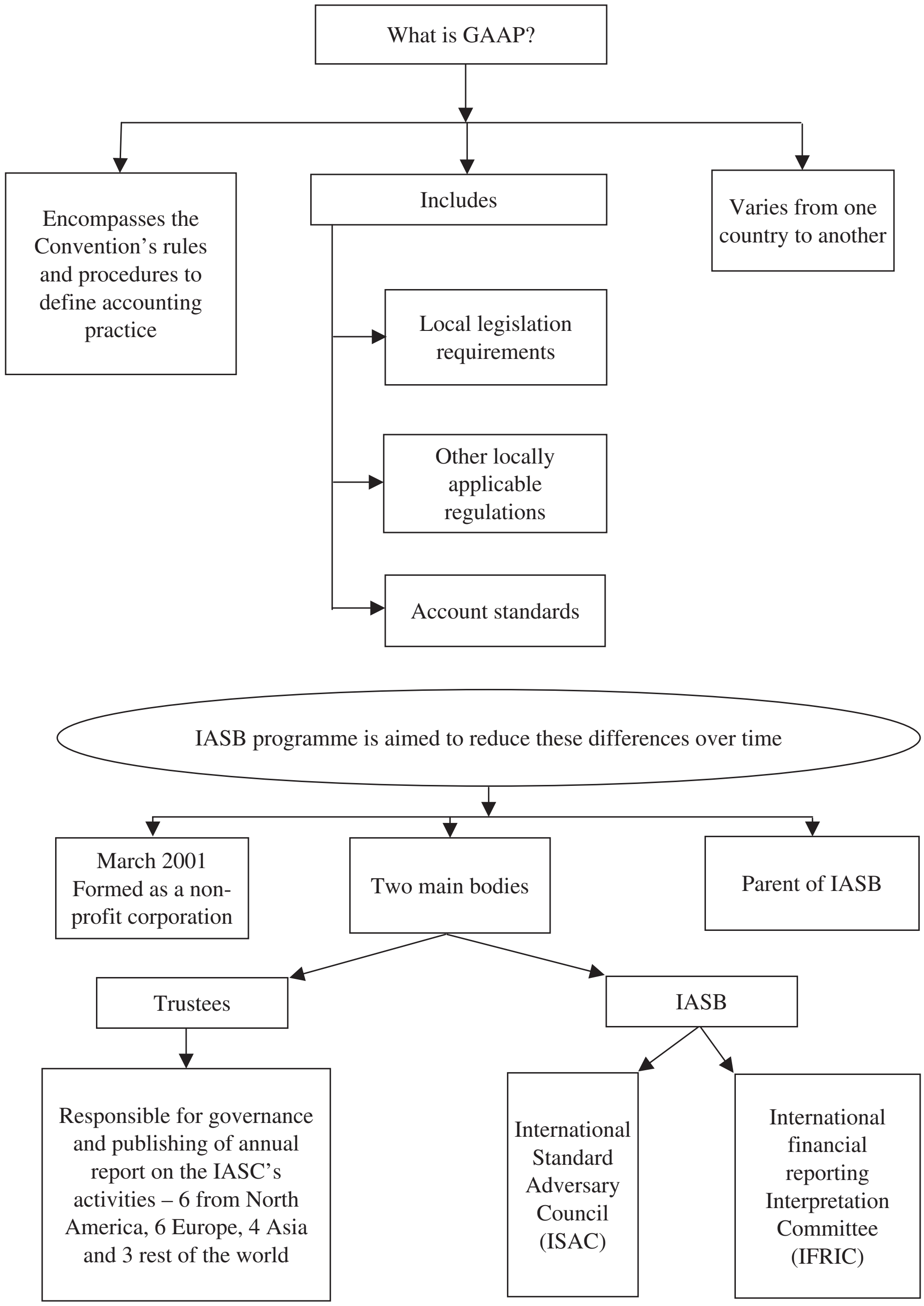

Elements that might be expected in framework for published accounts
Local Law that applies to enterprises
Roman Law
Every thing is specified in the law
Anglo-Saxon Common Law
Locally adopted accounting standards
Standards developed using local processes that reflect
Social
Economic
Political
International accounting standards
Have significant influence over local standards
Locally developed or international conceptual framework for accounting
Further requirements for listed enterprises additional to other legal requirements
Locally developed or international conceptual framework for accounting
UK and USA have developed their own conceptual framework of accounting. Others adopt the IASB's framework
International body requirements
E.g. EU Directive applies to all countries within Europe International organisation of securities commissions (IOSCO)

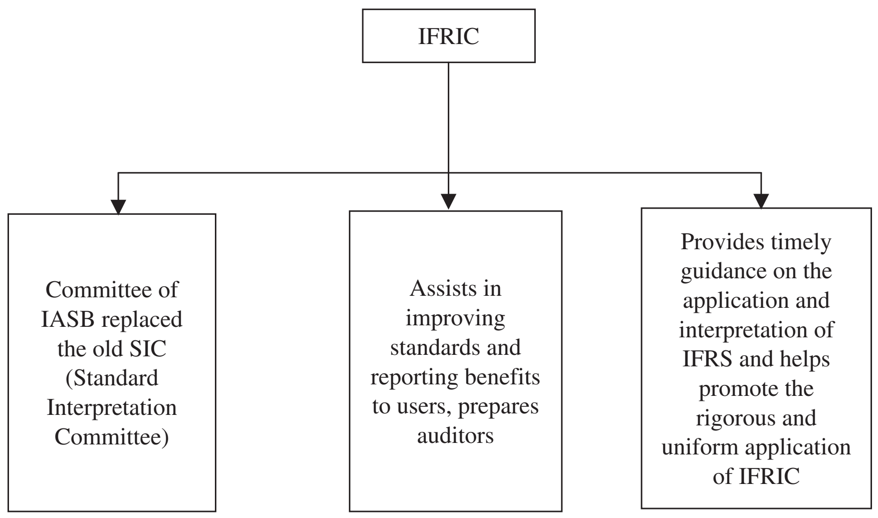

Advantages of having GAAP based on prescription standards versus GAAP based on principles
Prescriptive
Principle
Precise, requirements are clear and well understood
Can be taught/ learnt more easily
One 'correct' way of dealing with an item
It ensures similar items are treated in similar way
Makes it more obvious when an enterprise does not follow GAAP
Harder to construct way of avoiding the requirements of individual standards
Requirement of certain situations will need to be applied using professional judgement aiding correct application is used
Ensure that the spirit of the regulations are adhered to
IFRS's are principle-based standards

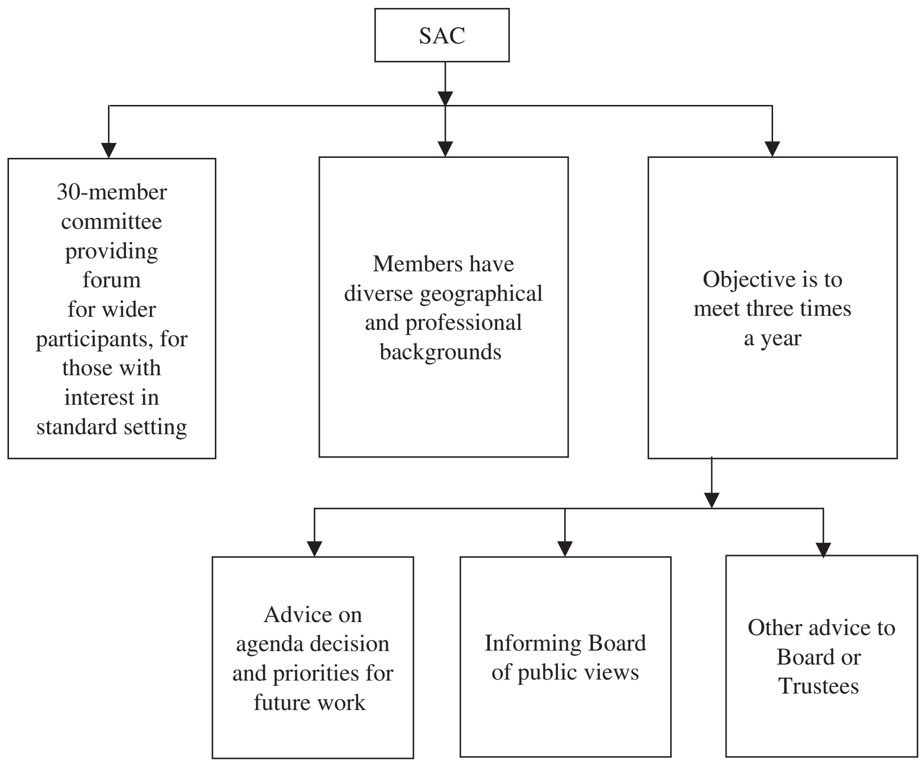

Regulatory Framework
Purpose
Assist the Board in the development of future IFRS, and review existing IFRS
Assist the Board in the promotion of
Assist in the preparation of financial statements in applying IFRSs and in dealing with topics yet to be covered by IFRSs
Assist national standard-setting bodies in developing national standards
Assist users of financial statements that are prepared using IFRSs
Assist auditors in forming opinion as to whether financial statements conform with IFRSs
Harmonisation of regulations
Accounting standards
Procedures

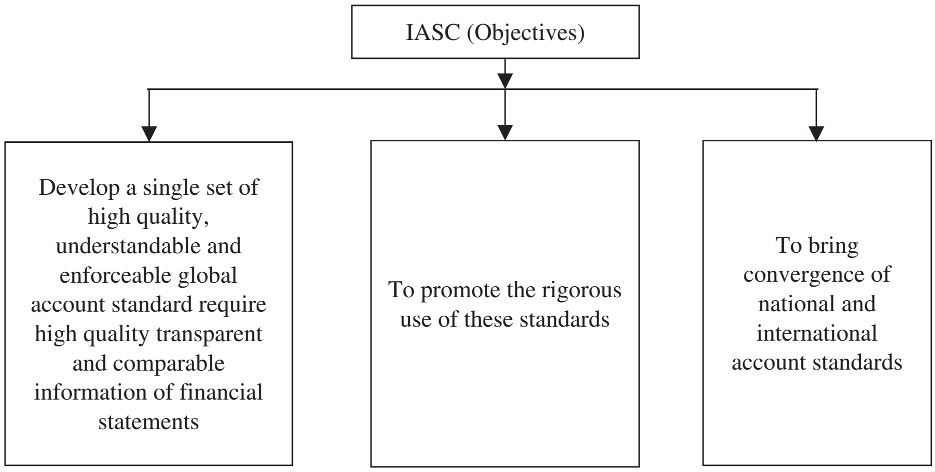

Scope of the framework
Applies to both
Private enterprise
and
Public enterprise
Full set of financial statements using IFRS's includes
Balance sheet
Income statement
Cash-flow statement
Notes to accounts
Uses as per framework
Investors
Employees
Lenders
Suppliers
Trade Creditors
Customers
Government
Public

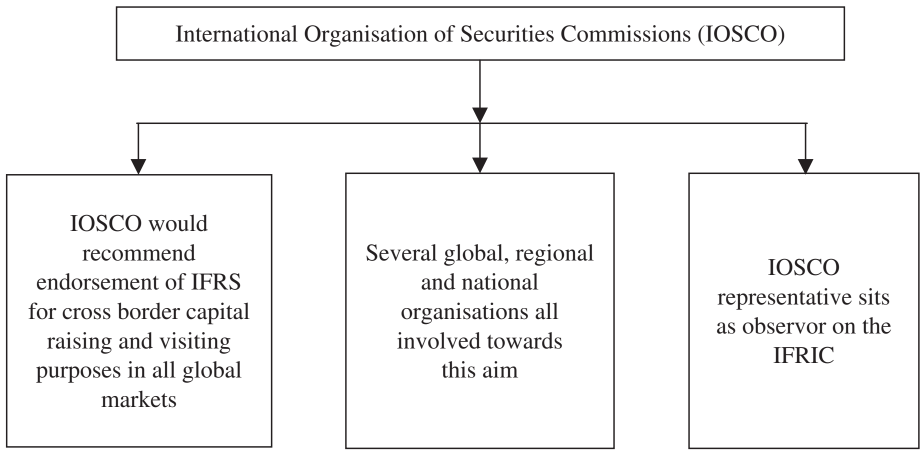

The framework
Objectives of financial statements
Underlying assumptions
Quantitative characteristics of financial statements
Elements of financial statements
Recognition of elements of financial statements
Measurements of elements of financial statements
Concepts of capital maintenance
To provide information on financial position, performance and changes in financial position to users of accounts to make economic decisions; all the above are carried out by preparation of balance sheet, income statement and cash-flow statement
Going concern
Financial statements prepared on the assumption that the enterprise will carry out into the foreseeable future without the necessity to liquidate
Accruals
Financial statements are prepared on the assumption that effects are recognised when they occur and are recorded and reported in the period in which they relate, irrespective of cash flow arising from these transactions


What is GAAP?
Encompasses the Convention's rules and procedures to define accounting practice
Includes
Varies from one country to another
Local legislation requirements
Other locally applicable regulations
Account standards
IASB programme is aimed to reduce these differences over time
March 2001 Formed as a non-profit corporation
Two main bodies
Parent of IASB
Trustees
IASB
Responsible for governance and publishing of annual report on the IASC's activities – 6 from North America, 6 Europe, 4 Asia and 3 rest of the world
International Standard Adversary Council (ISAC)
International financial reporting Interpretation Committee (IFRIC)


IFRIC
Committee of IASB replaced the old SIC (Standard Interpretation Committee)
Assists in improving standards and reporting benefits to users, prepares auditors
Provides timely guidance on the application and interpretation of IFRS and helps promote the rigorous and uniform application of IFRIC


SAC
30-member committee providing forum for wider participants, for those with interest in standard setting
Members have diverse geographical and professional backgrounds
Objective is to meet three times a year
Advice on agenda decision and priorities for future work
Informing Board of public views
Other advice to Board or Trustees


IASC (Objectives)
Develop a single set of high quality, understandable and enforceable global account standard require high quality transparent and comparable information of financial statements
To promote the rigorous use of these standards
To bring convergence of national and international account standards


International Organisation of Securities Commissions (IOSCO)
IOSCO would recommend endorsement of IFRS for cross border capital raising and visiting purposes in all global markets
Several global, regional and national organisations all involved towards this aim
IOSCO representative sits as observor on the IFRIC

International reaction

In June 2000 European Commission published a list of companies in the EU which required to publish their consolidated accounts from 2005 using IFRS

The full adoption of IFRS by 2005 is already the focus of companies and auditors

The issue raised includes

How the changes will be recognised and measured

Many companies state their financial statements are already stated in accordance with IFRS e.g.: Nokia, Adidas, Puma, Bayer, Nestle, Gucci and Zurich Financial Services, currently there are 350 public listed companies that comply with the IFRS; within 2005 there will be 7000 public listed companies.

USA

The US Securities and Exchange Commission (SEC) is responsible for the regulation of the debt and equity securities in the USA.

In 1996 the SEC agreed its support for the IASC objection in developing account standards.

THE STANDARD SETTING PROZERS

The IASB may form advisory committees or specialist technical groups to advise on major projects. It may outsource detailed research or other work to national standards.

Development of standards

IASB set up an advisory committee consultation with this committee and the SAC occurs throughout the project

Publishes discussion papers for public comment

Publishes exposure draft for public comment

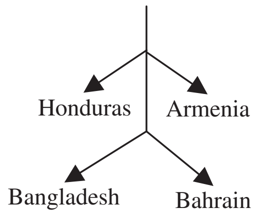
Hold public hearing or carry out. IASB issue final IFRS

Ways in which IFRS are used by countries

– Adopting as local GAAP

In countries where accounting profession is not well developed, they would take the international standard and adequate it to their local standard with little or no amendments.

Very quick to implement but may not take account of any specific local traditions or variations. For example:



– Model for local GAAP
– Persuasive influence in local GAAP

Questions

7.1 What does IFRIC stand for?

A International Financial Reporting Issue Committee
B International Financial Recommendations and Interpretations Committee
C International Financial Reporting Interpretation Committee
D International Financial Reporting Issue Council

(2 marks)

7.2 Which of the following is NOT a function of the International Accounting Standard Board?

A Issuing Accounting Standards
B Withdrawing Accounting Standards
C Developing Accounting Standards
D Enforcing Accounting Standards

(2 marks)

7.3 The International Accounting Standard Committee Foundation (IASC Foundation) has two main bodies

(i) Trustees
(ii) International Accounting Standards Board
(iii) International Financial Reporting Interpretation Committee
(iv) Standards Advisory Council

A (i) and (ii)
B (i) and (iv)
C (ii) and (iv)
D (iii) and (iv)

(2 marks)

7.4 The IASC Foundation trustees appoint

(i) International Accounting Standard Board
(ii) Standard Advisory Council
(iii) International Financial Reporting Interpretation Committee

A (i)
B (i) and (ii)
C (i), (ii) and (iii)
D None of the above

(2 marks)

7.5 What is the role and objective of the International Financial Reporting Interpretation Committee?

(4 marks)

7.6 What are the objectives of International Accounting Standards Committee?

(4 marks)

7.7 Set out the stages of the development of standards?

(4 marks)

7.8 List three ways in which IFRSs can be implemented in a country?

(3 marks)

7.9 Explain the benefits that could accrue from the development of a single set of accounting standards that could be applied to all countries.

(7 marks)

7.10 Discuss the elements that might be expected in regulatory framework for published accounts.

(10 marks)

7.11 (i) Explain how the International Accounting Standards Board (IASB) goes about setting an International Accounting Standard (IAS).

Explain how the process could be influenced by the preparers of financial statements.

(10 marks)

(ii) Explain why there may be a conflict between the chracteristics of relevance and reliability, and state, with reasons, which of these you consider to be the more important in financial reporting.

(10 marks)
(Total = 20 marks)

7.12

The IASB's framework for the preparation and presentation of financial statements is a set of theoretical principles which are designed to influence the drafting for future accounting standards.

Discuss the advantages of IASB issuing its Framework documents and whether the contents are theoretical for use in the standard setting process.

(15 marks)

7.13

The International Accounting Standards Committee (IASC), the predecessor of the International Accounting Standards Board (IASB), issued the Framework for the preparation and presentation of financial statements (Framework) in 1989.

Requirements

(i) Explain the four principal chracteristics that make financial information useful, as outlined in the Framework.

(9 marks)

(ii) The introduction to the IASB's Framework states 'The purpose of the Framework is to assist the Board in the development of future International Accounting Standards and in its review of existing International Accounting Standards'.

Requirement

Explain how the framework can help with the development and review of Accounting Standards. Use IAS 1 – Presentation of financial statements to illustrate your answer.

(10 marks)

(iii) IAS 1 states that financial statements should present fairly the financial position, financial performance and cash flows of an enterprise. It goes on to say that financial statements that comply with all relevant IASs almost always achieve this objective of fair presentation.

Requirement

Explain what should be disclosed in the minority of cases where following a specific IAS requirement would not achieve fair presentation.

(6 marks)
(Total = 25 marks)

Answers

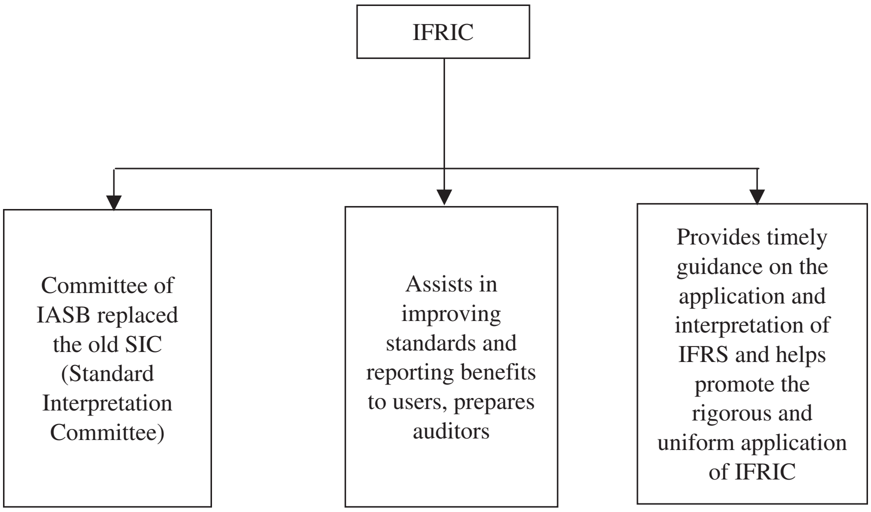
7.1 **C**

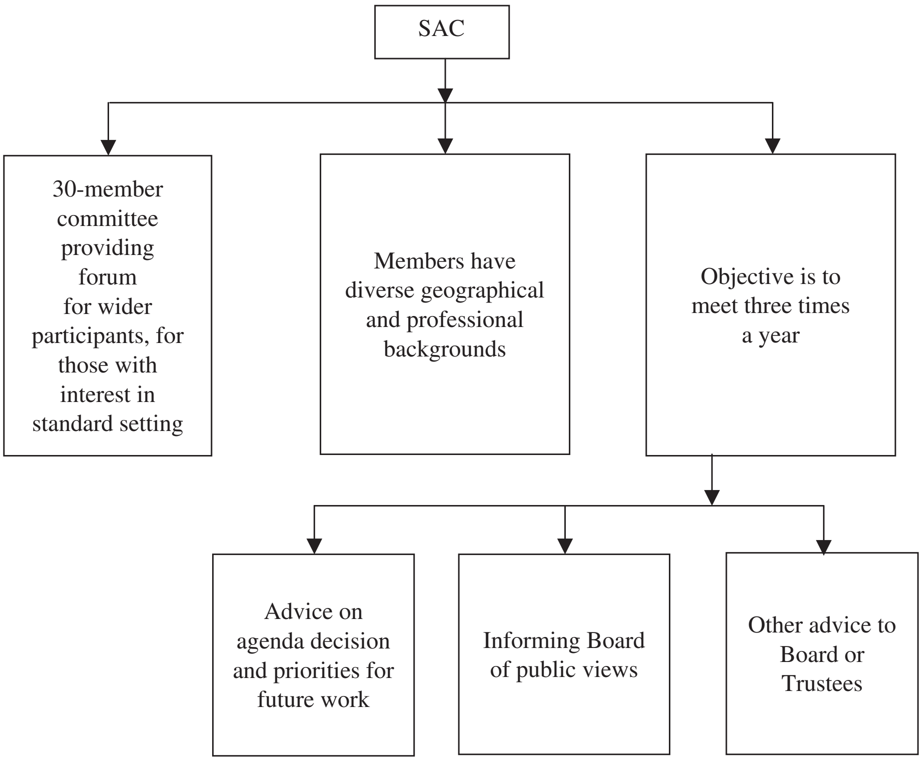
7.2 **D**

7.3 **A**

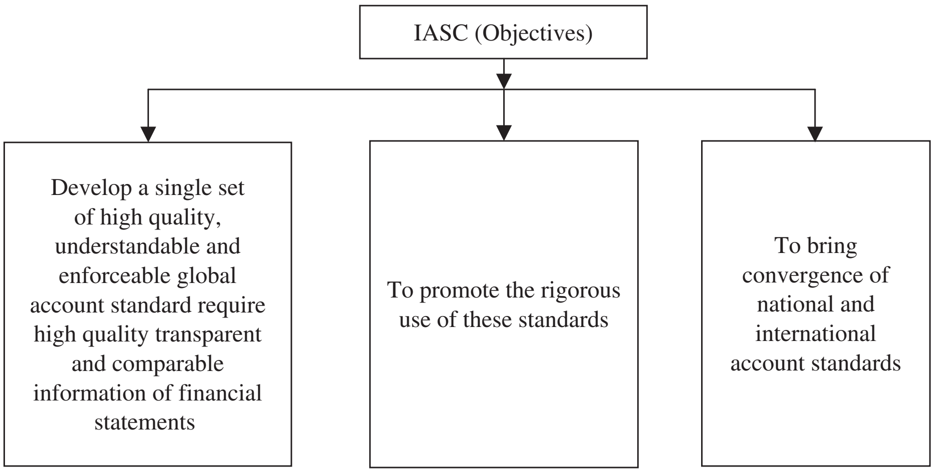
7.4 **C**

7.5

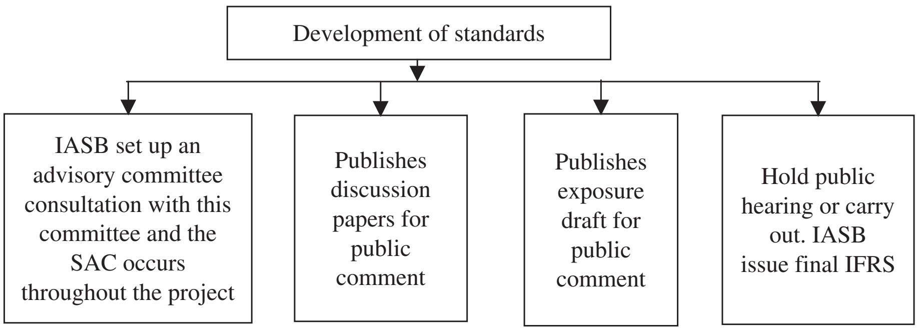




7.6



7.7



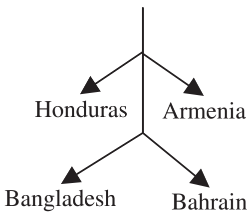
7.8

Ways in which IFRS are used by countries

- Adopting as local GAAP

In countries where accounting profession is not well developed, they would take the international standard and adequate it to their local standard with little or no amendments.

Very quick to implement but may not take account of any specific local traditions or variations. For example:



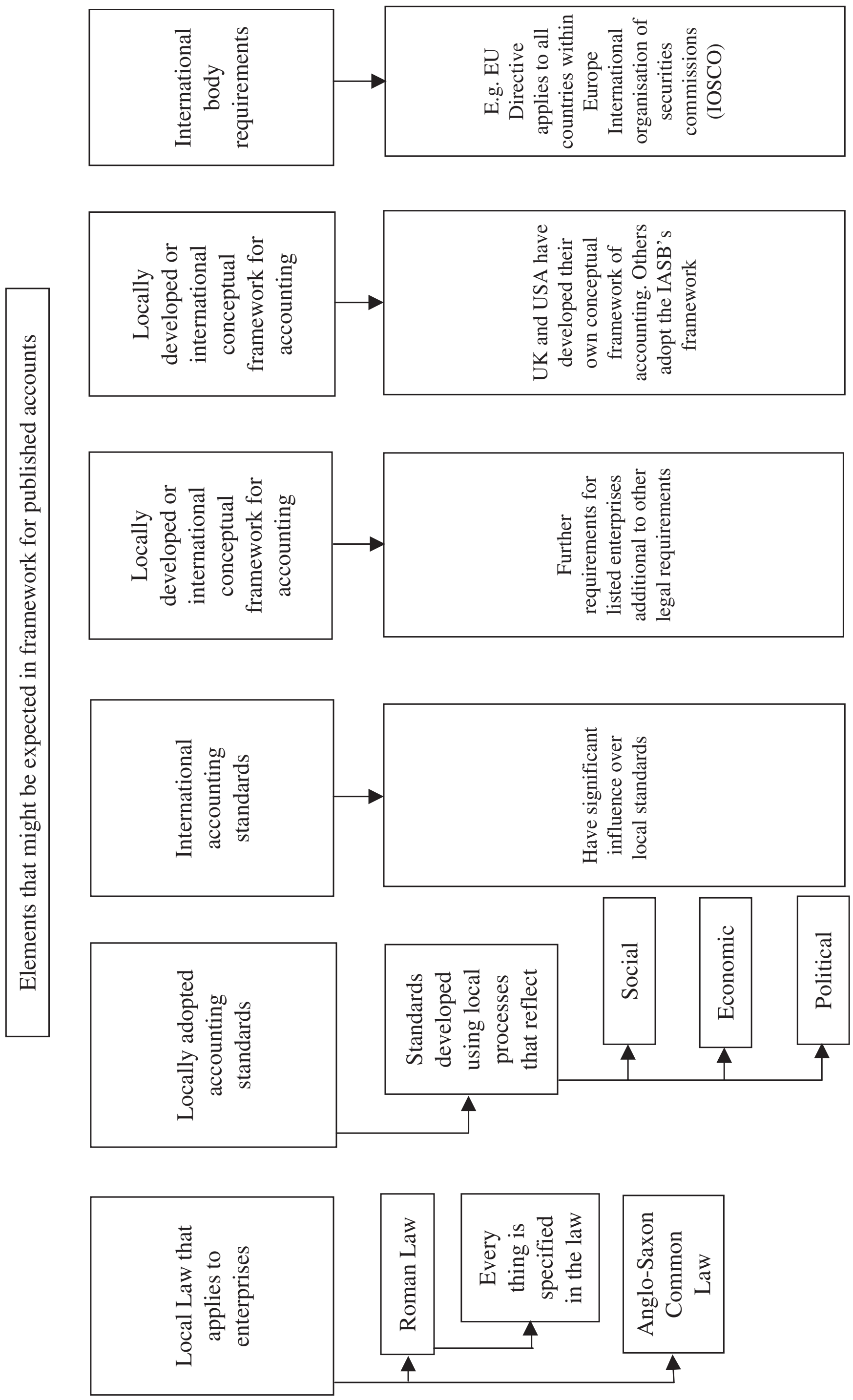
- Model for local GAAP
- Persuasive influence in local GAAP

7.9 Multinational enterprises could benefit:

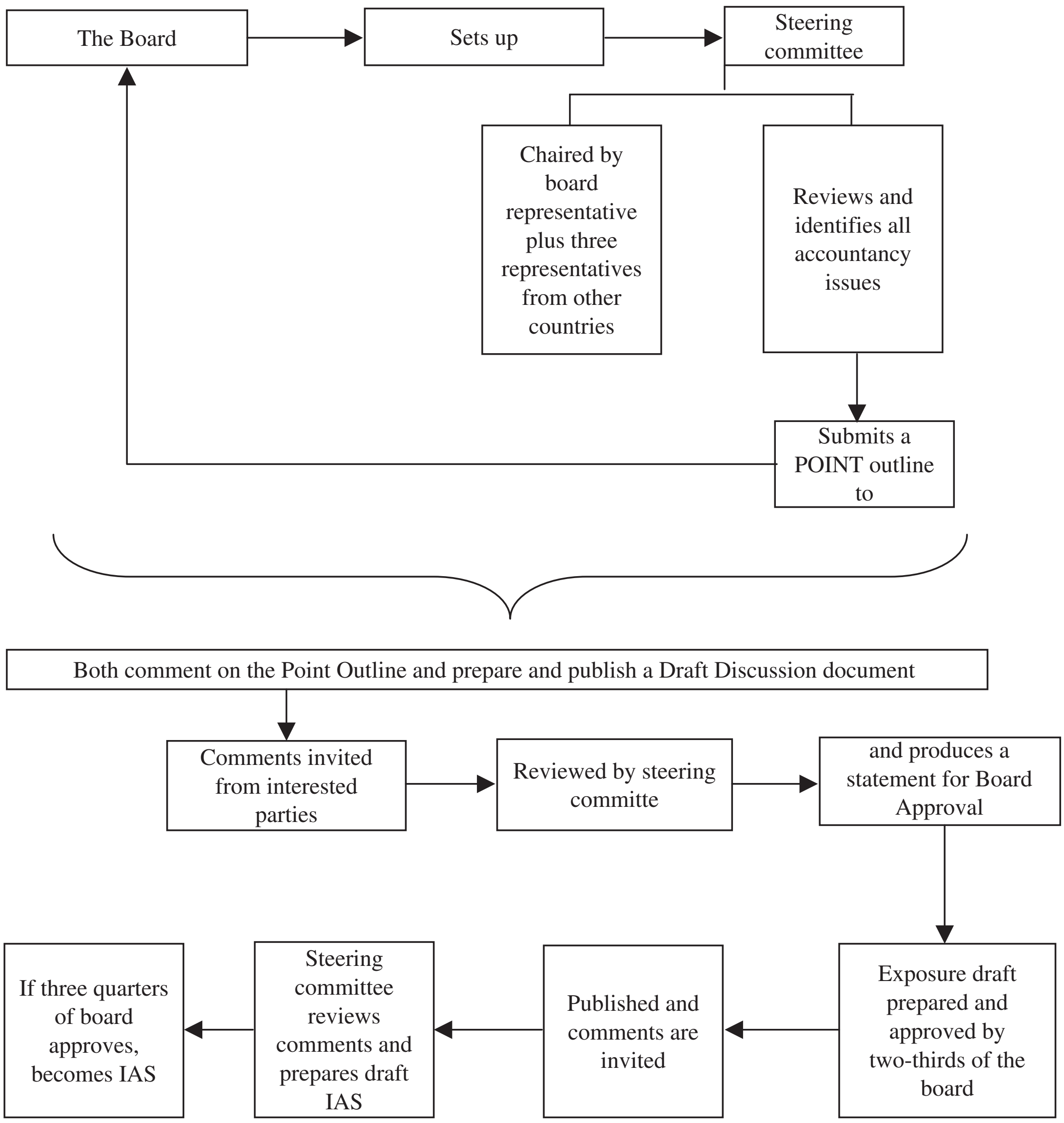
(i) From access to a wide range of international finance opportunities and hence help reduce financing costs.
(ii) There could be improved management control as all parts of the enterprise would be reporting using consistent basis.
(iii) There could be greater efficiency in accounting departments as they would not have to spend time converting data from one accounting basis to another.
(iv) Consolidation of subsidiaries results to prepare graph accounts would be much easier.
(v) Investors should benefit by being able to compare the result of different enterprises more easily and be able to make more informed investment decisions.
(vi) Easier for international economic grouping such as the EU to function as the preparation of economic data would be easier.

i e a		i e c	
i	Improved Management	i	Investors Benefit
e	Greater efficiency	e	Economic Grouping
a	Access wider range	c	Consolidation easier

7.10


Elements that might be expected in framework for published accounts
Local Law that applies to enterprises
Roman Law
Every thing is specified in the law
Anglo-Saxon Common Law
Locally adopted accounting standards
Standards developed using local processes that reflect
Social
Economic
Political
International accounting standards
Have significant influence over local standards
Locally developed or international conceptual framework for accounting
Further requirements for listed enterprises additional to other legal requirements
Locally developed or international conceptual framework for accounting
UK and USA have developed their own conceptual framework of accounting. Others adopt the IASB's framework
International body requirements
E.g. EU Directive applies to all countries within Europe International organisation of securities commissions (IOSCO)

7.11 (i)


The Board
Sets up
Steering committee
Chaired by board representative plus three representatives from other countries
Reviews and identifies all accountancy issues
Submits a POINT outline to
Both comment on the Point Outline and prepare and publish a Draft Discussion document
Comments invited from interested parties
Reviewed by steering committe
and produces a statement for Board Approval
Exposure draft prepared and approved by two-thirds of the board
Published and comments are invited
Steering committee reviews comments and prepares draft IAS
If three quarters of board approves, becomes IAS

(ii) Loans, Dividends Paid and Bank Balances } may be considered as both relevant and reliable as these are items which result in decision-making and can be accurately determined

Cost of non-current assets which are shown at historical costs is a reliable figure but this is not particularly relevant to users, i.e.

	Year 1	Year 2
	$	$
Cost	100	100
Depreciation say 10% straight line	(10)	(20)
Net Book Value	90	80

Shown at original historic cost

Would be more relevant to users of financial statements

	Year 2
	$
Cost	90
Depreciation	(10)
	80

Estimated life
Residual value
Most appropriate method

Same result; reason is that cost is influenced by accumulated depreciation based on judgement

7.12

IASB Framework

Advantages of IASB framework for presentation and preparation of financial statements

- Provides a body of principles that help produce standards that are more internationally consistent, e.g. IAS 37 'contingencies' adopt the concept of liabilities set out in the framework
- Helps reduce subjectivity in the preparation of financial statements
- If an item is not subject to an accountancy standard then the framework can provide guidance and hence produce consistency of treatment between companies
- Limits the areas where preparers of accounts use their judgement by providing structure and direction

Using the framework has resulted in a common set of objectives and terminology and hence this has influenced the understanding of and confidence in the financial statements.

It has also enhanced comparability of financial statements because it has limited the alternatives available.

The IASB is forever reviewing and revising standards at the earliest opportunity.

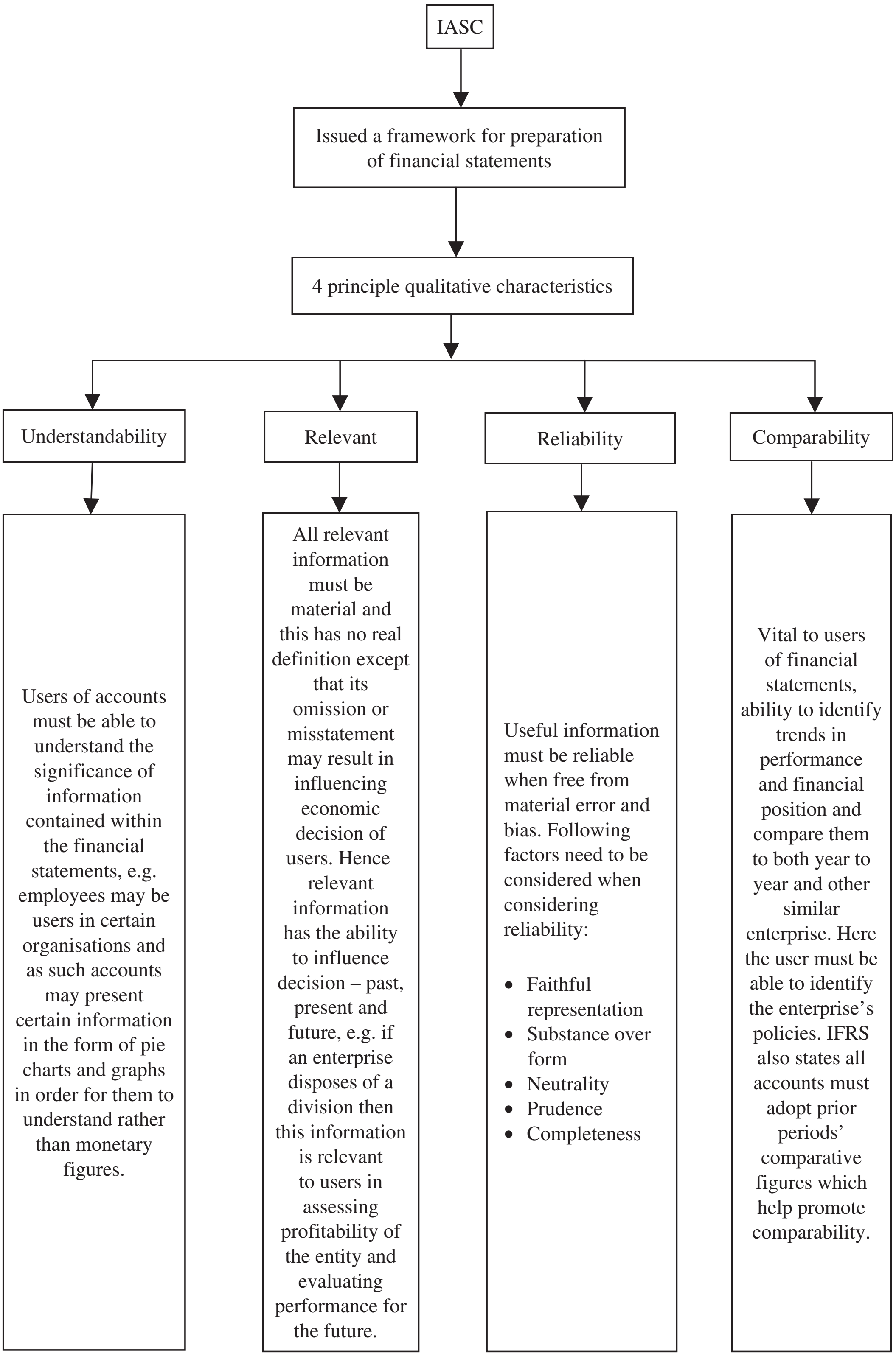
To overcome the problem, the cost could be revalued; however, revaluation relies on the judgement of valuer.

- Provision for doubtful debts
- Write-offs
- Accruals and
- Prepayments

are accepted methods of increasing relevance of accounts but all involve making estimates which leads to decrease in reliability

To obtain a balance between relevance and reliability, the needs of users of financial reports should be taken into account as different users have different needs, what may be relevant to one may not necessarily be relevant to another. However, all require information to be reliable.

7.13 (i)


IASC
Issued a framework for preparation of financial statements
4 principle qualitative characteristics
Understandability
Relevant
Reliability
Comparability
Users of accounts must be able to understand the significance of information contained within the financial statements, e.g. employees may be users in certain organisations and as such accounts may present certain information in the form of pie charts and graphs in order for them to understand rather than monetary figures.
All relevant information must be material and this has no real definition except that its omission or misstatement may result in influencing economic decision of users. Hence relevant information has the ability to influence decision – past, present and future, e.g. if an enterprise disposes of a division then this information is relevant to users in assessing profitability of the entity and evaluating performance for the future.
Useful information must be reliable when free from material error and bias. Following factors need to be considered when considering reliability:
• Faithful representation
• Substance over form
• Neutrality
• Prudence
• Completeness
Vital to users of financial statements, ability to identify trends in performance and financial position and compare them to both year to year and other similar enterprise. Here the user must be able to identify the enterprise's policies. IFRS also states all accounts must adopt prior periods' comparative figures which help promote comparability.

(ii)

Prior to the framework there were no guidelines as to how to develop accounting standards, and as a result it lacked consistency and some even contradicted each other.

Application of the framework assists the Board in promoting harmonisation with regulators, accounting standards and procedures relating to the presentation of financial statements by reducing the number of alternative treatments permitted by IFRS.

The framework states that the objective of financial statements (balance sheet, income statement, cash-flow statement and notes to the accounts form the integral part of the accounts) is to provide information about the financial position of enterprise that is useful to a wide range of users in making economic decisions.

IAS 1 sets out the financial statement definition of equity, assets, liabilities, income and expense elements, current and non-current assets and liabilities. It uses the four characteristic principles of understandability, comparability, reliability and relevance and states that information must be presented fairly which is achieved by compliance with IAS.

(iii)

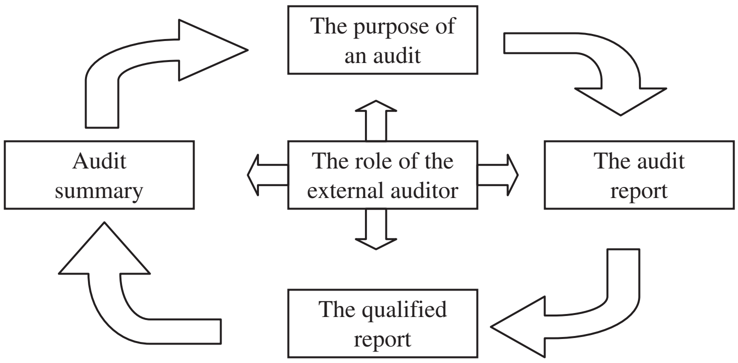
In the unlikely event that management decides that compliance with a particular requirement would result in misleading information which would conflict with the objective of financial statement set out in the framework, they can depart from that requirement in order to achieve fair presentation. In this event the enterprise should **disclose:**

- that the management has concluded that the financial statements are a fair presentation of the enterprise's financial position, performance and cash flows.
- that it has complied with all relevant IFRSs and has departed from a standard to achieve fair presentation
- the IFRS that it has departed from and details of the required treatment, why it was misleading and the treatment that has been adopted
- and the financial impact of the departure

All the above were reflected in the consolidated financial statements of Shering Aktiengesellschroft (Schering AG) for the year ended 31st December 2003.

The Role of the External Auditors

8

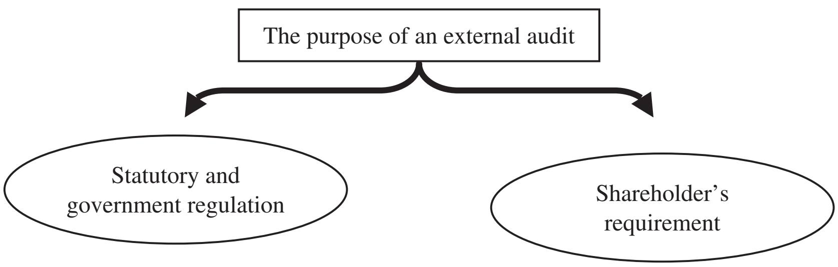


The background of external auditing

The role of the auditor goes back to many hundreds of years. There are records from ancient Egypt and the Roman Empire showing that people were employed to review work done by tax collectors and estate managers.

The word *AUDIT* is a Latin word meaning *LET IT BE HEARD*, i.e. the auditor is requiring responsible managers to explain their transactions.

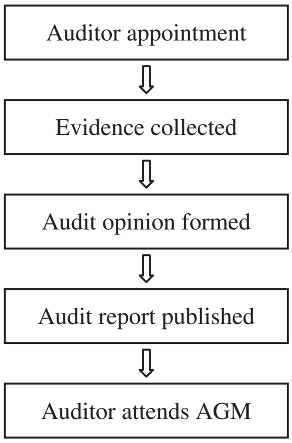
In medieval Britain, an independent auditor was employed by the feudal Barons to ensure profits from tenant farmers are accurately reflected in revenue receipt from the estate. Initially the focus was very much on the detection of fraud and other irregularities. However over time this emphasis of the external auditors has changed and the role of the auditor become much broader.



The External Auditor's duties:

- To express an independent opinion to whether the financial statement gives a true and fair view . . .
- To consider the company kept proper accounting records: The agreement between balance sheet and income statement with the underlying accounting records . . .

The audit process – steps in the auditing cycle



Auditing is governed by a comprehensive set of International Standards on Auditing (ISAs) issued by the International Auditing Practices Committee (IAPC). The IAPC is a committee of the International Federation of Accountants (IFAC). Membership of IFAC is open to accountancy bodies worldwide and automatically includes membership of the IASC.

The auditors gather evidence from phases of the audit

1 Bookkeeping phase
2 Accounting phase.

The audit report

- The provision of a clear expression of independent opinion on the financial statements lies at the heart of the external audit.
- Auditor's report
  - Appropriate addressee
  - Auditor
  - Date
  - Address
- The details of an audit report – ISA 700 The Auditor's Report on Financial Statement comprises of:
  - Title
  - Addressee
  - Opening or introductory paragraph
  - Scope paragraph
  - Opinion paragraph

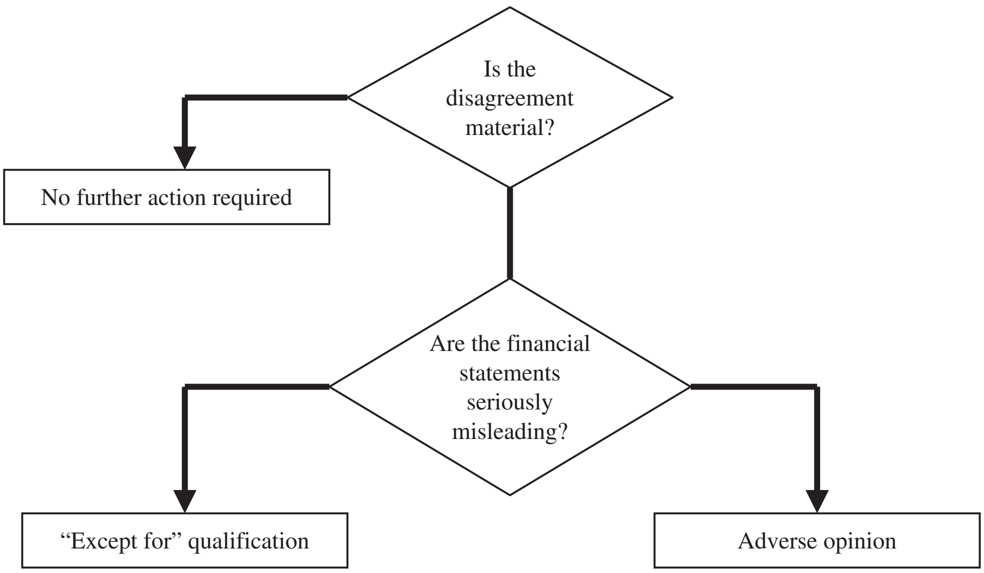
  - Date of report
  - Auditor's address
  - Auditor's signature
- Qualified Report

  The auditor has to conclude that the statement gives a true and fair view. Although in some cases it might be more difficult to do so. If the auditor is involved in a particular problem then he has to collect additional evidence before making a conclusion.

Materiality

The definition of a matter is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statement.

The materiality cannot be measured in terms of any objectives criteria. Some audit firms use rules of thumb and treat anything which exceeds. Normally it falls in between 5 and 10% of profit or 1 and 1.2% of turnover.



Classifying disagreement on the financial statements

Multiple choice questions

8.1 When is there sufficient audit evidence?

A When it substantiates the auditor's conclusion
B When the allotted time has been utilised
C When there is more evidence than was documented in previous years
D When 100% of the transactions have been tested

8.2 The demand for independent audits is now much greater than 50 years ago because of increased information risks. The following are possible factors that increase the likelihood that unreliable information will be provided, EXCEPT:

A the use of estimates
B voluminous data
C complex transactions
D the cost of information

8.3 A large amount of audit time is usually spent on cash transactions audits, EXCEPT for which of the following:

A cash is the end result of most transactions
B cash is susceptible to misappropriation
C it is expected that cash balances should be more precisely determined than other accounting figures
D all cash is deposited by the business into its bank account

8.4 Why do we need (audited) financial statements?

A To show details of revenues and expenses
B To provide fair, objective and independent opinions
C To identify who the shareholders are
D To summarise computer books and records

8.5 Unaudited financial statements may not be reliable because:

A they include economic data
B they are based on historical data
C the target audience includes shareholders
D the level of assurance provided is lower than in an audit

8.6 As an external auditor, what would be the responsibility of undertaking an audit assignment of a client?

A To examine the financial account produced by the management
B To form an opinion about the financial account of the client
C To form an opinion of true and fair view of financial affair with the business board of director's influence
D To form an Independent opinion of true and fair view of financial affair of the business

8.7 Which of the following is a good reason why the auditor should properly plan an audit?

A to enable the auditor to obtain sufficient appropriate audit evidence
B to complete the audit in a timely fashion
C to enable the disclosure of the scope and purpose of the audit
D all of the above

8.8 The following are ways in which a client can be contacted to arrange an audit, EXCEPT for one of the following. Which one?

A By telephone
B In writing
C A surprise visit
D Contacting the client's authorised representative

8.9 In which order should the following four steps be taken when an auditor evaluates a client's internal control?

(i) Determine internal controls that should prevent or detect errors and other irregularities
(ii) Identify weaknesses to determine their effect on the extent of auditing procedures to apply
(iii) Determine whether the necessary procedures are being followed satisfactorily
(iv) Consider the type of errors or fraud and other irregularities that could occur

A (i), (ii), (iii) and (iv)
B (i), (iii), (iv) and (ii)
C (iv), (i), (iii) and (ii)
D (iii), (iv), (i) and (ii)

8.10 An audit manual:

A is a guide for the conduct of an examination
B takes the place of professional judgment
C applies to specific industries
D should be updated after each audit

8.11 A tour of a company's premises:

A is not important, as the books and records suffice for the audit
B is not important, as the tour is time-consuming
C is important, as it provides additional information
D does not affect the audit results

✓ Multiple choice answers

8.1 **A**

8.2 **D**

8.3 **D**

8.4 **B**

8.5 **D**

8.6 **D**

8.7 **D**

8.8 **C**

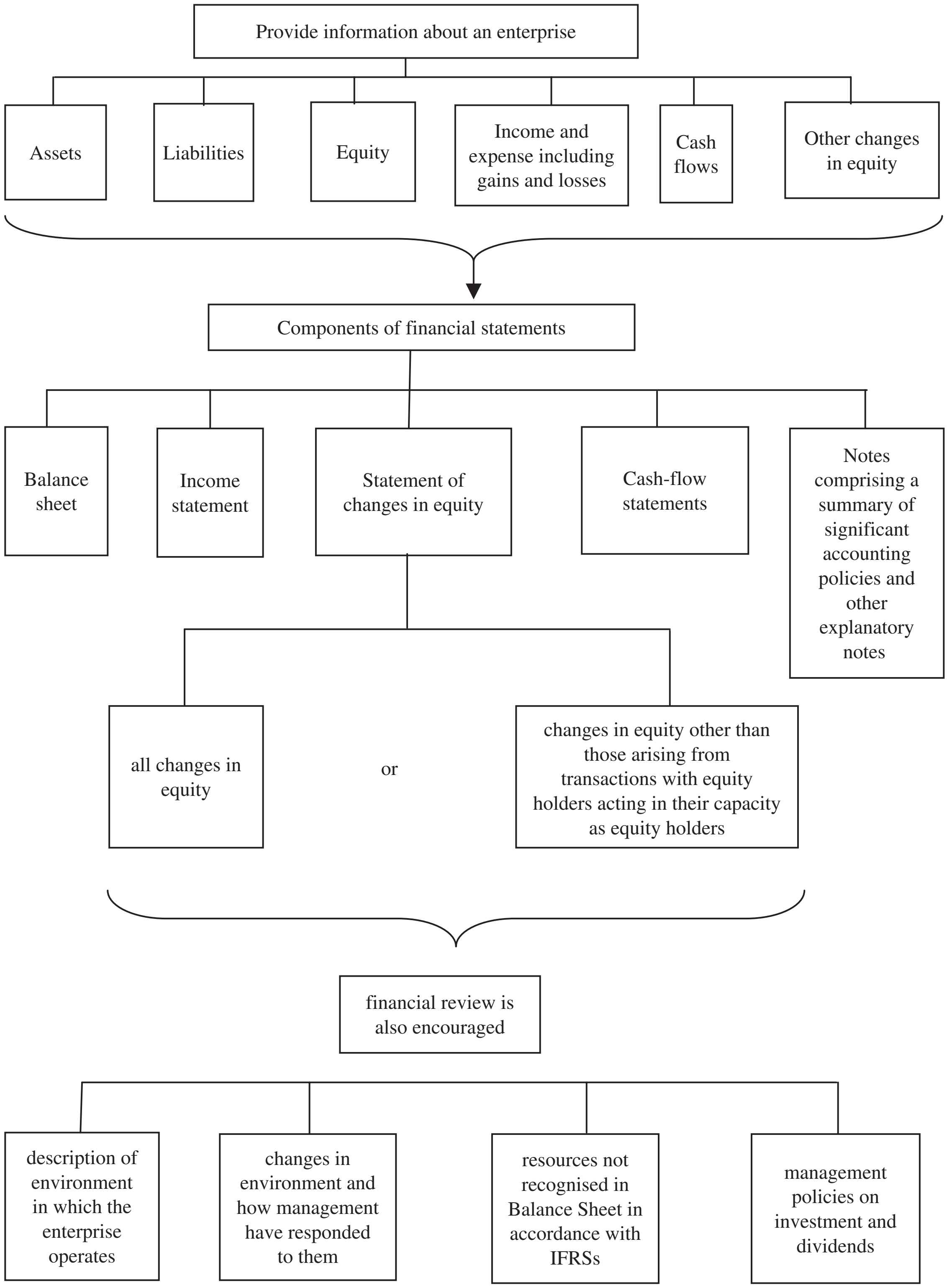
8.9 **C**

8.10 **A**

8.11 **C**

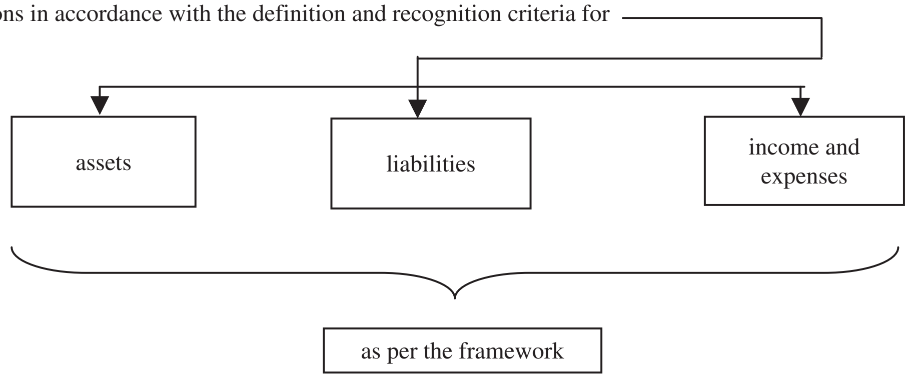
Published Financial Statements

9

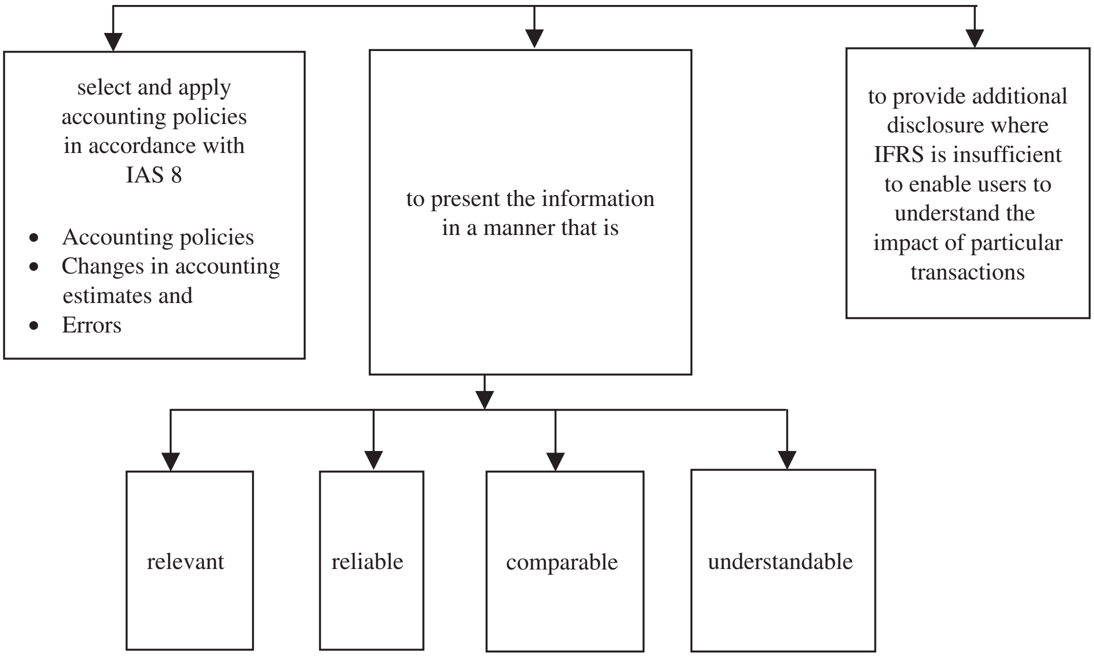

Provide information about an enterprise
Assets
Liabilities
Equity
Income and expense including gains and losses
Cash flows
Other changes in equity
Components of financial statements
Balance sheet
Income statement
Statement of changes in equity
Cash-flow statements
Notes comprising a summary of significant accounting policies and other explanatory notes
all changes in equity
or
changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders
financial review is also encouraged
description of environment in which the enterprise operates
changes in environment and how management have responded to them
resources not recognised in Balance Sheet in accordance with IFRSs
management policies on investment and dividends

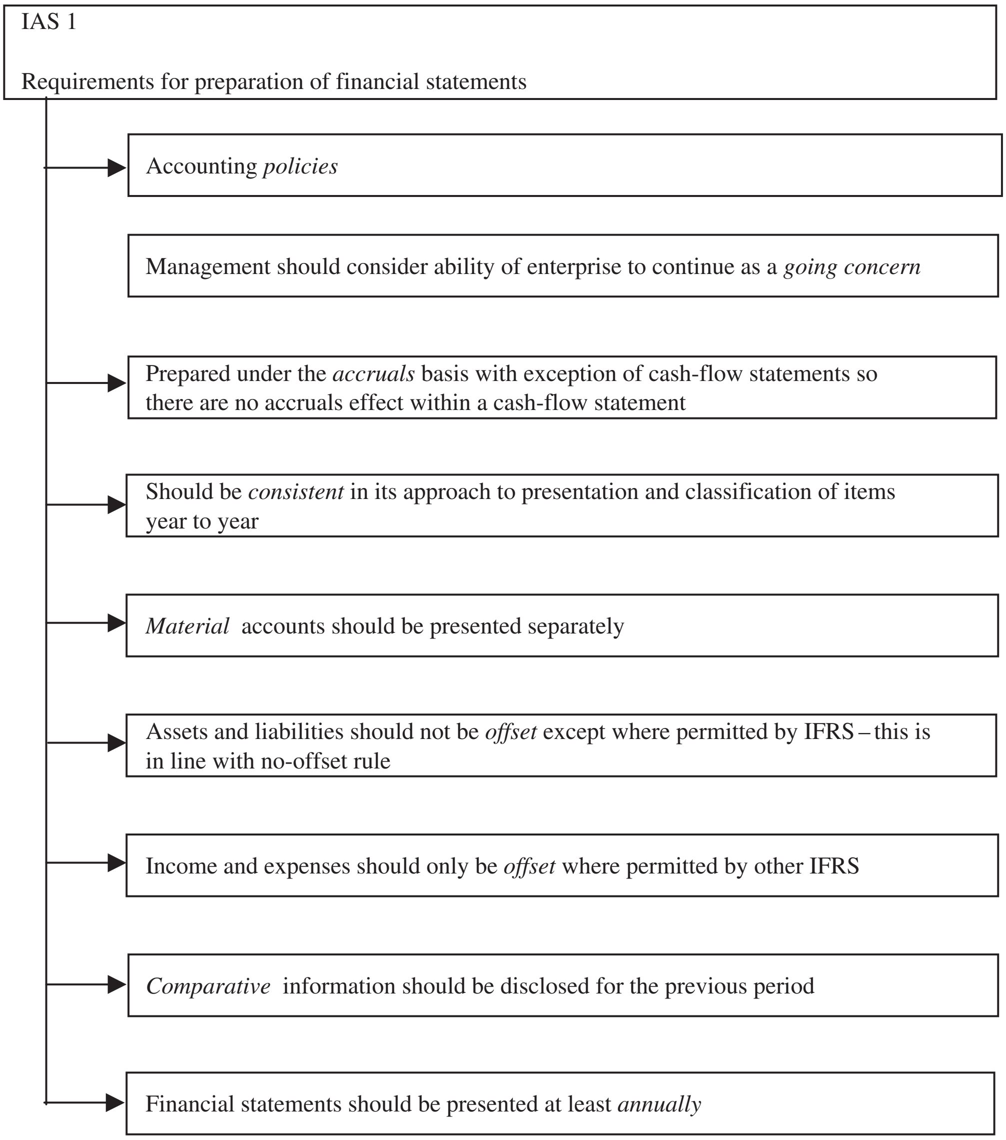
Financial statements should present fairly the *financial position, financial performance and cash flow of an enterprise.*

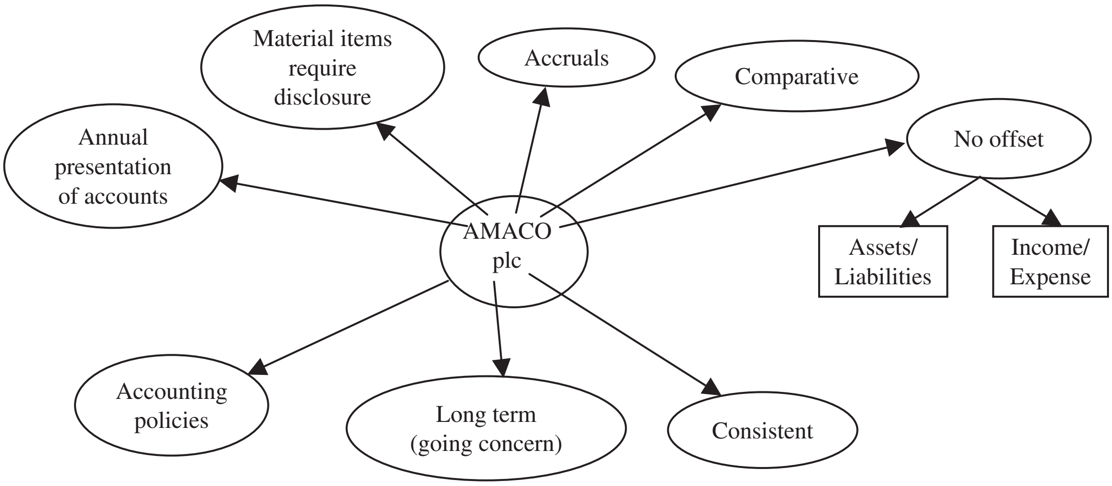
Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definition and recognition criteria for

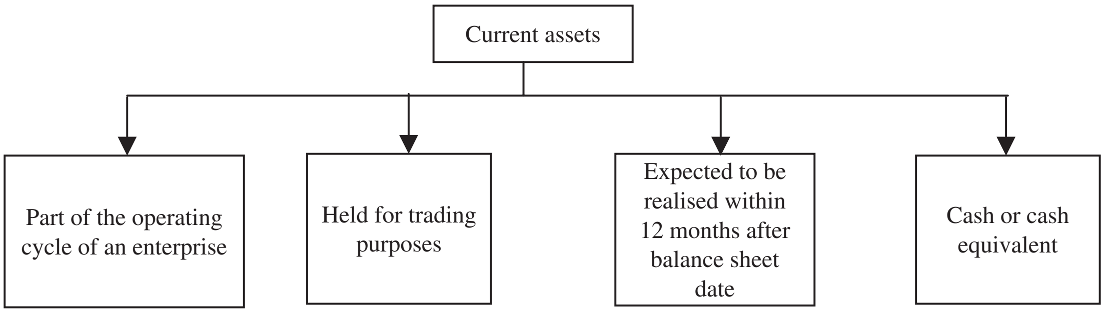


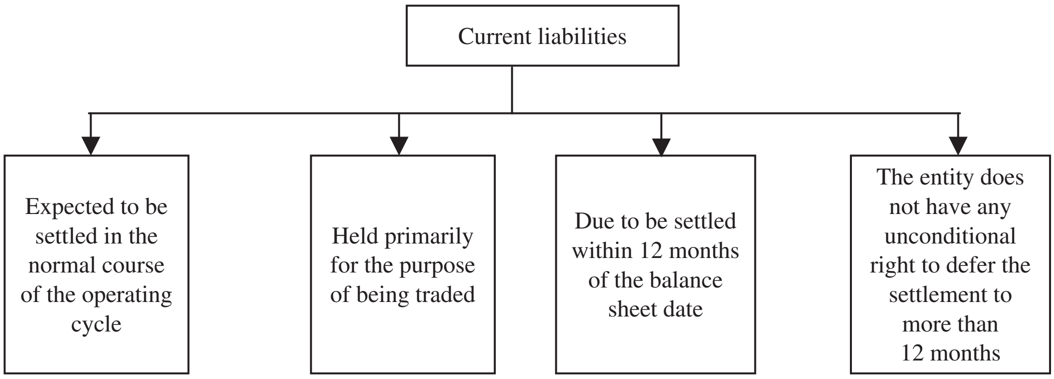
IFRS expects additional disclosure in achieving a fairer presentation and also requires an entity to

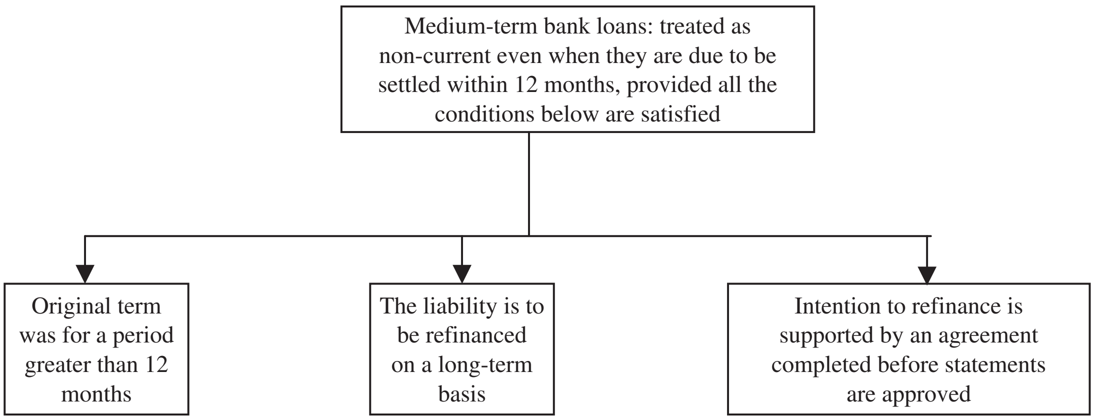



IAS 1
Requirements for preparation of financial statements
Accounting *policies*
Management should consider ability of enterprise to continue as a *going concern*
Prepared under the *accruals* basis with exception of cash-flow statements so there are no accruals effect within a cash-flow statement
Should be *consistent* in its approach to presentation and classification of items year to year
Material accounts should be presented separately
Assets and liabilities should not be *offset* except where permitted by IFRS – this is in line with no-offset rule
Income and expenses should only be *offset* where permitted by other IFRS
Comparative information should be disclosed for the previous period
Financial statements should be presented at least *annually*


Material items require disclosure
Accruals
Comparative
Annual presentation of accounts
No offset
AMACO plc
Assets/ Liabilities
Income/ Expense
Accounting policies
Long term (going concern)
Consistent


Current assets
Part of the operating cycle of an enterprise
Held for trading purposes
Expected to be realised within 12 months after balance sheet date
Cash or cash equivalent


Current liabilities
Expected to be settled in the normal course of the operating cycle
Held primarily for the purpose of being traded
Due to be settled within 12 months of the balance sheet date
The entity does not have any unconditional right to defer the settlement to more than 12 months


Medium-term bank loans: treated as non-current even when they are due to be settled within 12 months, provided all the conditions below are satisfied
Original term was for a period greater than 12 months
The liability is to be refinanced on a long-term basis
Intention to refinance is supported by an agreement completed before statements are approved

Assets = Liabilities + Capital

Balance sheet as at 31 December 2003

	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment	X	
Goodwill	X	
Other intangible assets	X	
Available for sale investments	X	
		X
Current assets		
Inventories	X	
Trade receivables	X	
Other current assets	X	
Cash and cash equivalents	X	
		X
Total assets		X
Equity and liabilities		
Equity		
Share capital	X	
Other reserves	X	
Retained earnings*	X	
Total equity		X
Non-current liabilities		
Long-term borrowings	X	
Deferred tax	X	
Long-term provisions	X	
Total non-current liabilities		X
		X
Current liabilities		
Trade and other payables	X	
Short-term borrowings (overdraft)	X	
Current portion of long-term borrowings	X	
Current tax payable	X	
Short-term provisions	X	
Total current liabilities		X
Total liabilities		X
Total equity and liabilities		X

may be re-classified as per IAS 16

as per IAS 2
- Merchandise
- Production supplies
- Work-in-progress
- Materials
- Finished goods

- Trade customers
- Related parties
- Prepayments
- Other amounts

IAS 1

- paid up
- share premium
- reserves

* accumulated funds

IAS 1

Share capital and reserves disclosure

- for each class of share capital
  - number of shares authorised
  - reconciliation of shares outstanding at start and end of year
  - number of shares issued and fully paid
  - shares under options and sale contract
  - the rights, preferences and restrictions attached to that class
  - shares held by enterprise itself or by subsidiaries or associates
  - par value per share
- for reserves
  - nature and purpose of reserve within owners equity
  - dividend to be proposed or declared
    - Note under IAS 1 and IAS 10. DO NOT allow proposed dividend to be included as a liability in the balance sheet (or as distribution of profit) UNLESS the dividend was declared before balance sheet date
  - amount of any cumulative preference dividend not recognised

Income statement for the year ended 31 December 2003

(nature of expenditure note)
(for manufacturing enterprises)

- Changes in inventories of finished goods and work in progress
- Raw material and consumables
- Staff costs
- Depreciation

	$'000
Revenue	X
• Cost of sales	(X)
• Gross profit	X
• Other income	X
• Distribution costs	(X)
• Administrative expenses	(X)
• Other expenses	(X)
	X
• Finance cost (interest cost)	(X)
• Profit before tax	X
• Income tax expense	(X)
Profit for the period	X

Disadvantages

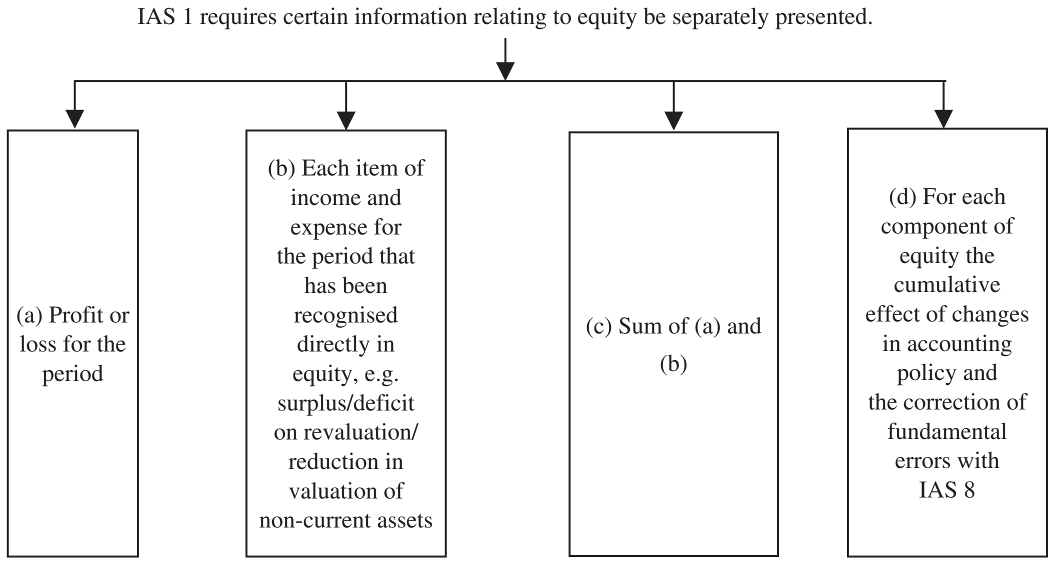
- Classification of expenses is often arbitrary and based on management judgement
- Does not show analysis of some important expenses and hence under IAS 1 additional information must be disclosed in the notes to the accounts

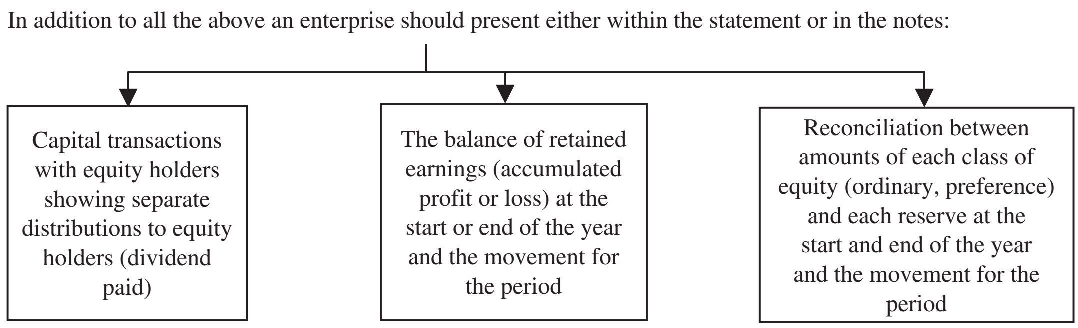
depreciation

employee benefit cost

Changes in equity

Change in equity between two Balance Sheet dates reflects increase or decrease in net assets or wealth of the company, which is useful information to users of accounts excluding changes resulting from transactions with shareholders (capital injections and dividends).





Statement of changes in equity for the year ended 31 December 2004

	Share capital $'000	*Other reserves** $'000	*Translation reserve* $'000	*Retained earnings* $'000	*Total* $'000
Balance as at 31.12.04	X	X	X	X	X
Changes in accounting policy				X/(X)	X/(X)
Restated balance	X	X	X	X/(X)	X/(X)
Gain on property revaluation		X			X
Deficit on revaluation of property		(X)			(X)
Available for sale investments:					
Valuation gains and losses taken to equity		(X)			(X)
Transferred to profit or loss on sale		(X)			(X)
Cash-flow hedges:					X/(X)
Gains/(losses) taken to equity		X/(X)			X/(X)
Transferred to profit or loss for the period		X/(X)			X/(X)
Transferred to initial carrying amount of hedged items		(X)			(X)
Exchange differences on translating foreign operations		(X)			(X)
Tax on items taken direct or transferred from equity	(X)	X			X
Net Income recognised directly in income	X	(X)			
Profit for the period				X	X
Total recognised income and expenses for the period		X		X	X
Dividends				(X)	(X)
Issue of share capital	X				(X)
Equity share options issued		X			X
Balance at 31.12.05	X	X	X	X	X

* Other reserves are analysed into their components if material.

Questions

9.1 What are the components and elements of the financial statements of a company and also discuss the financial reviews which are encouraged?

(8 marks)

9.2 Discuss why financial statements should be presented fairly in accordance with IFRS.

(5 marks)

9.3 What are the requirements for preparation of financial statements as per IAS 1?

(5 marks)

9.4 How are current assets defined by IAS 1?

(3 marks)

9.5 How are current liabilities defined by IAS 1?

(3 marks)

9.6 What items must be shown, as a minimum requirement, on the face of the balance sheet?

(5 marks)

9.7 What items in the balance sheet must be sub-classified? State relevant IASs, where applicable.

(4 marks)

9.8 The following is an extract from the list of balance of Ideal Promotions at 31 March 2004, after the necessary year-end adjustments have been made:

	Debit $'000	*Credit* $'000
Cost of sales	3,646	
Revenue		8,974
Distribution costs	1,094	
Administrative expenses	1,948	
Loan interest	1,294	
Other income		50

Requirement

Show the first part of the income statement of the company using the function of expenditure method.

(5 marks)

9.9 The directors of Ideal Promotions are interested to see how the income statement would look if it were prepared using nature of expenditure method. You discover that the sum of cost of sales, distribution and administrative expenses which appear in the original income statement as 6,688 (3,646 + 1,094 + 1,948) can be alternatively analysed as:

	$'000
Increase in inventories of financial goods and WIP	104
Raw materials and consumables	1,750
Depreciations	1,886
Staff costs	2,130
Other operating expenses	1,026

Requirement

Show the income statement down to profit before tax using the nature of expenditure method.

(7 marks)

9.10 Past exam question

Trial Balance at 30 September 2001

	Notes	$'000	$'000
Revenue			430
Inventory (at 1.10.2000)		10	
Purchases		102	
Advertising		15	
Administration salaries		14	
Manufacturing wages		57	
Interest paid		14	
Dividends received	(d)		12
Audit fee		7	
Bad debts		10	
Taxation	(d)	10	
Dividends paid	(d)	120	
Premises (cost)	(b)	450	
Plant (cost)	(c)	280	
Premises (depreciation)			40
Plant (depreciation)			160
Investment (long term)		100	
Trade receivables		23	
Bank		157	
Payables			7
Deferred taxation	(e)		89
Loan notes			140
Share capital			100
Retained earnings (at 1.10.2000)			391
		1,369	1,369

Notes:

(a) Inventory was worth $13,000 on 30 September 2001.
(b) Premises consist of land costing $250,000 and building costing $200,000. The buildings have an expected useful life of 50 years.
(c) Plant includes an item purchased during the year at a cost of $70,000. These were the only transactions involving non-current assets during the year.

Depreciation of plant is to be charged at 10 per cent per annum on straight-line basis.

(d) The balance on the tax account is underprovision for tax brought forward from the year ended 30 September 2000.

The enterprise paid $48,000 on 27 November 2000 as a final dividend for the year ended 30 September 2000. A dividend of $12,000 was received on 13 January 2001.

The 2001 interim dividend was paid on 15 April 2001.

(e) The provision for deferred tax is to be reduced by $17,000.
(f) The directors have estimated that tax of $57,000 will be due on the profits of the year.
(g) The directors have proposed a final dividend for the year of $50,000.

Requirements

Prepare an income statement for V for the year ended 30 September 2001, a statement of changes in equity and a balance sheet at that date. These should be in a form suitable for presentation to the shareholders in accordance with the requirements of IFRSs and be accompanied by notes to the accounts so far as possible from the information given above.

You are not required to prepare the note relating to accounting policies.

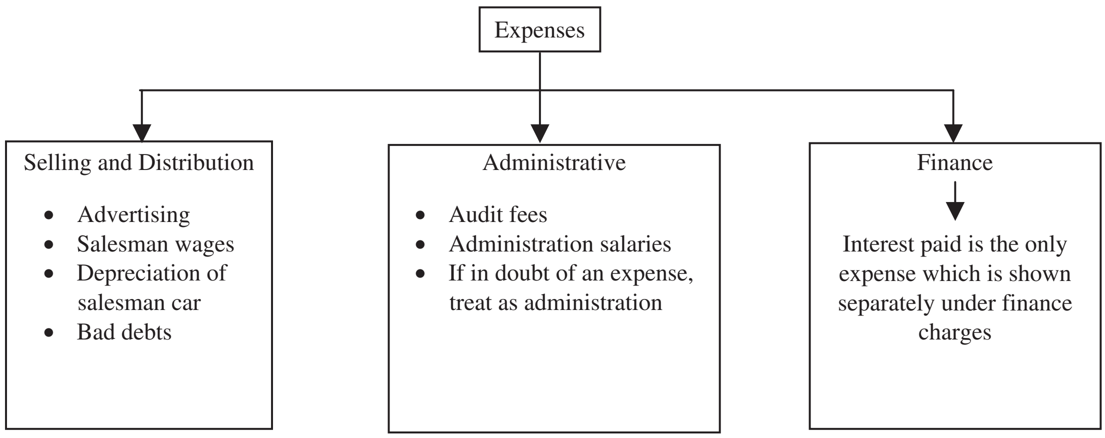
(25 marks)

Revenue	$'000
Sales	X
Less:	
Trade discount	(X)
Return inwards	(X)
Overstated sales	(X)
Understated sales	X
VAT on sales	(X)
Revenue/Turnover	X

Cost of Sale	$'000	$'000
Opening inventories		X
Add:		
Purchases	X	
Less:		
Return outwards	(X)	
Add:		
Carriage onwards	X	
Add:		
Overstated purchases	(X)	
Less:		
Overstated purchases	X	
Less:		
VAT on purchases	X	
	X	
Less:		
Closing inventories	(X)	
Net purchases	X	X
Cost of sales		X

Notes:

If manufacturing company, you need to add factory wages and depreciation of plant, building, etc. to Cost of Sales. Read the exam question as they normally guide to where to allocate the factory wages and depreciation cost.



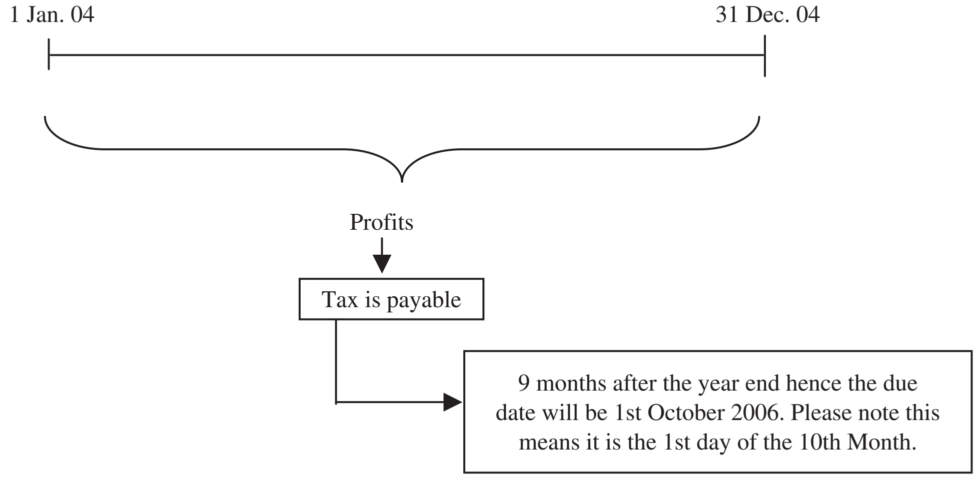
Investment income: Normally these will be made up of dividends the enterprise receives and will be stated in the notes to the question.

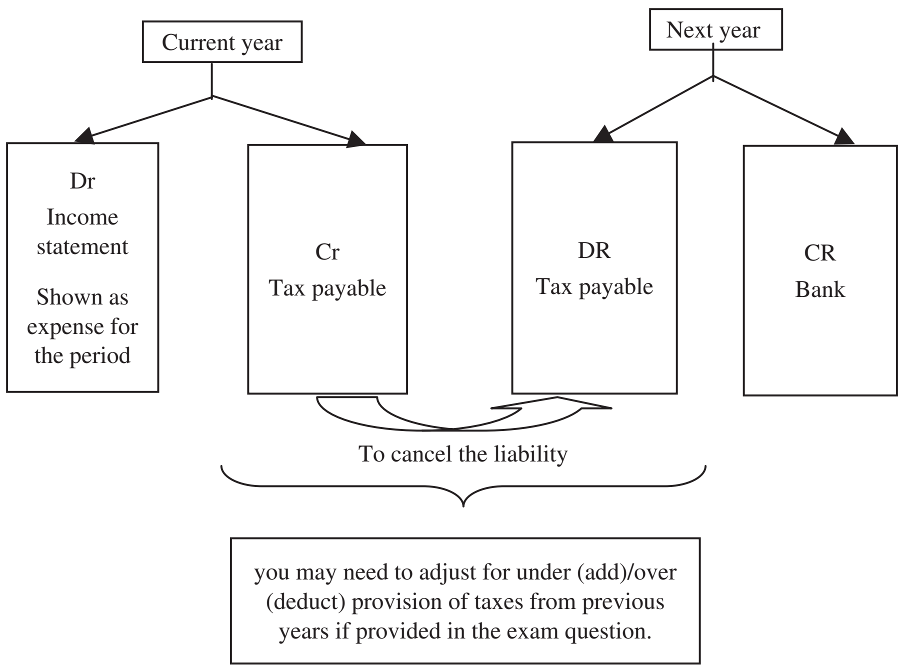
Profit before tax: Other names for this are

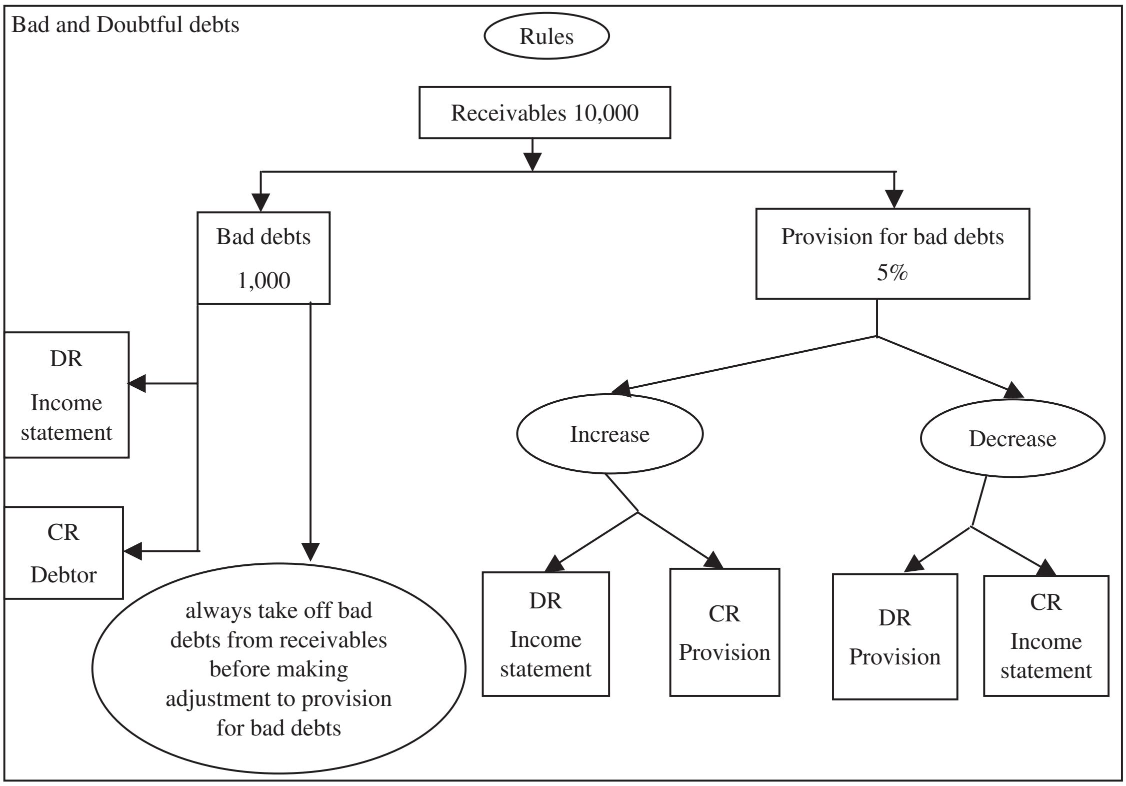
- Profit on ordinary activities before tax
- Profit before interest and tax

Taxation:

Points to consider:
Never calculate the tax figure in the exam question, it will always be given to you in the additional notes to the question.







Hence

Receivables	10,000	Receivables	10,000
Bad debts write-off	(1,000)	Provision 5%	(500)
	9,000		9,500
Provision for bad debts 5%	(450)	Bad debts write-off	(1,000)
	8,550		8,500
	Correct answer		Wrong answer

9.11 The following trial balance was extracted from the books of U at 31 March 2004:

	$'000	$'000
5% loan notes		10,000
Administration expenses	5,900	
Bank	4,200	
Buildings at valuation (at 31.3.03)	50,000	
Cost of goods sold	66,200	
Distribution expenses	1,600	
Dividend paid	1,500	
Inventories (at 31.3.03)	6,100	
Land at valuation (at 31.3.03)	6,000	
Loan note interest (six months to 30.9.03)	250	
Ordinary shares $1 each		25,000
Payables		9,539
Plant and machinery at cost	30,000	
Provision for depreciation – buildings (at 31.3.03)		5,000
Provision for depreciation – plant and machinery (at 31.3.03)		10,000
Provision for doubt receivables (at 31.3.03)		400
Receivables	14,300	
Retained profit (at 31.3.03)		4,411
Revaluation reserve – land and buildings		3,000
Revenue		101,050
Share premium account		17,650
	186,050	186,050

Additional information available was as follows:

(i) The directors had a valuation carried out on the land and buildings by an independent valuer and were informed that at 31 March 2004 the buildings' value was $39,000,000. The directors had decided to adjust the valuation of the buildings in the financial statements for the year ended 31 March 2004. The land was revalued at $6,000,000 at 31 March 2003 and had not changed at 31 March 2004. The land had originally cost $4,000,000. The buildings had originally cost $53,260,000 on 1 April 1994 and were revalued on 31 March 1998.

(ii) Depreciation on buildings is regarded as an administrative expense and is 2% of gross valuation per annum. Depreciation on plant and machinery is regarded as a 'cost of sales' expense and is at 20% per annum on cost.

(iii) On 15 April 2004, U was advised that one of its major customers had gone into liquidation. The outstanding balance on their account at 31 March 2004 was $3,059,000. It is very unlikely that any money will be received from the liquidator.

(iv) Because of the recent increase in bankruptcies, U have decided that it would be prudent to increase the provision for doubtful receivables to 5% of the receivables' balance.

(v) Income tax due for the year is estimated at $5,660,000.

(vi) During the year, the directors made a bonus issue; all existing shareholders received one new share free for every four shares held.

Requirements

(i) Explain, with reference to International Accounting Standards, how item (i) above, the valuation of land and buildings, should be treated in U's income statement for the year ended 31 March 2004 and its balance sheet at that date.
(5 marks)

(ii) Prepare U's income statement for the year ended 31 March 2004 and its balance sheet at that date, in a form suitable for presentation to the shareholders, in accordance with all current regulations.
(16 marks)

(iii) Prepare U's disclosure note for movement on reserves.
(4 marks)
(Total = 25 marks)

9.12 V imports electronic goods and resells these to large retail organisations. It specialises in luxury products such as electronic games and portable audio equipment. Almost half of the company's sales occur during the months of October and November.

V faces intense competition and attempts to compete by anticipating consumer trends and offering products which are new to the market.

The company's trial balance at 30 September 2007 is as follows:

	$'000	$'000
Sales revenue		9,800
Purchases	1,300	
Inventory (at 30.9.06)	480	
Warehouse and delivery wages	350	
Sales commissions	180	
Sundry distribution costs	310	
Sundry administration expenses	85	
Administration staff salaries	240	
Legal fees and damages	270	
Income tax	45	
Interim dividend paid	600	
Warehouse premises – cost	8,500	
Warehouse premises – depreciation		800
Computer network – cost	900	
Computer network – depreciation		200
Delivery vehicles – cost	700	
Delivery vehicles – depreciation		280
Trade receivables	910	
Trade payables		470
Bank	90	500
Loan – repayable 20Y2		
Loan interest	5	110
Application and allotment		1,000
Share capital		1,805
Accumulated profits		
	14,965	14,965

Notes:

(i) The closing inventory was counted on 30 September 2007 and was valued at $520,000.
(ii) The legal fees and damages were paid in settlement of a claim against V. A wiring fault in a compact disc player had caused a fire in a customer's store. This is the first time that such an event has occurred. V has introduced safety checks on new products which will help to prevent any recurrence of this type of accident.
(iii) Depreciation has still to be charged for the year on the following bases:
Warehouse premises 2% of cost
Computer network 25% of book value
Vehicles 25% of book value.
(iv) The tax charge for the year has been estimated at $1,900,000.
(v) In October 2007 the directors proposed a final dividend of $1,000,000.
(vi) The company is in the process of issuing 200,000 new shares. V's shares have a nominal value of $1.00 each. At the year end the company had received $110,000 from applicants for the new issue. This balance should be treated as a current liability in the balance sheet at 30 September 2007.

Requirement

Prepare an income statement and statement of changes in equity for the year ended 30 September 2007, and balance sheet at that date, together with notes to the financial statements for V. These should be in a form suitable for publication insofar as is possible given the information provided. You are NOT required to provide a statement of accounting policies.

(20 marks)

9.13 Percy

The following information has been extracted from the accounting records of Percy.

Trial balance at 31 March 2004

	$'000	$'000
Sales revenue		5,000
Cost of sales	1,350	
Interest received		210
Administration	490	
Distribution	370	
Interest payable	190	
Application and allotment		300
Income tax		20
Dividends paid	390	
Tangible non-current assets	4,250	
Short-term investments	2,700	
Inventory	114	
Receivables	443	
Bank	12	
Payables		116
Non-current loans (repayable 21X2)		1,200
Share capital		1,500
Share premium		800
Accumulated profits		1,163
	10,309	10,309

(i) The balance on the application and allotment account represents money received from the issue of 200,000 $1 shares at a premium of 20 cents per share. This offer was oversubscribed. The shares were allotted on 28 March 2004. Applicants received four fully-paid shares for every five applied for, and surplus payments were refunded in April 2004. No entries had been made in the accounting records in respect of the allotment by 31 March 2004.

(ii) During the year, the company paid a final dividend of $240,000 in respect of the year ended 31 March 2003. This was in addition to the interim dividend of $150,000 paid on 1 September 2003 in respect of the year ended 31 March 2004. The balance on the income tax account is the balance remaining from the settlement of the estimated income tax charge for the year ended 31 March 2003.

(iii) The income tax charge for the year has been estimated at $470,000.

(iv) In April 2004 the directors proposed a final dividend of $270,000.

You are required to prepare an income statement, a statement of changes in equity and balance sheet for the year ended 31 March 2004. These should be in a form suitable for publication.

Your answer should include any notes intended for publication and these should be distinguished from workings.

You are not required to provide a note on accounting policies.

(20 marks)

9.14 Hi plc Nov 2003

Hi, listed on its local stock exchange, is a retail organisation operating several retail outlets. A reorganisation of the enterprise was started in 2002 because of a significant reduction in profits. This reorganisation was completed during the current financial year.

The trial balance for Hi at 30 September 2003 was as follows:

	$'000	$'000
10% loan notes (redeemable 2010)		1,000
Accumulated profits at 30.9.02		1,390
Administrative expenses	615	
Bank and cash	959	
Buildings	11,200	
Cash received on disposal of equipment		11
Cost of goods sold	3,591	
Distribution costs	314	
Equipment and fixtures	2,625	
Interest paid on loan notes – half year to 31.3.03	50	
Interim dividend paid	800	
Inventory at 30.9.03	822	
Investment income received		37
Non-current asset investments at market value 30.9.02	492	
Ordinary shares of $1 each, fully paid		4,000
Provision for deferred tax		256
Provision for reorganisation expenses at 30.9.02		1,010
Provision for depreciation at 30.9.02		
Buildings		1,404
Equipment and fixtures		1,741

	$'000	$'000
Reorganisation expenses	900	
Revaluation reserve		172
Sales revenue		9,415
Share premium		2,388
Trade payables		396
Trade receivables	852	
	23,220	23,220

Additional information provided:

(i) The reorganisation expenses relate to a comprehensive restructuring and reorganisation of the enterprise that began in 2002. Hi's financial statements for 2002 included a provision for reorganisation expenses of $1,010,000. All costs had been incurred by the year end, but an invoice for $65,000, received on 2 October 2003, remained unpaid and is not included in the trial balance figures. No further restructuring and reorganisation costs are expected to occur and the provision is no longer required.

(ii) Non-current asset investments are carried in the financial statements at market value. The market value of the non-current asset investments at 30 September 2003 was $522,000. There were no movements in the investments held during the year.

(iii) On 1 November 2003, Hi was informed that one of its customers, X, had ceased trading. The liquidators advised Hi that it was very unlikely to receive payment of any of the $45,000 due from X at 30 September 2003.

(iv) Another customer is suing for damages as a consequence of a faulty product. Legal advisers are currently advising that the probability of Hi being found liable is 75%. The amount payable is estimated to be the full amount claimed of $100,000.

(v) The income tax due for the year ended 30 September 2003 is estimated at $1,180,000 and the deferred tax provision needs to be increased to $281,000.

(vi) During the year, Hi disposed off old equipment for $11,000. The original cost of this equipment was $210,000 and accumulated depreciation at 30 September 2002 was $205,000. Hi's accounting policy is to charge no depreciation in the year of the disposal.

(vii) Depreciation is charged using the straight-line basis on non-current assets as follows:
Buildings 3%
Equipment and fixtures 20%

Depreciation is regarded as a cost of sales.

On 1 April 2003, Hi made a rights issue of 1 new share for 4 existing shares, at a price of $3. The fair value of one share prior to the rights issue was $4.25 per share. All the rights were taken up and all money paid by 30 September 2003.

Requirements

(i) Prepare the income statement for Hi for the year to 30 September 2003 and a balance sheet at that date, in a form suitable for presentation to the shareholders, in accordance with the requirements of International Accounting Standards.

Notes:

Notes to the financial statements are NOT required, but all workings must be clearly shown. DO NOT prepare a statement of accounting policies or a statement of recognised gains and losses.

(20 marks)

(ii) Prepare a statement of changes in equity for Hi for the year ended 30 September 2003.

(5 marks)

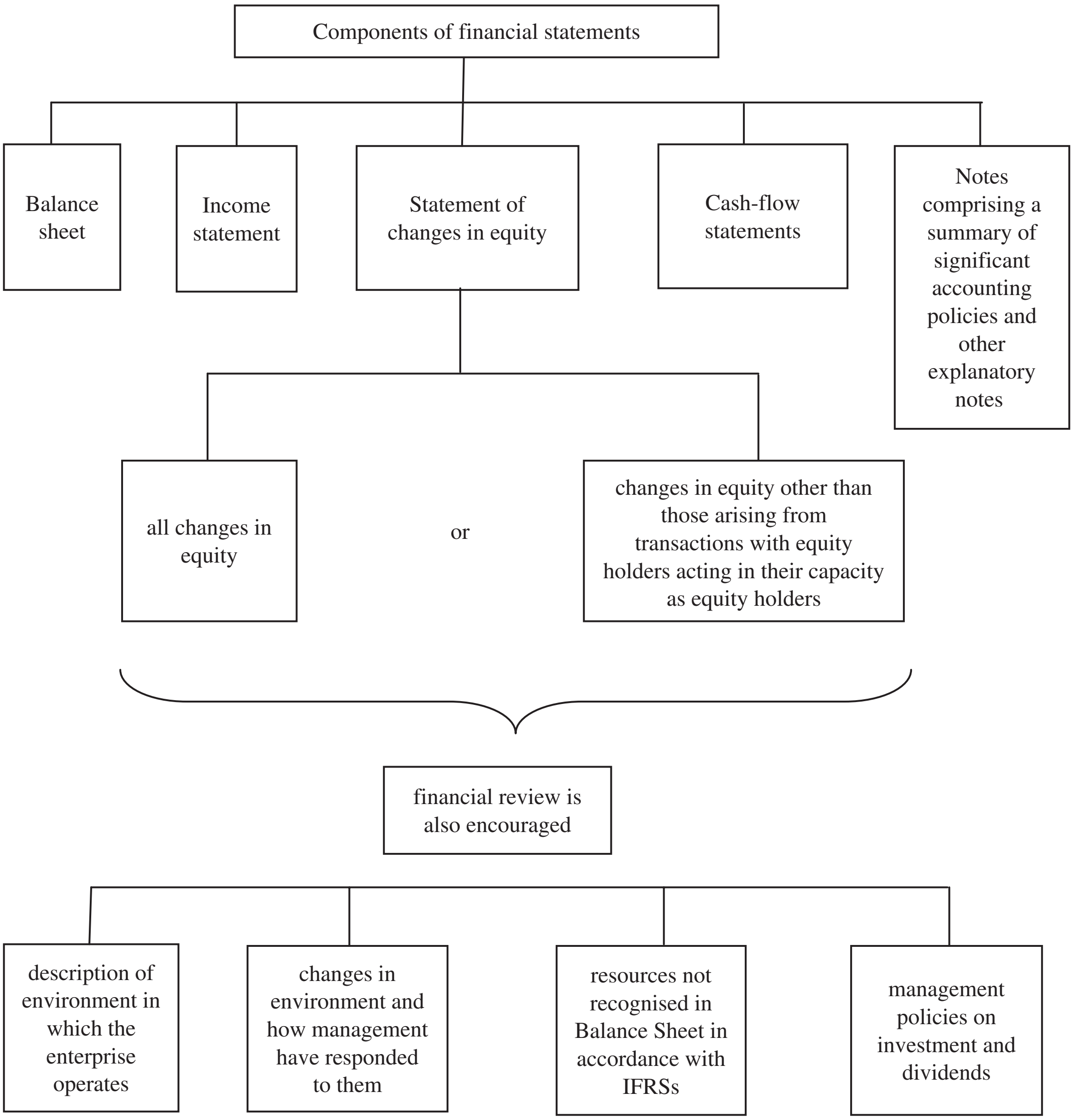
(iii) Calculate Hi's earnings per share for the year ended 30 September 2003.

(5 marks)

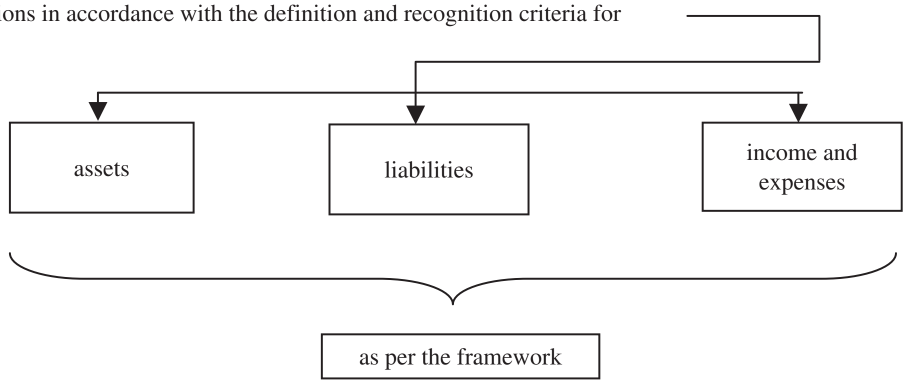
(Total = 30 marks)

Answers

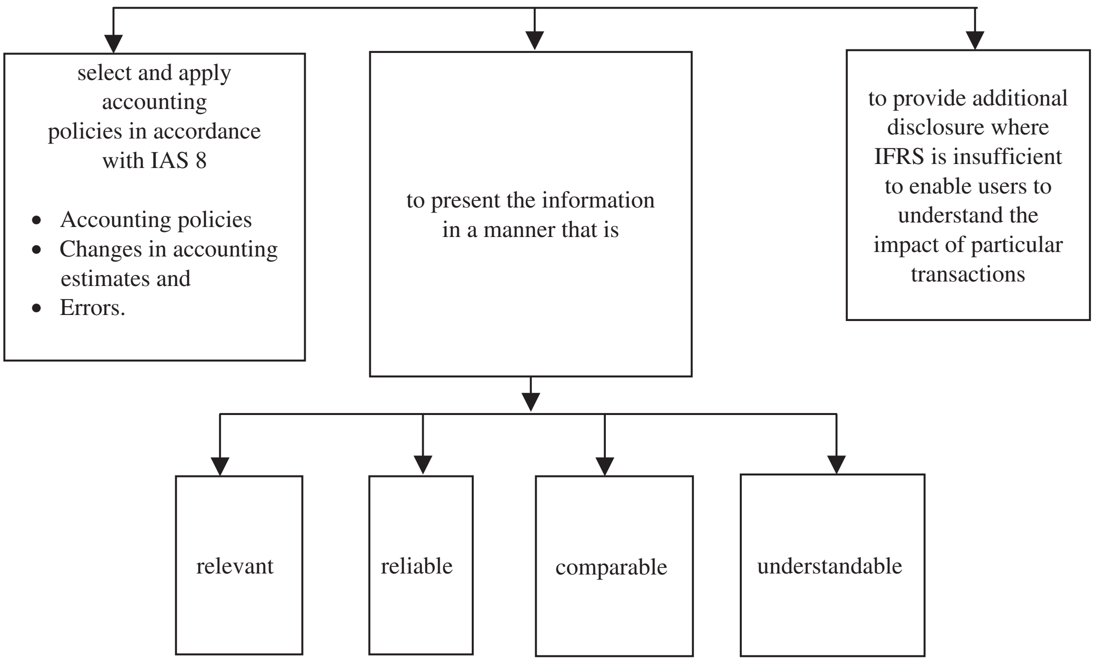
9.1


Components of financial statements
Balance sheet
Income statement
Statement of changes in equity
Cash-flow statements
Notes comprising a summary of significant accounting policies and other explanatory notes
all changes in equity
or
changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders
financial review is also encouraged
description of environment in which the enterprise operates
changes in environment and how management have responded to them
resources not recognised in Balance Sheet in accordance with IFRSs
management policies on investment and dividends

9.2 Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definition and recognition criteria for



IFRS expects additional disclosure in achieving a fairer presentation and also requires an entity to

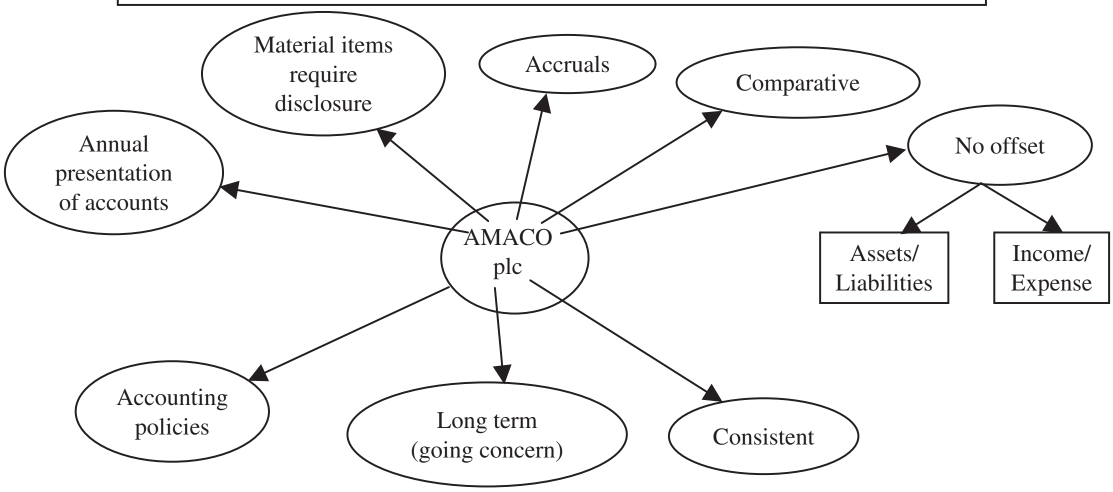


9.3

IAS 1

Requirements for preparation of financial statements

- Accounting *policies*
- Management should consider ability of enterprise to continue as a *going concern*
- Prepared under the *accruals* basis with exception of cash-flow statements so there are no accruals effect within a cash-flow statement
- Should be *consistent* in its approach to presentation and classification of items year to year
- *Material* accounts should be presented separately
- Assets and liabilities should not be *offset* except where permitted by IFRS – this is in line with no-offset rule
- Income and expenses should only be *offset* where permitted by other IFRS
- *Comparative* information should be disclosed for the previous period
- Financial statements should be presented at least *annually*



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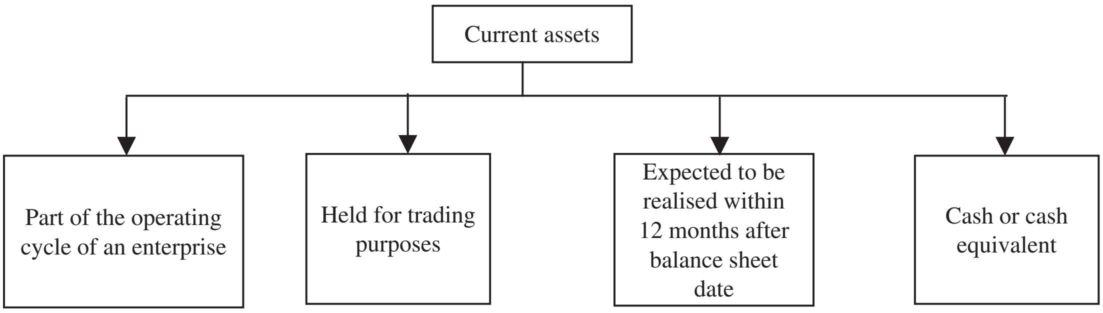
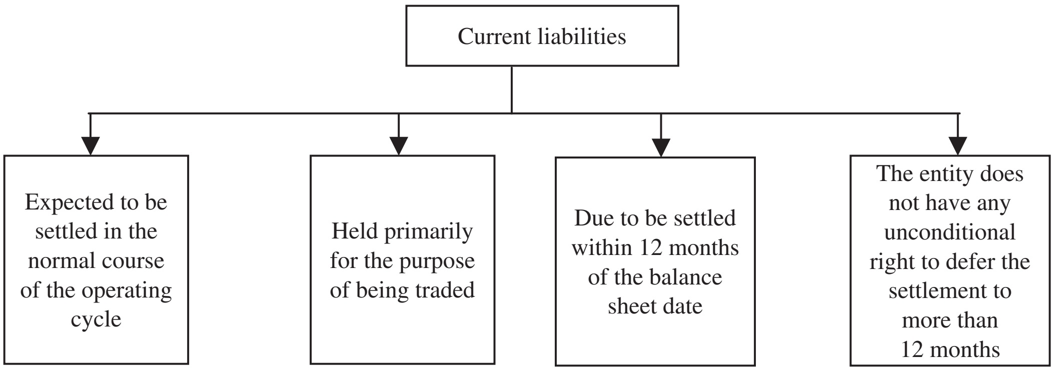


9.5



9.6 **Information to be presented on the face of the balance sheet**

IAS 1 requires that, as a minimum, the following line items appear on the face of the balance sheet (where there are amounts to be classified within these categories):

(i) property, plant and equipment
(ii) investments property
(iii) intangible assets
(iv) financial assets (excluding amounts shown under (e), (h) and (i))
(v) investments accounted for using the equity method
(vi) biological assets
(vii) inventories
(viii) trade and other receivables
(ix) cash and cash equivalents.

9.7

Assets

Non-current assets

- Property, plant and equipment
- Goodwill
- Other intangible assets
- Available for sale investments

may be reclassified as per IAS 16

Current assets

- Inventories
- Trade receivables
- Other current assets
- Cash and cash equivalents

as per IAS 2

- Merchandise
- Production supplies
- Work in progress
- Materials
- Finished goods

- Trade customers
- Related parties
- Prepayments
- Other amounts

Total assets

Equity and liabilities

Equity

IAS 1

- Share Capital
- Other reserves
- Retained earnings*

- Paid up
- Share premium
- Reserves

Total equity

Non-current liabilities

- Long-term borrowings
- Deferred tax
- Long-term provisions

Total non-current liabilities

Current liabilities

- Trade and other payables
- Short-term borrowings (overdraft)
- Current portion of long-term borrowings

Current tax payable

- Short-term provisions

Total current liabilities

Total liabilities

Total equity and liabilities

* accumulated funds

9.8 Ideal promotions

Income statement for the year ended 31 March 2004

	$'000
Revenue	8,974
Cost of sales	(3,646)
	5,328
Other income	50
Distribution costs	(1,094)
Administrative costs	(1,948)
	2,336
Finance costs	(1,294)
Profit before tax	1,042

There is a 'silly trick' in this question. Since there has been an increase in the inventories, the adjustment for the inventory changes should be a REDUCTION in the cost for the period.

The increase in inventory is therefore a negative expense (whereas a decrease in inventory adds to the expense).

9.9 Income statement for the year ended 31 March 2004

	$'000	$'000
Revenue		8,974
Other Income		50
		9,024
Changes in inventories of finished goods and WIP	(104)	
Raw materials and consumables used	1,750	
Staff costs (employee benefit costs)	2,130	
Depreciation and amortisation *Ideal Promotions*	1,886	
Other expenses	1,026	
Total expenses		(6,688)
Profits from operations		2,336
Finance costs		(1,294)
Profit before tax		1,042

9.10 Income statement for the year ended 30 September 2001

Notes/Workings		$'000	$'000
	Sales revenue		430
W1	Cost of sales		(188)
	Gross profit		242
W2	Distribution costs	(25)	
W2	Administrative expenses	(21)	
			(46)
			196
(d)	Income from Investments		12
	Finance cost		(14)
	Profit before tax		194
W3	Income tax expense		(50)
	Net profit for the period		144

Balance sheet as at 30 September 2001

Notes/Workings	$'000	$'000
Assets		
Non-current assets		
Tangible assets		498
Investments		100
		598
Current assets		
Inventory	13	
Trade receivables	23	
Bank	157	
		193
		791
Equity and liabilities		
Equity		
Share capital	100	
Retained earnings	415	515
Non-current liabilities		
Loan notes	140	
Deferred tax	72	
		212
Current Liabilities		64
		791

(W/1) Cost of sales

	$	$
Opening inventories		10
Add:		
Purchases	102	
Less:		
Return outwards	0	
Add:		
Carriage inwards	0	
Add:		
Understated purchases	0	
Less:		
Overstated purchases	0	
Less:		
VAT on purchases	0	
Add:		
Manufacturing wages (Factory wages)	57	
Add:		
Depreciation (Notes)		
Building	4	
Plant	28	
	191	
Less:		
Closing inventory	(13)	
	178	178
		188

Depreciation: Building

Note: Under IAS 16 land is not depreciated unless specified in exam question or is a quarry, mine, etc.

Hence, $\frac{200,000}{5}$ = $4,000/annum for 50 years

Plant: There was a 'silly trick' in the Question Note (c) which states that the plant purchased during the year at a cost of $70,000 is 'INCLUDED' within the figure of $280,000 stated in the trial balance.

(W/2)

Expenses

	Selling and distribution $'000	*Administrative expenses* $'000
Advertising	15	–
Administration salaries	–	14
Audit fees	–	7
Bad debts	10	–
	25	21

(W/3)

	Note	$
Taxation	(f)	57,000
Deferred tax	(e)	(17,000)
		40,000
Under provision from previous year		10,000
Charge for the year		50,000

(W/4)

Tangible non-current assets	*Land and building*		*Plant*		*Total*
	$'000		$'000		$'000
Cost @ 1.10.2000 (start)	450		210		660
D Disposal	0		70	(b)	70
A Addition	0		0		0
R Revaluation	0		0		0
T Transfer	0		0		0
Cost @ 1.10.01 (end)	450	(b)	280	(b)	730
Depreciation @ 1.10.2000 (start)	(40)	(TB)	(160)	(TB)	(200)
D Disposal	0		0		0
A Addition	4	(W1)	28	(W1)	(32)
R Revaluation	0		0		0
T Transfer	0		0		0
Depreciation @ 1.10.01 (end)	(44)		(188)		(232)
Net book value @ 30.9.01 (end)	406		92		498
Net book value @ 1.10.2000 (start)	410		50		460

Cost end − Depreciation end = Net book value
(450 − 44 = 406)

Cost start − Depreciation start = Net book value
(450 − 40 = 410)

(W/5) Equity Statement

	Share capital	*Retained earning*	*Total*
	$'000	$'000	$'000
Balance @ 30.9.2000	100	391	491
Profit to be paid	0	144	144
Dividends paid	0	(120)	(120)
Balance @ 30.10.01	100	415	515

(W/6) Deferred tax

	$'000
Opening balance	89
Decrease in provision	(17)
	72

(W/7) Current liabilities

	$'000
Trade payables	7
Taxation W3/(f)	57
	64

9.11 (i)

	$
Cost @ 31.3.03	50,000
Depreciation accumulated @ 31.3.03	(5,000)
	45,000
	(1,000)
	44,000

Land	*Original amount* $'000	*Revalued amount* $'000	*Revaluation surplus* $'000
	4,000	6,000	2,000

Building	*Original amount* $'000	*Revalued amount* $'000	*Revaluation deficit* $'000
	44,000	39,000	5,000

As per IAS 16, this states that the property has been impaired and hence the Net book value will be reduced from $44,000 to $39,000, its current value.

In the trial balance at 31 March 2004, there is a revaluation reserve balance of $3,000 which represents

$3,000 → $2,000 Land (see above)
→ $1,000

Hence as per IAS 16 the maximum that can be debited to the building will be $1,000.

Thus,

$5,000 impairment → $1,000 debited to revaluation reserve
→ $4,000 will be charged to income statement

(ii)

U – Income statement for the year ended 31 March 2004

	$'000
Revenue	101,050
Cost of sales (W1)	(72,200)
Gross profit	28,850
Administrative expense (W2)	(14,121)
Distribution costs	(1,600)
Profit from operation	13,129
Finance costs (250 + 250)	(500)
6 months + 6 months	12,629
Taxation	(5,660)
Net profit for the period	6,969

U – Balance sheet at 31 March 2004

	$'000	$'000
Non-current tangible assets (NBV)		
Land and building		45,000
Plant and machinery (W4)		14,000
		59,000
Current assets		
Inventories (Trial balance)	6,100	
Receivables (W3)	10,679	
Cash at bank	4,200	
	20,979	20,979
		79,979
Capital and reserves		
Ordinary share capital		25,000
Share premium		17,650
Revaluation reserve		2,000
Accumulated profit (W5)		9,880
		54,530
Payables falling due after more than one year		
5% Loan notes		10,000
Payables falling due within one year		
Trade payables	9,539	
Tax	5,660	
Accrued interest	250	
	15,449	15,449
		79,979

(iii) Movement of reserve statement at 31 March 2004

	Share premium $'000	*Revaluation reserve* $'000	*Retained profit* $'000
Balance b/f at 31.3.04	22,650	3,000	4,411
Dividends			(1,500)
Bonus Issue (W6)	(5,000)		
Impairment		(1,000)	
Profit			6,969
Balance at 31.3.04	17,650	2,000	9,880

W1/ Cost of sales

	$'000
As per trial balance	66,200
Depreciation on Plant (ii) (30,000 × 20%)	6,000
	72,200

W2/ Administrative expenses

	$'000
As per trial balance	5,900
Depreciation on building (ii) on gross amount	
Impairment	4,000
Depreciation for the year	1,000
Bad debts	3,059
Provision for doubtful debts (W3)	162
	14,121

W3/ Receivables

	$'000
As per trial balance	14,300
Bad debts	(3,059)
	11,241
Provision for bad debts 5%	(562)
	10,679

Provision	31.3.04 per Trial balance	400
	31.4.04 as stated above	562
	Increase in provision of bad debts	162

W4/ Plant and machinery

	$'000
Cost	30,000
Accumulated depreciation	(10,000)
Charge for the year	(6,000)
Net Book Value	14,000

W5/ Accumulated profit

	$'000
As per trial balance	4,411
Dividends paid	(1,500)
Current year's profit	6,969
	9,880

W6/ Bonus issue

1 bonus share for every 4 shares held

25,000/5 = 5,000

9.12 V (i) NOVEMBER 97

With questions on published accounts always try to focus on earning the easy marks first; there will always be issues within the questions which may prove to be difficult. In this question the legal fees and damages, and application and allotment account are classic examples.

Think time, think marks!!

Income Statement
For the year ended 30 September 2007

	$'000
Sales revenue	9,800
Cost of sales (W1)	(1,430)
Gross profit	8,370
Distribution costs (W1)	(945)
Administrative expenses (W1)	(770)
Profit from operations	6,655
Finance costs	(5)
Profit before tax	6,650
Income tax expenses (Note 2)	(1,945)
Net profit for the year	4,705

Statement of changes in equity
For the year ended 30 September 2007

	Share capital $'000	*Accumulated profits* $'000	*Total* $'000
Balance at 30.9.06	1,000	1,805	2,805
Net profit for the year		4,705	4,705
Dividends paid		(600)	(600)
	1,000	5,910	6,910

Balance sheet as at 30 September 2007

	$'000	$'000
Non-current assets		
Tangible assets (Note 5)		8,370
Current assets		
Inventory	520	
Receivables	910	
Cash at Bank and in Hand	90	
	1,520	1,520
Total assets		9,890
Capital and reserves		
Issued share capital		1,000
Accumulated profit		5,910
		6,910

	$'000	$'000
Non-current liabilities		
Long-term loans (Note 4)		500
Current liabilities		
Trade payables	470	
Application and allotments	110	
Income tax	1,900	2,480
		9,890

Notes to financial statements

(1) Operating profit — $'000

Operating profit is stated after charging

	$'000
Depreciation	450
Exceptional item – non-recurring legal fees and damages	270

(2) Income tax — $'000

	$'000
Income tax on profit for the year	1,900
	45
	1,945

(3) Dividends

A final dividend of $1,000,000 for the year

(4) Long-term loan

This loan is repayable in five years

(5) Tangible non-current assets

		Premises $'000	*Computer network* $'000	*Delivery vehicles* $'000	*Total* $'000
Cost					
**at	30.9.06	8,500	900	700	10,100
D	Disposals	0	0	0	0
A	Additions	0	0	0	0
R	Revaluations	0	0	0	0
T	Transfers	0	0	0	0
*at	30.9.07	8,500	900	700	10,100
Accumulated depreciation					
**at	30.9.06	800	200	280	1,280
D	Disposal	0	0	0	0
A	Additions/Charge for the year	170	175	105	450
R	Revaluation	0	0	0	0
T	Transfer	0	0	0	0
*at	30.9.07	970	375	385	1,730
Net Book Value					
**	at 30.9.07	7,530	525	315	8,370
*	at 30.9.06	7,700	700	420	8,820

Premises

cost − depreciation = Net Book Value

$$\begin{pmatrix} ** & 8500 - 800 = 7{,}700 \\ * & 8500 - 970 = 7{,}530 \end{pmatrix}$$

Similarly computer network and delivery vehicles.

(W1)

	Cost of sales $'000	*Distribution costs* $'000	*Administrative expenses* $'000
Opening inventories	480		
Purchases	1,300		
Warehouse and delivery wages		350	
Sales commission		180	
Sunday distributor expenses		310	
Sunday administrative expenses			85
Administrative staff salaries			240
Legal fees and damages			270
Closing inventories	(520)		
Depreciation on premises (8,500 × 2%)	170		
Depreciation on vehicles ((700 − 280) × 25%)		105	
Depreciation on computers ((900 − 2000) × 25%)			175
	1,430	945	770

9.13 PERCY MAY 1994

This question is very straightforward however it helps focus on issue and allotment of shares and I will show you how to tackle this point, which seems to be a problem for students.

PERCY
Income Statement for the year ended 31 March 2004

	$'000
Sales revenue	5,000
Cost of sales	(1,350)
Gross profit	3,650
Distribution costs	(370)
Administrative expenses	(490)
Profit from operations	2,790
Income from investments	210
Finance costs	(190)
Profit before tax	2,810
Income tax expenses (Note 1)	(450)
Net profit for the year	2,360

PERCY
Balance sheet as at 31 March 2004

	$'000	$'000
Non-current assets		
Tangible assets		4,250
Current assets		
Inventories	114	
Receivables	443	
Investments	2,700	
Cash at Bank and in Hand	12	
	3,269	3,269
Total assets		7,519
Capital and reserves: (Note 3)		
Issued share capital (1,500 + 200)		1,700
Share premium account (800 + 40)		840
Accumulated profits		3,133
		5,673
Non-current liabilities		
Loans (Note 4)		1,200
Current liabilities		
Trade payables	116	
Taxation	470	
Surplus application on share	60	
Issues (W1)	646	646
Total equity and liabilities		7,519

Notes to the accounts $'000

(1) Income Tax

	$'000
Income tax charge for the year	470
Overprovision from 2003	(20)
	450

(2) Dividends

	$'000
Paid in years: final dividend for year ended 31.3.03	240
Interim paid	150
	390

A final dividend of $270,000 is proposed for the year ended 31.3.04.

(3) Statement of changes in equity Year ended 31 March 2004

	Share capital $'000	*Share premium* $'000	*Accumulated profits* $'000	*Total* $'000
Balance at 31.3.03	1,500	800	1,163	3,463
Net profit for the year			2,360	2,360
Dividends paid			(390)	(390)
Issue of share capital	200	40		240
Balance at 31.3.04	1,700	840	3,133	5,673

(4) Loans
The loans are all repayable after more than 5 years.

Working

W1/ Application and allotment of shares

	$'000
Money received as per trial balance	300
Due on issue (200,000 × $1.20)	(240)
Excess to be returned	60

9.14 (i)

Hi plc income statement for year ended 30 September 2003

	$'000	$'000
Revenue (TB)		9,415
Cost of sales (W1)		(4,404)
Gross Profit		5,011
Administrative expenses (W4)	(760)	
Distribution expenses (TB)	(314)	
	(1,074)	(1,074)
Profit from operation		3,937
Reorganisation expenses	(965)	
Reorganisation provision utilised (i)/TB	1,010	
	45	45
		3,982
Income from non-current assets investments (TB)	37	
Finance cost (iv)	(100)	
	(63)	(63)
Profit before tax		3,919
Income tax payable (W6)		(1,205)
Net profit from the period		2,714

Hi – Balance sheet at 30 September 2003

	Cost $'000	*Depreciation* $'000	*NBV* $'000
Non-current assets			
Tangible assets			
Building (W2)	11,200	1,740	9,460
Equipment (W3)	2,415	2,019	396
			9,856
			522
			10,378

	Cost $'000	*Depreciation* $'000	*NBV* $'000
Current assets			
Inventories (TB)		822	
Trade receivables (W7)		807	
Cash in Hand and Bank (TB)		959	
		2,588	2,588
Total assets			12,966
Capital and reserves			
Called-up share capital			
Ordinary share capital		4,000	
Share premium		2,388	
Revaluation reserve		202	
Accumulated profit		3,304	
		9,894	9,894
Non-current liabilities			
10% loan stock (TB)		1,000	
Deferred tax (v)		281	
Other provisions		100	
		1,381	1,381
Current liabilities			
Trade payables (TB)		396	
Other trade payables including tax (W10)		1,245	
Accrued loan interest (TB)		50	
		1,691	1,691
			12,966

W1/ Cost of sales

Note that part (v00) states that depreciation is to be treated as part of cost of sales.

	$
Cost of goods sold	3,591
Depreciation building (W2)	336
Depreciation equipment (W3)	483
Gain on disposal (W3)	(6)
	4,404

W2/ Building depreciation

			Accumulated depreciation
Cost	11,200	b/f	1,404
Depreciation 3%	(336)	→ add	336
NBV	10,864		1,740

W3/ Equipment and fixture

F/A Disposal account

Cost	210	Accumulated Depreciation	205
Gain on disposal	6	Disposal	11
	216		216

Cost	2,625
Less:	
Disposal	(210)
	2,415
Depreciation 20%	(483)
NBV	1,932

Depreciation account

Disposal	205	B/F	1,741
Depreciation c/d	2,019	Charge for year	483
	2,224		2,224

W4/ Adminstrative expenses

	$
As per trial balance	615
Legal claim (iv)	100
Bad debts (iii)	45
	760

W5/ Reorganisation expenses

	$
As per trial balance	900
Accrued at year end (i)	65
	965

W6/ Deferred tax

		B/F D.T.	25
c/d D.T.	281	Charge for year	256
	281		281

Income tax	1,180
Deferred tax	25
Income statement	1,205

W7/ Trade receivables:

	$'000
As per trial balance	852
Less: bad debts write-off	(45)
	807

W8/ Revenue reserve

	$'000
As per trial balance	172
Increase in non-current assets	30
	202

W9/	Accumulated profit	$'000
	As per trial balance	1,390
	For the year	2,714
	Dividends	(800)
		3,304

W10/	Other trade payables	$'000
	Tax (v)	1,180
	Reorganisation costs	65
		1,245

(ii)

Statement of change in equity for year ended 30 September 2003

	Share capital	*Share premium*	*Revaluation reserve*	*Accumulated profit*	*Total*
	$'000	$'000	$'000	$'000	$'000
Balance b/f	3,200	788	172	1,390	5,550
Share issue	800	1,600	0	0	2,400
Revaluation of non-current assets	0	0	30	0	30
Profit for the year	0	0	0	2,714	2,714
Dividends	0	0	0	(800)	(800)
Balance at 30.9.03	4,000	2,388	202	3,304	9,894

(iii)

Earning per share @ 30.9.03
Calculate theoretical ex-right price

			$	$
Original Holding	4	@	4.25	17.00
Rights	1	@	3.00	3.00
New Holding	5			20.00

Hence 20/5 = $4.00
Bonus element 4.25/4.00 = $1.0625

Weighted number of shares

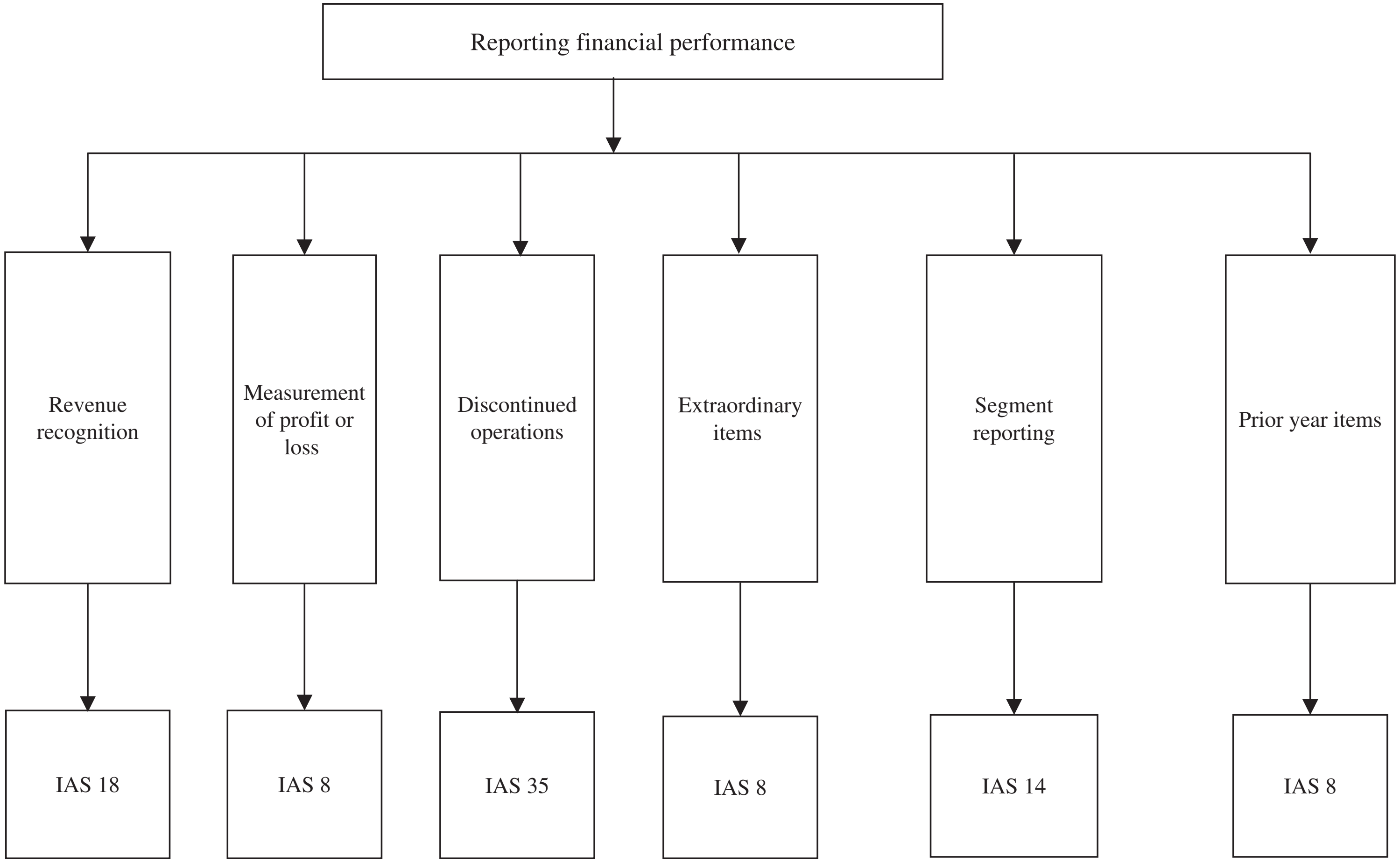
3,200,000 × 6/12 (1 April) × 1.0625 = $1,700,000
4,000,000 × 6/12 = $2,000,000
3,700,000

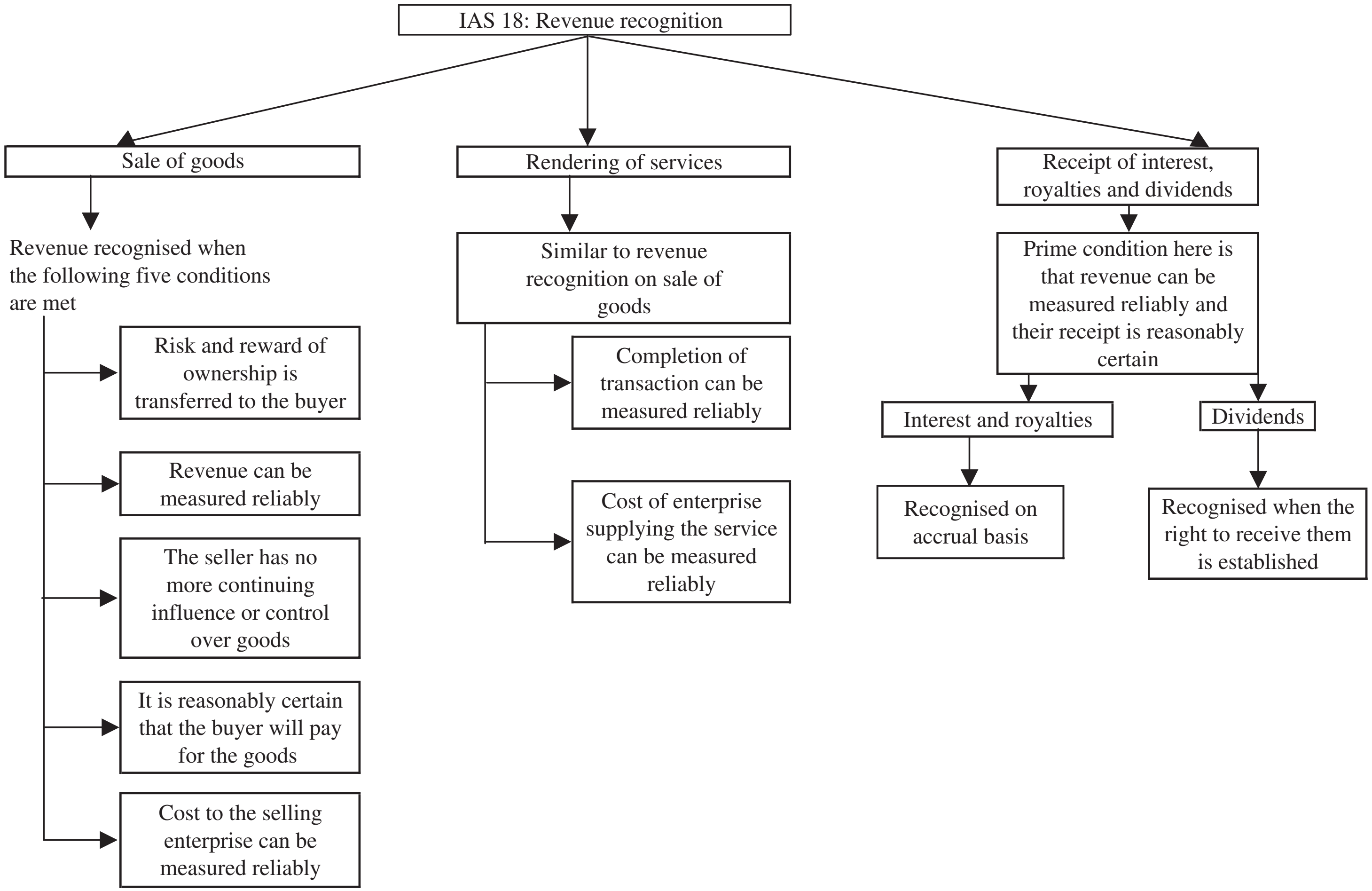
$$\text{EPS} = \frac{\text{Earnings}}{\text{Weighted number of shares}}$$

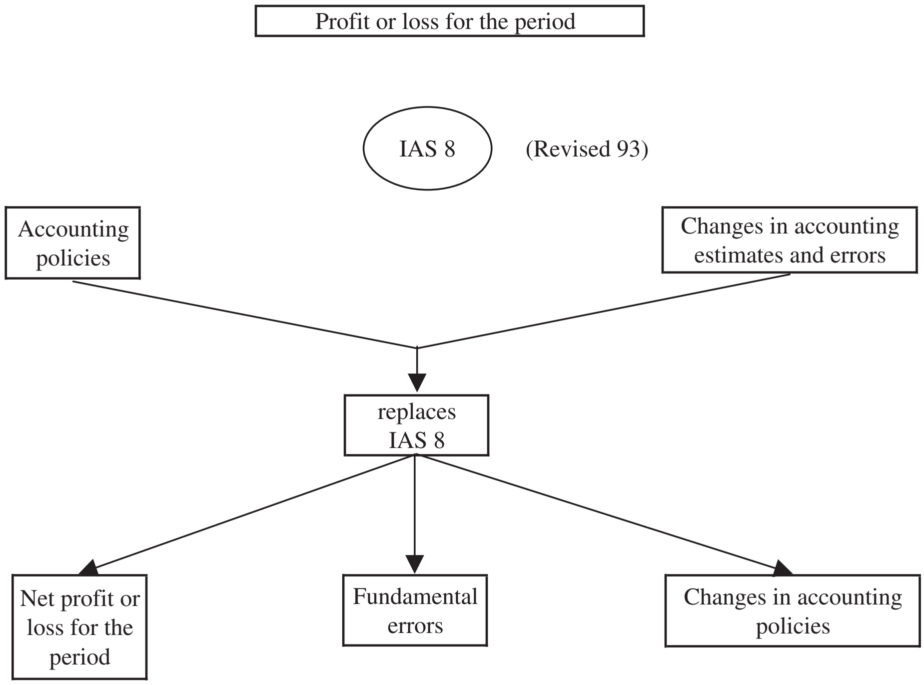
2,714,000/3,700,000 × 100 = 73.4 cents

EPS = 73 cents

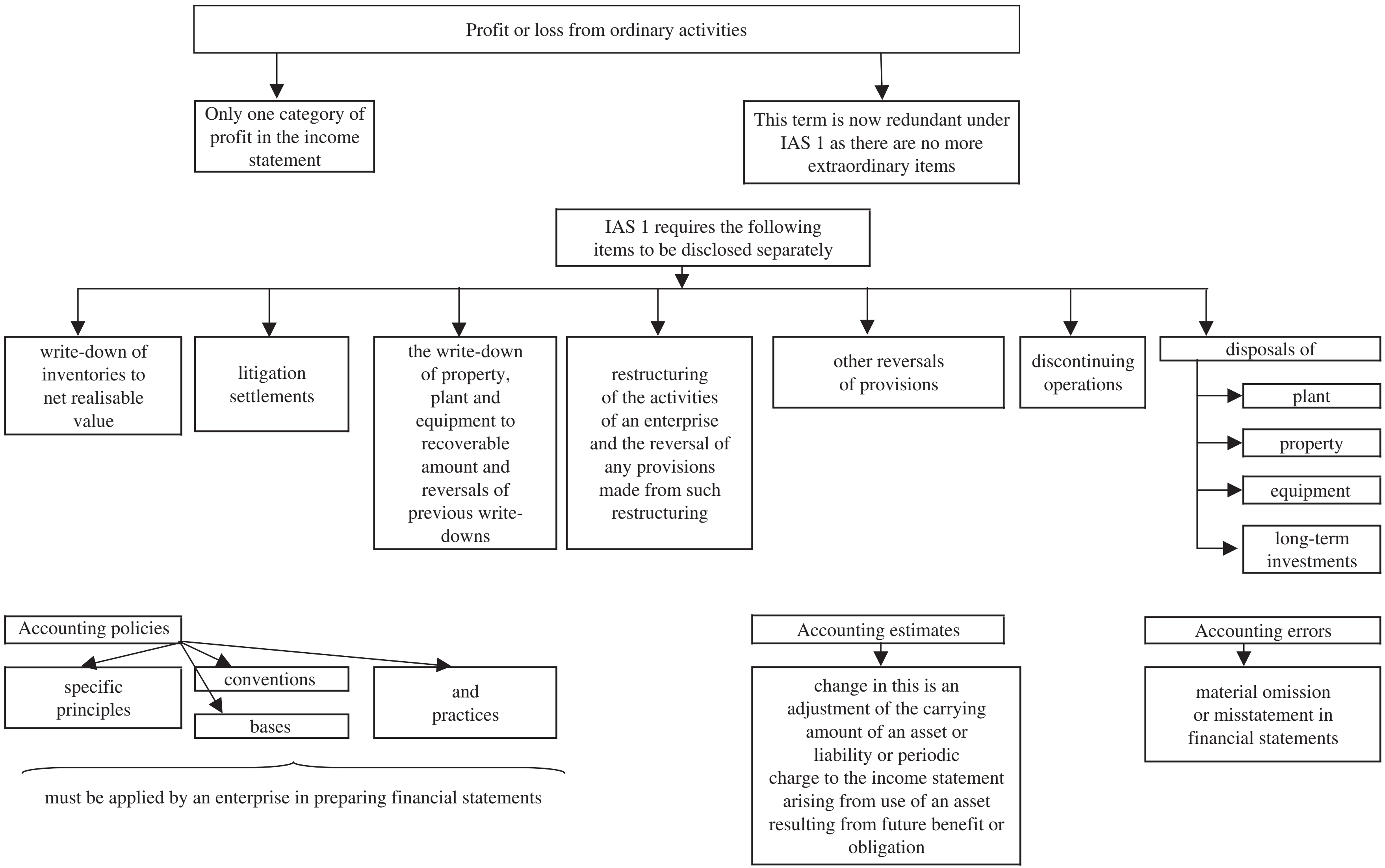
10 Reporting Financial Performance


Reporting financial performance
Revenue recognition
Measurement of profit or loss
Discontinued operations
Extraordinary items
Segment reporting
Prior year items
IAS 18
IAS 8
IAS 35
IAS 8
IAS 14
IAS 8


IAS 18: Revenue recognition
Sale of goods
Revenue recognised when the following five conditions are met
Risk and reward of ownership is transferred to the buyer
Revenue can be measured reliably
The seller has no more continuing influence or control over goods
It is reasonably certain that the buyer will pay for the goods
Cost to the selling enterprise can be measured reliably
Rendering of services
Similar to revenue recognition on sale of goods
Completion of transaction can be measured reliably
Cost of enterprise supplying the service can be measured reliably
Receipt of interest, royalties and dividends
Prime condition here is that revenue can be measured reliably and their receipt is reasonably certain
Interest and royalties
Recognised on accrual basis
Dividends
Recognised when the right to receive them is established



Note: IAS 1 states that an entity should not present any items of income or expense as extraordinary items either on the face of the income statement or in the notes. This is also noted in new IAS 8 which eliminates extraordinary items.


Profit or loss from ordinary activities
Only one category of profit in the income statement
This term is now redundant under IAS 1 as there are no more extraordinary items
IAS 1 requires the following items to be disclosed separately
write-down of inventories to net realisable value
litigation settlements
the write-down of property, plant and equipment to recoverable amount and reversals of previous write-downs
restructuring of the activities of an enterprise and the reversal of any provisions made from such restructuring
other reversals of provisions
discontinuing operations
disposals of
plant
property
equipment
long-term investments
Accounting policies
specific principles
conventions
bases
and practices
must be applied by an enterprise in preparing financial statements
Accounting estimates
change in this is an adjustment of the carrying amount of an asset or liability or periodic charge to the income statement arising from use of an asset resulting from future benefit or obligation
Accounting errors
material omission or misstatement in financial statements

Changes in accounting policies

Due to comparability, enterprises will adopt the same accounting policies year after year.

Reasons for changes

- A new statutory requirement
- A new accounting standard
- Change may result in more appropriate presentation of financial statements

Note: IAS 8 states that if an accounting standard is applied to conditions that differ in substance from previous situations, it is not to be treated as a change in accounting policy.

Disclosure requirements

- Nature of change
- Reason for change
- Description of transitional provision
- Amount of adjustments for the current period and comparative period
  - IAS 33 basic and diluted EPS show where applicable
- Adjustments relating to the periods prior to those included in the comparative information

Changes in accounting estimates

The whole process of accounting requires estimations, for example:

- doubtful debts
- useful life of non-current assets
- inventory obsolescence

Estimation needs regular reviews especially when new information becomes available.

Notes

Change in accounting policy → usually requires a prior year adjustment

Change in estimate → must be adjusted in the income statement for the period and is not allowed to be treated as a prior year adjustment

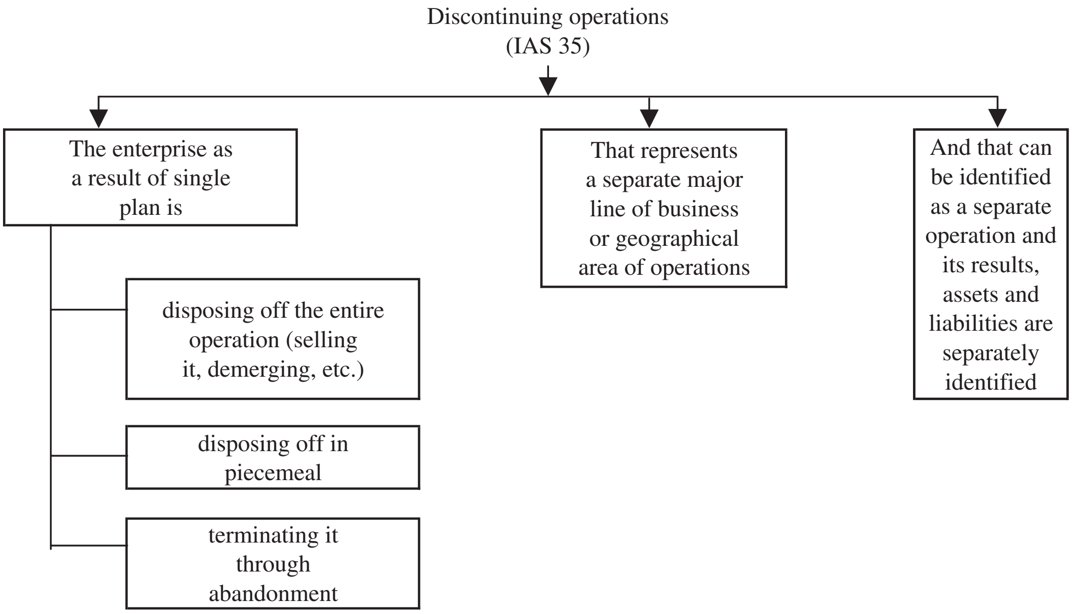
Errors

Old IAS 8 looked at fundamental errors. The revised IAS 8 refers to material omissions and misstatements and is material either individually or collectively when they influence economic decision of users.

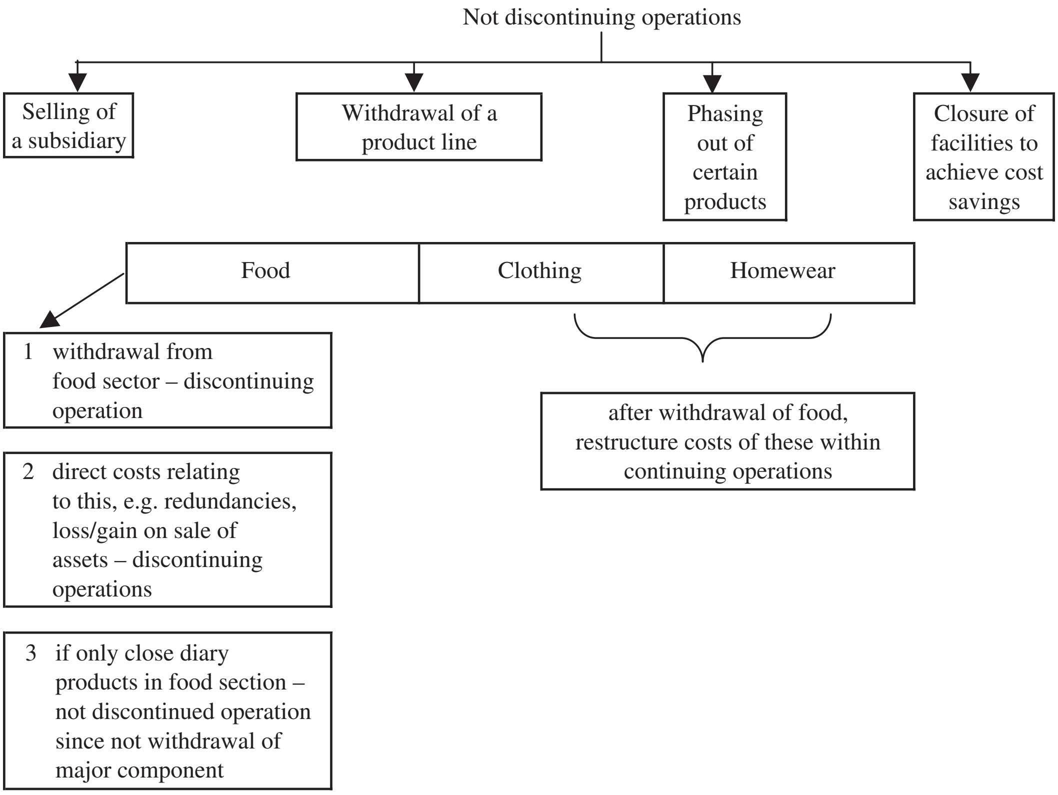
Materiality depends on size and nature of error.

Prior period errors or misstatements may result due to

- mathematical errors
- mistakes in applying accounting policies
- mis-interpretation of facts
- fraud
- oversights

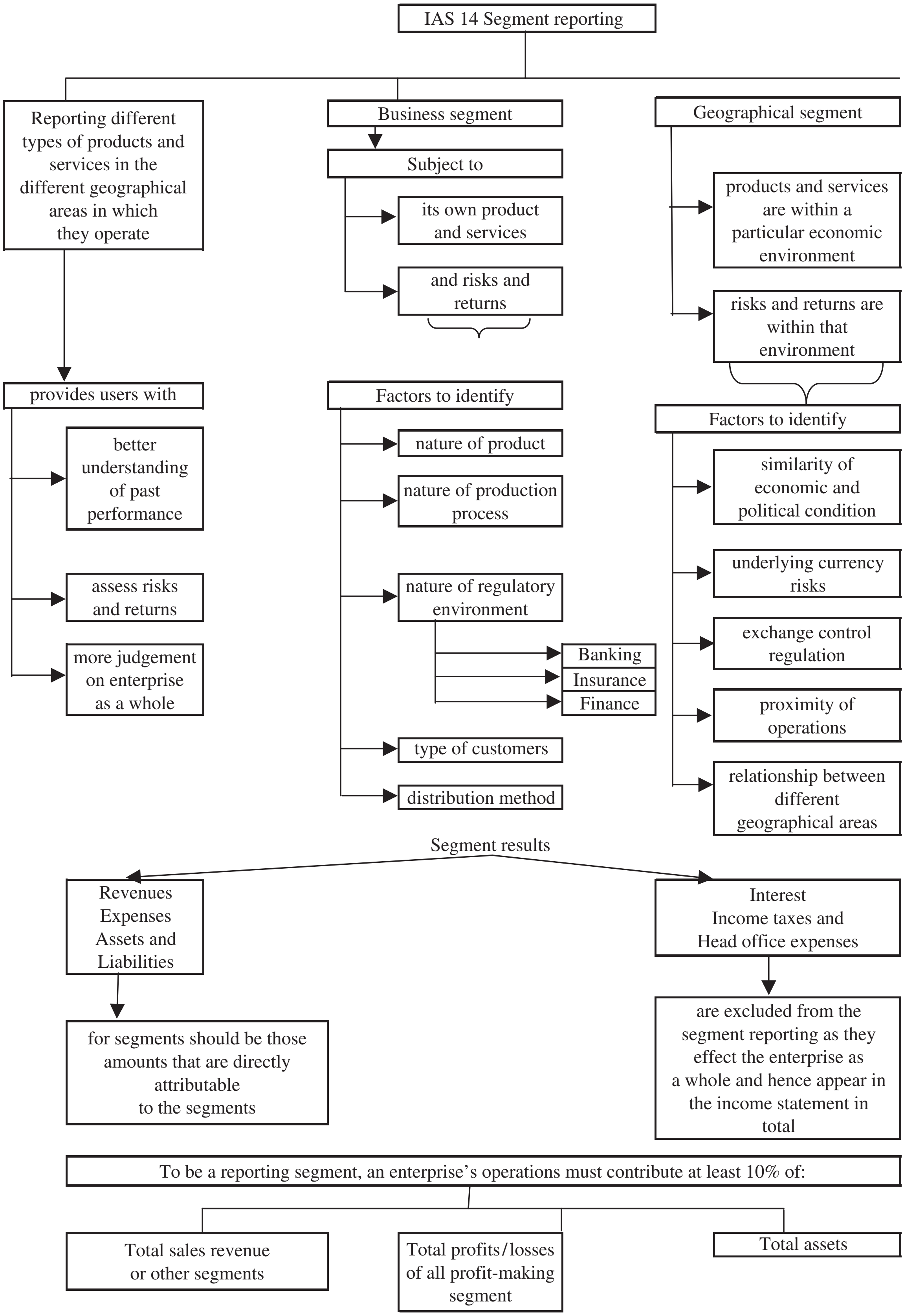


Discontinuation of operation must intend to completely withdraw from certain markets or be discontinuing a significant area of their business.



Disclosure

- Description of discontinuing operation
- Date and nature of initial disclosure
- Business or geographical location as per IAS 14
- Date or period in which discontinuance is expected to be complete
- Carrying amounts of assets and liabilities to be disposed
- Amount of profit or loss from ordinary activities and revenues and expenses


IAS 14 Segment reporting
Reporting different types of products and services in the different geographical areas in which they operate
provides users with
better understanding of past performance
assess risks and returns
more judgement on enterprise as a whole
Business segment
Subject to
its own product and services
and risks and returns
Factors to identify
nature of product
nature of production process
nature of regulatory environment
Banking
Insurance
Finance
type of customers
distribution method
Geographical segment
products and services are within a particular economic environment
risks and returns are within that environment
Factors to identify
similarity of economic and political condition
underlying currency risks
exchange control regulation
proximity of operations
relationship between different geographical areas
Segment results
Revenues Expenses Assets and Liabilities
for segments should be those amounts that are directly attributable to the segments
Interest Income taxes and Head office expenses
are excluded from the segment reporting as they effect the enterprise as a whole and hence appear in the income statement in total
To be a reporting segment, an enterprise's operations must contribute at least 10% of:
Total sales revenue or other segments
Total profits/losses of all profit-making segment
Total assets

? Questions

10.1 Which of the following is NOT part of IAS 8

A Measurement of profit or loss
B Extraordinary items
C Prior year adjustments
D Revenue recognition

(2 marks)

10.2 Discontinued operations is covered under which IAS?

A IAS 18
B IAS 8
C IAS 14
D IAS 35

(2 marks)

10.3 Revenue from sale of goods is recognised when certain conditions are met.

(i) Risk and reward of ownership is transferred to the buyer
(ii) Completion of transaction can be measured reliably
(iii) Cost of enterprise supplying the service can be measured reliably
(iv) Revenue can be measured reliably
(v) Cost to the selling enterprise can be measured reliably
(vi) The seller has no more continuing influence or control over goods

Which of the above are included in IAS 18 revenue recognition's conditions for recognition:

A (i), (ii), (iv) and (vi)
B (i), (iii), (iv) and (v)
C (i), (iv), (v) and (vi)
D (ii), (iv), (v) and (vi)

(2 marks)

10.4 Which of the following is true about recognition of Interest and Royalties.

A Recognised when right to receive is established
B Recognised on accrual basis
C Recognised on prepayment basis
D None of the above

(2 marks)

10.5 The accounting standard states that due to comparability, enterprises will adopt the same accounting policies year after year, however it may change its accounting policies provided the following reasons are satisfied.

(i) There is a new statutory requirement
(ii) There is a new accounting standard
(iii) Change may result in more appropriate presentation of financial statements

A (i), (ii) and (iii)
B (i) only
C (i) and (ii) only
D (ii) and (iii) only

(2 marks)

10.6 Under IAS 14 Segment Reporting, what are the factors to identify geographical segments.

(i) Similarity of economic and political conditions
(ii) Nature of product or service
(iii) Relationship between different geographical areas
(iv) Nature of production process
(v) Type of customers
(vi) Distribution methods
(vii) Underlying currency risk and exchange control regulation
(viii) Nature of regulatory environment

A (i), (iii) and (iv)
B (i), (iii) and (vii)
C (ii), (iii) and (iv)
D (v), (vi) and (vii)

(2 marks)

10.7 Jupiter, an incorporated entity has previously followed a policy of capitalisation of development expenditure. It has recently decided to adopt the provisions of IAS 38 intangible assets, for the year ending 31 December 2005. Jupiter has been advised by their auditors that the expenditure previously capitalised does not qualify for capitalisation under the recognition criteria set out in standard.

The notes to the accounts for the year ended 31 December 2004 in respect of the deferred development expenditure was as follows:

	$
Balance as at 1.1.04	2,000
Additions	1,000
Amortisation	(800)
Balance as at 31.12.04	2,200

During the year ended 31 December 2004 the company has expensed all expenditure in the period on the projects, in respect of which, expenditure has previously been capitalised, and no amortisation has been charged in the income statement in 2005.

The following are extracts from the draft accounts for the year ended 31 December 2005.

Income statements	*2005*	*2004 (As previously published)*
	$	$
Revenue	2,400	2,200
Expenses	(1,600)	(1,360)
Profit for the year	800	840

Statement of changes in equity (extract)	$	$
Balance as at 1 January	6,000	5,160
Profit for the year	800	840
Balance as at 31 December	6,800	6,000

Requirement

Show how the income statement and statement of changes in equity would appear in the financial statements for the year ended 31 December 2005, processing the necessary adjustments in respect of the change in accounting policy by applying the new policy retrospectively.

(20 marks)

10.8 Nutrition operates in many business lines and many geographical areas. Its internal support is prepared by both product lines and by country.

Explain how nutrition should determine its primary and secondary reporting format.

(7 marks)

✓ Answers

10.1 **D**

This is part of IAS 18.

10.2 **D**

IAS 18	Looks at revenue recognition
IAS 8	Looks at measurement of profit or loss
	Extraordinary items
	Prior year adjustments
IAS 14	Looks at segmental reporting

10.3 **C**

The other condition which was not included in the answers as per IAS 8 was it is reasonably certain that the buyer will pay for the goods.

(ii) and (iii) are conditions for rendering of service under IAS 18.

10.4 **B**

A is recognition criteria for dividends
C not applicable
D incorrect

10.5 **A**

All are reasons for change in accounting policies.

10.6 **B**

10.7

Income statements	*2004*	*2005*
	$	$
Revenue	2,400	2,200
Expenses	(1,600)	(1,560)
Profit for the year	800	640
Statement of changes in equity (extract)	$	$
	6,000	5,160
Prior year adjustment	(2,200)	(2,000)
	3,800	3,160
Profit for the year	800	640
Balance as at 31.12.05	3,600	3,800

Notes:

(i) The entity amortised $800 in 2004 but spent $1,000. The policy would have been to write-off the amount of expenditure directly to the income statement, therefore the entity needs to adjust last year's figures by an extra $200 expense.

The adjustment against last year's income statement ($200) has the effect of restating it to what it would have been if the company had been following the same policy last year. This is important because the income statements as presented shall be prepared on a comparable basis.

(ii) The balance left on the deferred expenditure account at the end of the previous year ($2,200) is written off against the accumulated profit that existed at that time. This 2,200 is made up of an amount that arose last year, the difference between the amount spent ($1,000) and the amount amortised (800), and the balance that existed at the beginning of the previous year ($2,000).

These amounts are written off against last year's profit and the opening balance on the accumulated profit last year, respectively.

10.8 Under IAS 14, an entity has to decide which of the segmental basis, be its business or geographical, is more important, this will determine its primary segment.

The guideline quotes: 'the internal reporting structure will usually be established to provide management with information to enable them to control each significant component of the business, whether by product or by area. This information will also be useful to users.'

IAS 14 states an entity must make extensive disclosure on the primary segments supported by less rigorous disclosure as the secondary.

Primary segment is governed by the primary source and nature of risk and return of an entity.

If risk and return are affected predominantly by differences in its product and services, its primary format for the reporting segment information should be the business segment.

If risk and return are affected predominantly by the fact that it operates in different areas then the primary format for reporting segment information should be geographical segment.

Cash-flow Statements

11

Do the *opposite entry to that in the income statement*, hence opposite is add back to net profit before tax. For example, profit on sale of asset increases income statement hence opposite is reduce in cash-flow operating activities.

Think what is happening to cash: in (+) or out (−)

Think what is happening to cash: increase (+) decrease (−)

Cash flow from operating activities	$	$
Net profit before taxation	x	
Adjustments for:		
Depreciation	x	
Amortisation	x	
Investment income	(x)	
Interest expense	x	
Loss on sale of plant	x	
Profit on sale of plant	(x)	
Premium on redemption	x	
Operating profit before working capital changes	x	
Increase/decrease in receivables	(x)/x	
Increase/decrease in inventories	(x)/x	
Increase/decrease in payables	x/(x)	
Cash generated from operations	x	
Interest paid	(x)	
Income tax paid	(x)	
Net cash flow from operating activities	x	X/(X)
Cash flow from investing activities		
Purchase of plant, property, equipment	(x)	
Proceeds for sale of equipment	x	
Interest received	x	
Dividend received	x	
Purchase of government stock	x	
Net cash-flow from investing activity	x/(x)	X/(X)
Cash flow from financing activities		
Proceeds from issue of shares	x	
Proceeds from long-term borrowing	x	
Payment of finance lease liabilities	(x)	
Dividends paid	(x)	
	x	X/(X)
Net income in cash and cash equivalents		X
Cash and cash equivalent at the start of year		X/(X)
Cash and cash equivalent at the end of year		X/(X)

Think cash: in (+) or out (−)

Think cash: in (+) or out (−)

Note:

	31 December 2005 $	31 December 2004 $
Cash and cash equivalent		
Cash at bank	X	X
Bank overdraft	(X)	(X)
	X/(X)	X/(X)

Questions

11.1 Why would users of financial statements find cash-flow statements useful?

(3 marks)

11.2 What are cash equivalents and what disclosure about cash and cash equivalents are required by IAS 7?

(5 marks)

11.3 Discuss the major differences between the direct and the indirect method.

(10 marks)

11.4 As per IAS 7, which of the following best describes cash equivalents?

A Cash in hand and demand deposits
B Short-term highly liquid investments
C Demand deposits and highly liquid investments
D Cash in hand and short-term investments

(2 marks)

11.5 The following relates to QPs for the year to 31 December 2005.

	$'000
Profit before tax	15,144.00
Depreciation	1,846.50
Profit on sale of non-current assets	159.00
Increase in inventories	573.00
Decrease in receivables	43.50
Increase in payables	691.50
Payment of tax on profits	3,000.00

The net cash flow from operating activities to be reported in the cash-flow statement for the year is (in $'000)

A 4,294
B 15,043
C 13,669
D 13,993

(7 marks)

11.6 Kallis Limited
Draft income statement for the period ended 31 March 2005

	$
Sales revenue	61,300
Cost of sales	(52,000)
Gross profit	9,300
Depreciation	900
Investment income	(1,360)
Interest expense	800
Administration and selling expense	(2,580)
Net profit before taxation	(7,060)
Taxation	600
	(6,460)

Additional information:

(i) $180 was paid under finance leases representing repayment of lease obligation.
(ii) Dividends paid amounted to $2,400.

(iii) Sold a plant for $40 which originally cost $160 and accumulated depreciation of $120.
(iv) Interest expense was $800 of which $340 was paid during the period. $200 relating to prior period was also paid during the period. $400 of interest was received during the year in cash.
(v) The receivables at the end of 2005 included $200 of interest receivables.
(vi) Tax liabilities at the start and end of the year were $2,000 and $400 respectively. Further $400 were provided for during the year. Withholding tax on dividends received amounted to $200.
(vii) Kallis also acquired property, plant and equipment costing $3,800 of which $1,000 was through finance lease. Cash payment of $2,000 were made for property, plant and equipment.

Draft balance sheet at 31 March 2005

	31 March 2005	*31 March 2004*
	$	$
Assets		
Property, plant and equipment cost	7,460	3,820
Accumulated depreciation	2,900	2,120
Property, plant and equipment net	4,560	1,700
Recoverables	3,800	2,400
Investments	5,000	5,000
Inventories	2,000	3,900
Short-term investments	40	270
Cash	80	50
Total assets	15,480	13,320

Shareholder's equity	*31st March 2005*	*31st March 2004*
	$	$
Share capital	3,000	2,500
Retained earnings	6,820	2,760
Total shareholders equity	9,820	5,260
Liabilities		
Long-term debt (including finance lease)	4,600	2,080
Interest payable	460	200
Trade payable	500	3,780
Tax payable	800	2,000
	6,360	8,060
Total liabilities	16,180	13,320

Requirement

Prepare cash-flow statement for the year ended 31 March 2005 using indirect method as per IAS 7.

(20 marks)

Note:

To answer this question, I will provide you with a skeleton layout.

All you will need to do as a student is complete the layout by inserting relevant figures in order to complete the answer.

Then go and attempt Question 11.7 Imran which is another past exam question but on this occassion I will not provide you with the skeleton layout.

	Cash flow from operating activities	$	$
Do the *opposite entry to that in the income statement*, hence opposite is add back to net profit before tax. For example, profit on sale of asset increases income statement hence opposite is reduce in cash-flow operating activities.	Net profit before taxation	x	
	Adjustments for:		
	Depreciation	x	
	Amortisation	x	
	Investment income	(x)	
	Interest expense	x	
	Loss on sale of plant	x	
	Profit on sale of plant	(x)	
	Premium on redemption	x	
	Operating profit before working capital changes	x	
Think what is happening to cash: in (+) or out (−)	Increase/decrease in receivables	(x)/x	
	Increase/decrease in inventories	(x)/x	
	Increase/decrease in payables	x/(x)	
	Cash generated from operations	x	
Think what is happening to cash: increase (+) decrease (−)	Interest paid	(x)	
	Income tax paid	(x)	
	Net cash flow from operating activities	x	X/(X)
	Cash flow from investing activities		
Think cash: in (+) or out (−)	Purchase of plant, property, equipment	(x)	
	Proceeds for sale of equipment	x	
	Interest received	x	
	Dividend received	x	
	Purchase of government stock	x	
	Net cash-flow from investing activity	x/(x)	X/(X)
	Cash flow from financing activities		
Think cash: in (+) or out (−)	Proceeds from issue of shares	x	
	Proceeds from long-term borrowing	x	
	Payment of finance lease liabilities	(x)	
	Dividends paid	(x)	
		x	X/(X)
	Net income in cash and cash equivalents		X
	Cash and cash equivalent at the start of year		X/(X)
	Cash and cash equivalent at the end of year		X/(X)

Note:

	31 December *2005* $	*2004* $
Cash and cash equivalent		
Cash at bank	X	X
Bank overdraft	(X)	(X)
	X/(X)	X/(X)

Skeleton layout

(W1) Trade receivables

Bal b/f	X		
Interest received	X		
		Decrease in receivables Balancing figure	X
Increase in receivable Balancing figure	X		
		Bal c/d	X
	X		X

(W2) Interest paid

		Balance b/f (balance sheet previous year)	X
Interest paid Balancing figure	X		
		Interest expense (income statement current year)	X
Bal c/d (balance sheet current year)	X		
	XX		XX

If both together as investment income { Interest receivable/dividend received

(W3)

Balance b/f (balance sheet previous year)	X		
Interest received (income statement current year)	X	Bal c/d (Balance sheet current year)	X
Interest receivable	X		
Dividends received Balancing figure	X		
	XX		XX

(W4) Taxation

		Balance b/f (balance sheet current year)	X
Tax paid Balancing figure	X		
Balance c/d (balance sheet current year)	X	Tax receivable Balancing figure	X
		Tax expense for the year (income statement)	X
	XX		XX

Capital expenditure: Normally this is given within the examination question, if so then there is no need to calculate the cash-flow figure.

Also note that acquisition of non-current assets by means of finance lease arrangements DO NOT affect cash flows at the time of acquisition.

(W5) Loans

Loans paid during the year	X	Balance b/f	X
Decrease in loans Balancing figure	X	Additional loan to finance lease	X
Bal c/d	X	Increase in loans Balancing figure	X
	XX		XX

11.7 Imran

Balance sheet for Imran at 31 March 2004

	2004	*2003*
	$	$
Land at cost	65,000	55,000
Property, plant and equipment at cost	75,500	60,000
Fixtures at cost	14,500	12,000
Inventories	25,500	18,500
Receivables	22,000	21,400
Government stock (do not qualify as cash equivalent)	2,300	–
Cash at bank	5,700	100
	210,500	167,000
Equity share capital	75,000	50,000
Share premium	17,500	7,500
Accumulated profit	28,000	10,750
Deferred tax	9,000	5,500
Bank overdraft	–	7,000
Loans	15,000	35,000
Tax payable	5,000	4,000
Depreciation:		
Plant	27,000	22,500
Fixtures	7,500	6,500
Trade payable	26,500	18,250
	210,500	167,000

The following additional information is available:

(i) Dividend of $5,000 was paid during the year.

(ii) Premium paid on redemption of loan was $1,000 which has been written-off to the income statement.

(iii) Tax liability for 31 March 2003 amounted to $4,000 and has been paid during the year.

(iv) A machine costing $4,000 (depreciation of $3,000 has been provided) was sold for $1,500 and fixtures costing $2,500 (depreciation provided – $1,000) were sold for $500. Profits/losses on transaction had been included in the operating profit.

(v) Income statement charges in respect of tax were: Income tax of $6,250 and deferred tax of $4,750.

(vi) Interest received during the year was $225 and charged in income statement was $3,200. Accrued interest of $220 is included in payables at 31 March 2003 (Nil in 2004).

Requirement

Prepare a cash-flow statement for the year ended 31 March 2004 in accordance with IAS 7.

(20 marks)

11.8

The financial statements of C for the year to 31 March 2004 were as follows:

Balance Sheets at	*31 March 2004*		*31 March 2003*	
	$'000	$'000	$'000	$'000
Non-current assets:				
Intangible assets	111		90	
Property, plant and equipment	7,724		4,923	
		7,835		5,013
Current assets:				
Inventories	1,337		864	
Trade receivables	743		435	
Investment	0		730	
Bank	489		7	
Cash	27		22	
Total assets:		2,596		2,058
		10,431		7,071
Capital and reserves:				
Ordinary shares $1 each	2,000			
Share premium account	1,500		1,500	
Revaluation reserve	1,080		500	
Accumulated profits	3,311		630	
		7,891	2,876	5,506
Non-current liabilities:				
Loans	1,006			
Deferred tax	254		410	
		1,260	291	701
Current liabilities:				
Trade payables				
Tax	626		552	
Interest payable	234		188	
Other provisions	20		4	864
Total equity and liabilities	400	1,280	120	
		10,431		7,071

Income statement for the year to 31 March 2004

	$'000	$'000
Revenue		14,780
Cost of sales		(9,607)
Gross profit		5,173
Distribution costs	(1,222)	
Administrative expenses (including provisions)	(2,924)	(4,146)
Profit from operations		1,027
Finance cost		
Income from investments	(45)	
Profit before tax	0	(45)
Income tax expense		982
Net profit for the period		(197)
		785

Additional information:

(i) Tangible non-current assets' balances were as follows:

	31 March 2004 Cost or valuation	*31 March 2003 Cost or valuation*	*Accumulated depreciation/ amortisation*
	$'000	$'000	$'000
Land	3,636	3,186	0
Buildings	3,063	1,663	416
Plant, machinery and equipment	2,188	1,108	671
Assets under construction	0	53	0

(ii) Intangible non-current assets comprise development expenditure incurred in previous years and in the current year, and are carried forward to future periods. Development expenditure amortised during the year was $18,000.

(iii) Tangible non-current assets include land which was revalued by $450,000 on 31 March 2004.

(iv) Machinery disposed off in the year had originally cost $400,000; accumulated depreciation at 31 March 2003 was $380,000. The agreed selling price of $31,000 had not been received by the year-end and is included in receivables.

(v) Assets under construction refer to a contract, started in February 2003, to build and supply C with new machinery. The machinery was installed and testing completed by 31 December 2003. Production began early January 2004. C had taken out a specific loan to finance the payments under the contract and, in accordance with IAS 23 – Borrowing costs, has decided to capitalise the interest payments up to 31 December 2003. The interest paid was $24,000; this amount was transferred from the interest-paid account to the assets-under-construction account. The balance on the assets-under-construction account was transferred to the plant-and-machinery account on 31 March 2004. The amount transferred was:

	$'000
Balance at 31 March 2004	526
Interest	24
Total cost	550

In addition to this contract, other new plant and machinery had been purchased during the year.

(vi) Depreciation charged for the year was:

Buildings	2.5% straight line
Plant, machinery and equipment	20% reducing balance

C's accounting policy is to charge a full year's depreciation in the year of acquisition and no depreciation in the year of disposal.

Receivables consist of:

	31 March 2004	*31 March 2003*
	$'000	$'000
Trade receivables	712	401
Receivable arising from sale of non-current assets	31	0
Interest receivable on current asset investments	0	34

(vii) The current asset investment was a government bond, which matured on 31 March 2003 and was redeemed in April 2003 for $750,000.
(viii) C did not repurchase any of its shares during the year.
(ix) An interim dividend of $350,000 was paid during the year.

Requirements

(i) Prepare the following disclosure notes, for the year ended 31 March 2004, as required by International Accounting Standards:
(a) Property, plant and equipment;

(8 marks)

(b) Finance cost.

(2 marks)

(ii) Prepare the following for C for the year ended 31 March 2004, in the form prescribed by IAS 7 – Cash-flow Statements:
(a) A cash-flow statement, using the indirect method;

(18 marks)

(b) An analysis of cash and cash equivalents.

(2 marks)
(Total = 30 marks)

Note:

DO NOT prepare a reconciliation of net cash flows to the movement in net debt or an analysis of changes in net debt. All workings must be clearly shown.

Notes to the accounts for non-current assets

		Land	*Building*	*Plant and machinery*	*Total*
		$	$	$	$
	Cost				
(a)	Balance at start of the year	X	X	X	X
	D Disposals	(X)	(X)	(X)	(X)
	A Additions	X	X	X	X
	R Revaluations	X/(X)	X/(X)	X/(X)	X/(X)
	T Transfers	X/(X)	X/(X)	X/(X)	X/(X)
(b)	Balance at the end of the year	X/(X)	X/(X)	X/(X)	X/(X)
	Depreciation				
(c)	Balance at start of the year	X	X	X	X
	D Disposal	(X)	(X)	(X)	(X)
	A Additional/charge for year	X	X	X	X
	R Revaluations	X/(X)	X/(X)	X/(X)	X/(X)
	T Transfers	X/(X)	X/(X)	X/(X)	X/(X)
(d)	Balance at the end of the year	X/(X)	X/(X)	X/(X)	X/(X)
	NBV				
(c − d)	At end of year	X	X	X	X
(a − b)	At start of year	X	X	X	X

The above is the MAXIMUM you will need to learn to answer any question that requests notes to the accounts for non-current assets.

✓ Answers

11.1

Benefits of cash-flow statements to users of accounts

- helps access the ability of the entity to generate cash and cash equivalents
- historical cash flows are often useful indicators of timing, amount and certainty of future cash flows
- aids in the comparison of performance of different entities as cash flows are not affected by differences in accounting policies between entities

11.2

IAS 7 defines cash and cash equivalents as

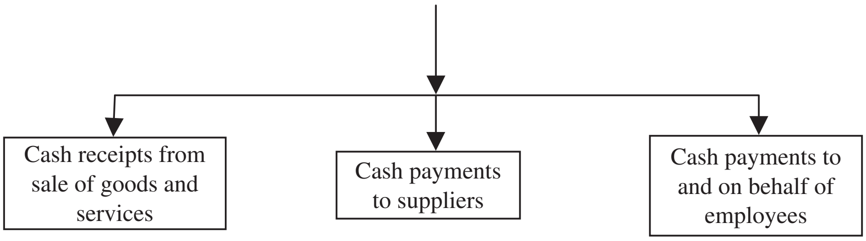
- Cash consists of cash on hand and demand deposits (deposits that can be withdrawn on demand)
- Cash equivalents are short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value
  - e.g. bank deposit with short notice of withdrawal
  - money-maker investments, treasury bills and certificate deposits

Disclosure requirements of cash and cash equivalents

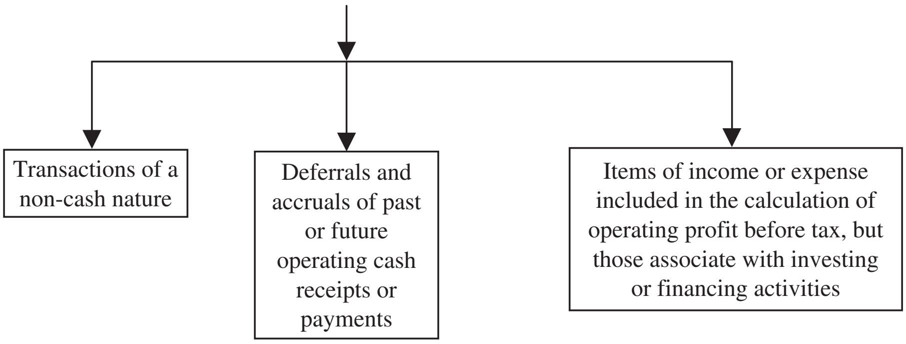
- a note showing components of cash and cash equivalents
- a reconciliation showing the amount of the cash-flow statement with the amounts in the balance sheet

11.3

Direct method presents the gross cash receipts or the gross cash payments for each major category of operational cash flow, i.e.



Indirect method presents cash flows from operating activities begins with the operating profit before taxation and then adjusted for:



11.4 **B**

Cash equivalent do not include cash hence answers A, C and D are incorrect.

11.5 **D**

	$'000
Profit before tax	
Adjustments:	15,144.00
Depreciation	1,846.50
Profit on disposal	(159.00)
Increase in Inventories	(573.00)
Decrease in receivables	43.50
Increase in payables	691.50
	16,993.50
Tax paid	(3,000.00)
Net cash flows from operating activities	13,993.50

11.6 Kallis (Standard layout of cash flow statement and maximum you need to learn for this level.)

Cash flow statement for Kallis as at 31 March 2005

		$	$
Cash flow from operating activities			
Net profit before taxation		7,060	
Adjustments for:			
Depreciation		900	
Amortisation		0	
Investment income		(1,360)	
Interest expense		800	
Loss on sale of plant		0	
Profit on sale of plant		0	
Premium on redemption		0	
Operating profit before working capital changes		7,400	
Increase in trade receivables	(W1)	(1,200)	
Decrease in inventories	(2,000 – 3,900)	1,900	
Decrease in payables	(500 – 3,780)	(3,280)	
Cash generated from operations		4,820	
Interest paid	(W2)	(540)	
Income tax paid	(W4)	(1,800)	
Net cash flow from operating activities		(2,480)	2,480
Cash flow from investing activities			
Purchase of plant, property, equipment	(vii)	(2,000)	
Proceeds for sale of equipment	(iii)	40	
Interest received	(W2)	400	
Dividend received	(W2)	760	
Purchase of government stock		0	
Net cash-flow from investing activity		(800)	(800)
Cash flow from financing activities			
Proceeds from issue of shares	(3,000 – 2,500)	500	
Proceeds from long-term borrowing	(W5)	900	
Payment of finance lease liabilities	(i)	(180)	
Dividends paid	(ii)	(2,400)	
		(1,180)	(1,180)
Net income in cash and cash equivalents			500
Cash and cash equivalent at the start of year			320
Cash and cash equivalent at the end of year			820

Do the *opposite entry to that in the income statement*, hence opposite is add back to net profit before tax. For example, profit on sale of asset increases income statement hence opposite is reduce in cash-flow operating activities.

Think what is happening to cash

in or out
\+ −

Think what is happening to cash

increase decrease
\+ −

Think cash

in or out
\+ −

Think cash

in or out
\+ −

Note:

	31 March 2005 $	31 March 2004 $
Cash and cash equivalent		
Cash at bank	80	50
(Bank overdraft)/(Short-term investments)	740	270
	820	320

(W1) Trade receivables

	$		$
Balance b/f	2,400		
Interest receivable (v)	200		
Increase in receivable Balancing figure	1,200	Balance c/d	3,800
	3,800		3,800

(W2) Interest paid

	$		$
Interest Paid Balancing figure	540	Balance b/f	200
Balance c/d	460	Interest Expense (iv)	800
	1,000		1,000

(W3) (Investment income) Dividend received/Interest received

	$		$
Balance b/f	0		
Interest received	400		
Interest receivable at the end of the year	200		
Dividend received Balancing Figure	760	Investment income (income statement)	1,360
	1,360		1,360

(W4) Tax

	$		$
Tax paid Balancing figure	1,800	Balance b/f	2,000
		Tax expense (iii)	400
		Withholding tax (iii)	200
Balance c/d	800		
	2,600		2,600

Loans

	$		$
Interest paid (i)	180	Balance b/f	2,080
		Additional finance	1,800
Balance c/d	4,600	Increase in loan Balancing figure	900
	4,780		4,780

11.7 Imran

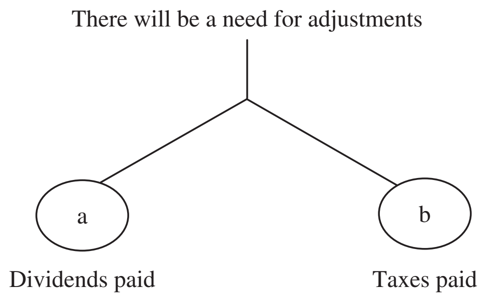
Cash flow statement for Imran as at 31 March 2004

			$	$
	Cash flow from operating activities			
Do the *opposite entry to that in the income statement*, hence opposite is add back to net profit before tax. For example, profit on sale of asset increases income statement, hence opposite is reduce in cash flow operating activities.	Net profit before taxation	(W1)	33,250	
	Adjustments for:			
	Depreciation	(W5)	9,500	
	Amortisation	–	0	
	Investment income	(vi)	(225)	
	Interest expense	(vi)	3200	
	Loss on sale of plant	(W6)/(W7)	500	
	Profit on sale of plant		0	
	Premium on redemption	(ii)	1,000	
	Operating profit before working capital changes		47,225	
Think what is happening to cash: in (+) or out (−)	Increase in trade receivables	(22,000 − 21,400)	(600)	
	Increase in Inventories	(25,500 − 18,500)	(7,000)	
	Increase in Trade Payables	(26,500 − (18,250 − 220))	8,470	
	Cash generated from operations		48,095	
Think what is happening to cash: increase (+) decrease (−)	Interest paid	(vi) 3,200 + 220	(3,420)	
	Income tax paid	step 5	(6,500)	
	Net cash flow from operating activities		38,175	38,175
	Cash flow from investing activities			
Think cash: in (+) or out (−)	Purchase of plant, property, equipment	W2/3/4	(34,500)	
	Proceeds for sale of equipment	(1,500 + 500)(iv)	2,000 (W6/W7)	
	Interest received	(vi)	225	
	Dividend received		0	
	Purchase of government stock		(2,300)	
	Net cash-flow from investing activity		(34,575)	(34,575)
	Cash flow from financing activities			
Think cash: in (+) or out (−)	Proceeds from issue of shares	(25,000 + 10,000)	35,000	
	Proceeds from long-term borrowing	(ii) 1,000 + (35,000 − 15,000)	(21,000)	
	Payment of finance lease liabilities		0	
	Dividends paid	(i)	(5,000)	
			9,000	9,000
	Net income in cash and cash equivalents			12,600
	Cash and cash equivalent at the start of year			(6,900)
	Cash and cash equivalent at the end of year			5,700

Note:

	31 March 2004 $	31 March 2003 $
Cash and cash equivalent		
Cash at bank	5,700	100
(Bank overdraft)/(Short-term investments)	Nil	(7,000)
	5,700	(6,900)

If the income statement is not given in the question, you will need to establish the profit before tax figure.



(W1) **Profit before tax**

	$		$
Dividend paid (i)	5,000	b/f	10,750
Tax paid (v)	4,750		
Deferred tax (v)	6,250		
		Profit before tax	33,250
C/F	28,000	Balancing figure	
	44,000		44,000

Asset purchase

(W2) **Fixtures**

	$		$
b/f	12,000	Disposal	2,500
Additions of fixtures	5,000	c/f Cost	14,500
Balancing figure			
	17,000		17,000

(W3) **Plant**

	$		$
b/f	60,000	Disposal (iv)	4,000
Additions plant	19,500	c/f	75,500
Balancing figure			
	79,500		79,500

(W4) **Land**

b/f	$		$
	55,000		
Additions of Land	10,000	c/f	65,000
Balancing figure			
	65,000		65,000

Total purchase = 19,500 + 10,000 + 5,000 = 34,500

(W5) Depreciation both assets

		b/f	
Depreciation on disposal of			
Plant (iv)	3,000	b/f Plant	22,500
Fixture (iv)	1,000	b/f Fixtures	6,500
c/f Plant	27,000	Depreciation charge for the year on both Plant and Machinery Balancing figure	9,500
c/f Fixture	7,500		
	38,500		38,500

Step 1 Do the layout of the Cash Flow Statement (CFS).

Step 2 Calculate the Profit before tax figure if not given.

Step 3 Adjustments from operating activities.

do opposite of what effect items will have in income statements	Depreciation	9,500
	Amortisation	0
	Loss on sale of asset	500
	Profit on sale of asset	0
	Interest income	(225)
	Interest expense	3,200
	Premium on redemption	1,000

Step 4 Operating profit before working capital changes.

Think cash if
inflow +   outflow −

Increase in inventories	(25,500 – 18,500)	(7,000)
Increase in receivables	(22,000 –21,400)	600
Increase in payables	(20,500 – (18,250 – 220))	8,470

(W6) Plant: Fixed asset disposal account

	$		$
Car	4,000	Accumulated depreciation	3,000
		Sale proceeds	1,500
Profit Balancing figure	500		
	4,500		4,500

Proceeds from sale $2,000

(W7) Fixtures

	$		$
Car cost	2,500	b/f	1,000
		Sale proceeds	500
		Loss Balancing figure	1,000
	2,500		2,500

Profit	500
Loss	(1,000)
	(500)

Step 5

Calculation

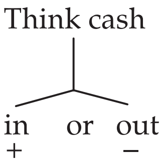
Interest

	$		$
Interest Paid Balancing figure	3,420	b/f	220
c/f	–	Income Statement	3,200
	3,420		3,420

Tax

	$		$
		b/f	5,500
Taxes paid Balancing figure	6,500	b/f	4,000
Int	9,000	Income statement – Current year	4,750
tax	5,000	Income statement – Current year	6,250
	20,500		20,500

Step 6 Cash flow from investing activity



	$
Purchase of property, plant and equipment	(34,500)
Proceeds on sale of plant and equipment	2,000
Purchase of government stock	(2,300)
Interest received	225
	(34,575)

Step 7 Cash flow from financing activity

		$
Issue of shares	(25,000 + 10,000)	35,000
Repayment of loan	(20,000 + 1,000)	(21,000)
Dividends paid		(5,000)
		9,000

11.8 (i) (a) Notes to the Accounts for non-current assets

		Land	*Under construction*	*Building*	*Plant and machinery*	*Total*
		$	$	$	$	$
	Cost					
(a)	Balance at start of the year	3,186	53	1,663	1,108	6,010
	D Disposals (iv)	0	0	0	(400)	(400)
	A Additions	0	473	1,400	930	2,803
	R Revaluations	450	0	0	0	450
	Interest on Loan	0	24	0	0	24
	T Transfers	0	(550)	0	550	0
(c)	Balance at the end of the year	3,636	–	3,063	2,188	8,887
(b)	Depreciation					
	Balance at start of the year	0	0	416	671	1,087
	D Disposal (iv)	0	0	0	(380)	(380)
	A Additional/charge for year	0	0	77*	379**	456
	R Revaluations	0	0	0	0	0
	T Transfers	0	0	0	0	0
(d)	Balance at the end of the year	0	0	493	670	1,163
	NBV					
(c – d)	At end of Year	3,613	0	2,570	1,518	7,724
(a – b)	At start of Year	3,186	53	1,247	437	4,923

Note:

* $3,063 \times 2.5\% = \$77$
** $2,188 + 380 - 671 = 1,897 \times 20\% = 379$
(reducing balance method)

Finance cost				$
8	(i)	(b)	Interest due (Balancing figure)	69
			Transfer to non-current assets	(24)
				45

(W1) Machine disposal account

	$		$
Cost	400	Accumulated Depreciation	380
Profit Balancing figure	11	Sale proceeds	31
	411		411

(W2) Interest paid

	$		$
Interest paid Balancing figure	29	Balance b/f	4
Balance c/d	20	Income statement (finance cost)	45
	49		49
Capitalisation	24		
(v) Interest paid	29		
	53		

(W3) Tax paid

	$		$
Tax paid Balancing figure	188	b/f deferred tax	291
		b/f tax	188
c/d deferred tax	254	Income statement	197
c/d tax	234		
	676		676

(W4) Development expenditure

	$		$
Amortised	18	Bal b/f	90
Bal c/d	111	New expenditure	39
	129		129

(W5) Interest received

	$		$
bal b/f	34	Received in year Balancing figure	34
		Bal c/d	0
	34		34

(ii) *C – Cash flow statement for Imran as at 31 March 2004*

> Do the *opposite entry to that in the income statement*, hence opposite is add back to net profit before tax. For example, profit on sale of asset increases income statement hence opposite is reduce in cash flow operating activities.

		$	$
Cash flow from operating activities			
Net profit before taxation		982	
Adjustments for:			
Depreciation		456	
Amortisation		18	
Investment income		0	
Interest expense		45	
Loss on sale of plant		0	
Profit on sale of plant		(11)	
Premium on redemption		0	
Operating profit before working capital changes		1,490	
Increase in trade receivables		(311)	
Increase in inventories	(1,337 − 864)	(473)	
Increase in trade payables	(626 − 552)	74	
Increase in provision	(400 − 120)	280	
Cash generated from operations		1,060	
Interest paid	(W2)	(53)	
Income tax paid	(W3)	(188)	
Net cash flow from operating activities		819	819
Cash flow from investing activities			
Purchase of plant, property, equipment	(Part ai)	(2,803)	
Proceeds for sale of equipment	(W4)	(39)	
Interest received	(vi)	34	
Dividend received		0	
Purchase of government stock		0	
Net cash-flow from investing activity		(2,808)	(2,808)
Cash flow from financing activities			
Proceeds from issue of shares (2,000 − 1,500) + (1,500 − 500)		1,500	
Proceeds from long-term borrowing	(1006 − 410)	596	
Payment of finance lease liabilities		0	
Dividends paid	(Note X)	(350)	
		1,746	1,746
Net income in cash and cash equivalents			(243)
Cash and cash equivalent at the start of year			759
Cash and cash equivalent at the end of year			516

Think what is happening to cash: in or out (+ / −)

Think what is happening to cash: increase or decrease (+ / −)

Think cash: in or out (+ / −)

Think cash: in or out (+ / −)

Note:

	31 March 2004 $	31 March 2003 $
Cash and cash equivalent		
Cash at bank	489	7
	27	22
Bank overdraft (Current asset investments)	0	730
	516	759

Non-current Tangible Assets

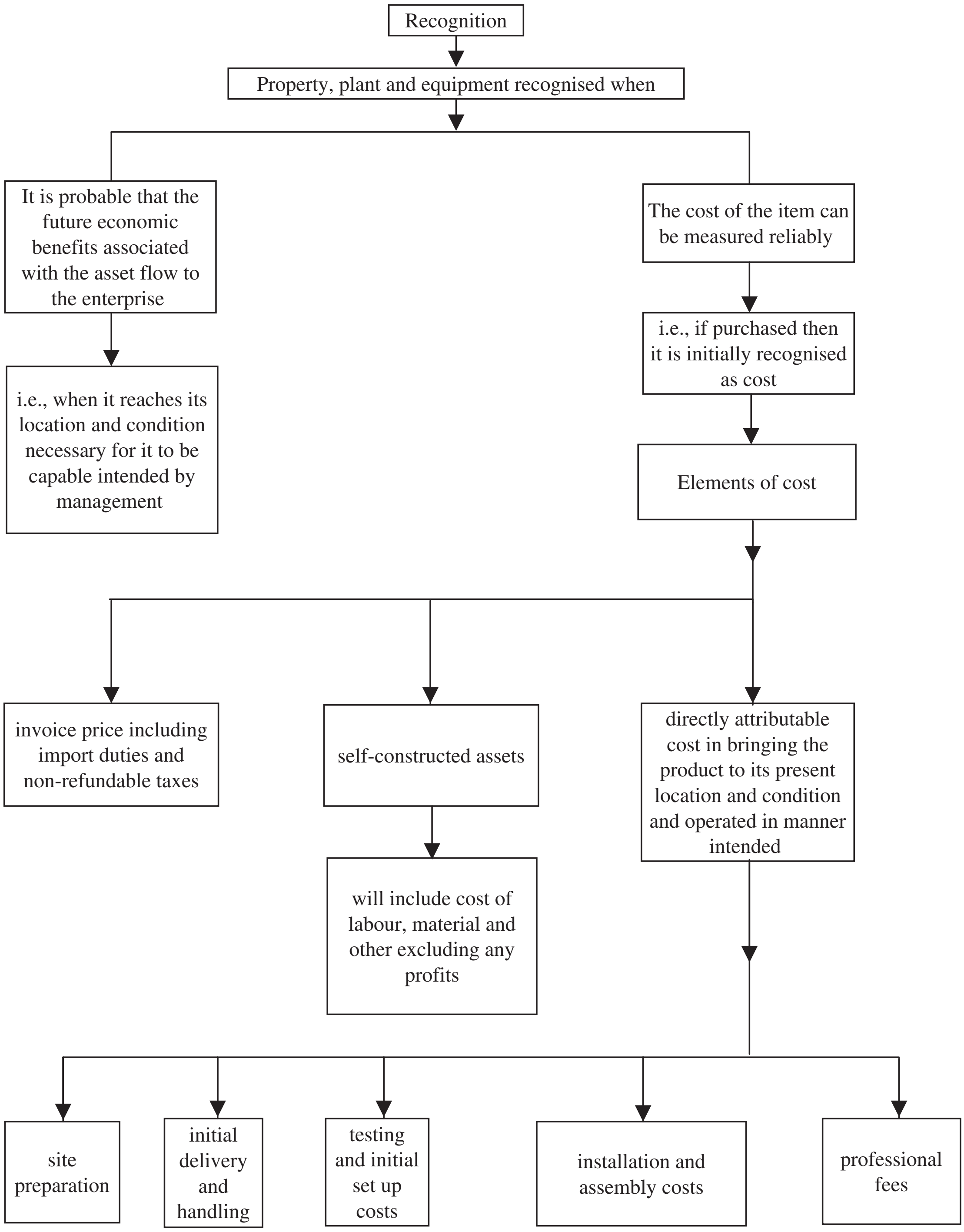
12

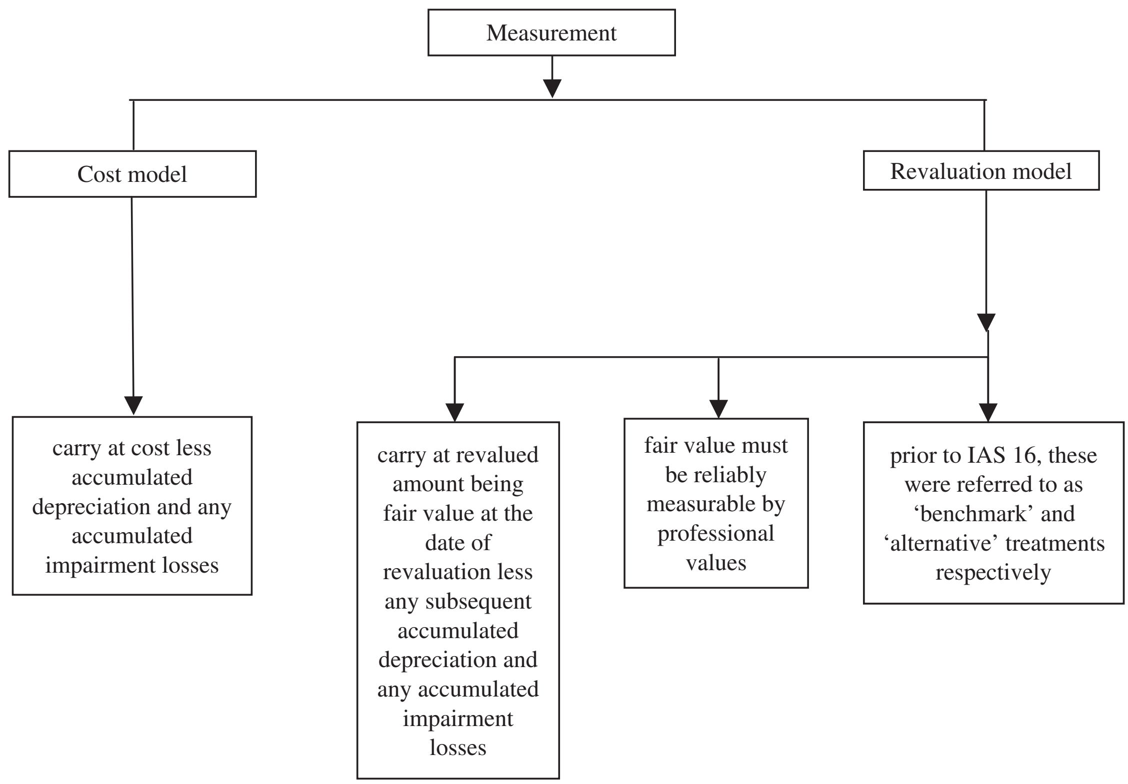
Standards

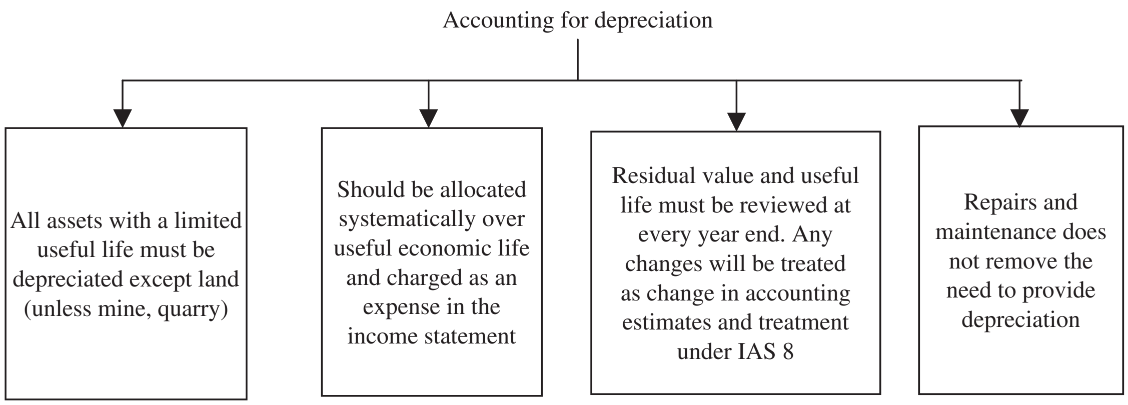
IAS 16

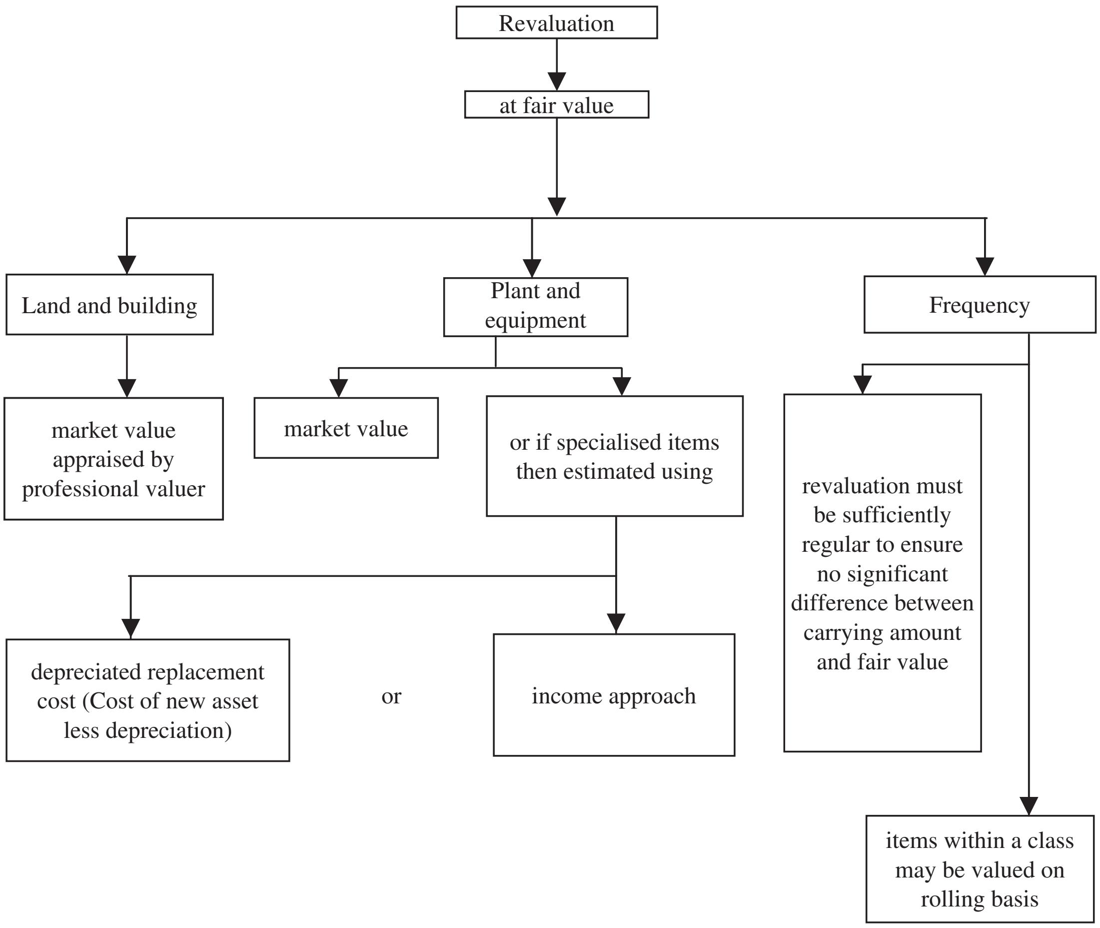
Property, Plant and Equipment, the calculation of depreciation and the effect of revaluation, charges in useful economic life, repairs, improvements and disposals.

- Property, plant and equipment: held for use in production, supply of goods and services, for rental to others or for administrative purposes
- Carrying amount: amount at which asset is recognised after deducting accumulated depreciation and impairment costs
- Cost: amount paid and the fair value of other consideration given to acquire an asset at the time of acquisition or construction
- Depreciable amount: cost or valuation of asset less its residual value
- Depreciation: systematic allocation of the depreciable amount of an asset over its useful economic life
- Fair value: amount at which the asset can be exchanged between knowledgeable, willing parties in an arm's length transaction
- Recoverable amount: higher of Net realisable value / Value in use
- Residual value: amount obtained from disposal of asset after deducting estimated costs
- Useful life: period over which the asset is expected to be available for use by the enterprise
- Impairment loss: where the carrying amount exceeds recoverable amount


Recognition
Property, plant and equipment recognised when
It is probable that the future economic benefits associated with the asset flow to the enterprise
i.e., when it reaches its location and condition necessary for it to be capable intended by management
The cost of the item can be measured reliably
i.e., if purchased then it is initially recognised as cost
Elements of cost
invoice price including import duties and non-refundable taxes
self-constructed assets
will include cost of labour, material and other excluding any profits
directly attributable cost in bringing the product to its present location and condition and operated in manner intended
site preparation
initial delivery and handling
testing and initial set up costs
installation and assembly costs
professional fees


Measurement
Cost model
Revaluation model
carry at cost less accumulated depreciation and any accumulated impairment losses
carry at revalued amount being fair value at the date of revaluation less any subsequent accumulated depreciation and any accumulated impairment losses
fair value must be reliably measurable by professional values
prior to IAS 16, these were referred to as 'benchmark' and 'alternative' treatments respectively

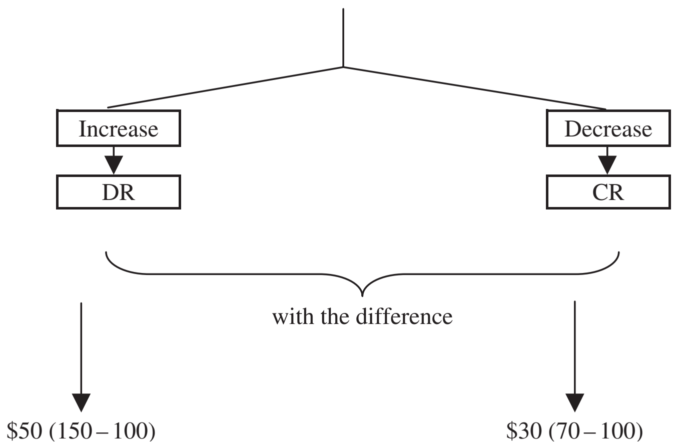

Accounting for depreciation
All assets with a limited useful life must be depreciated except land (unless mine, quarry)
Should be allocated systematically over useful economic life and charged as an expense in the income statement
Residual value and useful life must be reviewed at every year end. Any changes will be treated as change in accounting estimates and treatment under IAS 8
Repairs and maintenance does not remove the need to provide depreciation



Example	$
Cost	100
Accumulated depreciation	20
Revalue asset (a)	150
(b)	70

Step 1

Take the difference between the original cost and revalued cost if



Step 2

Eliminated accumulated depreciation hence, debit by $20

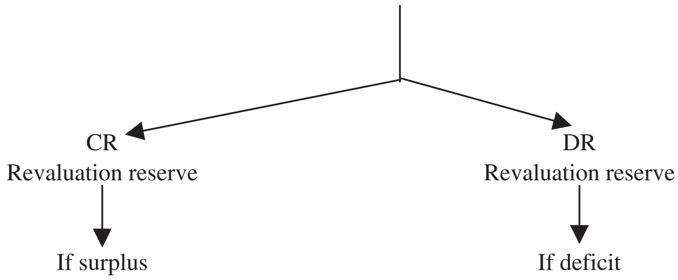
Step 3 (a)

Thus		$	$
DR	Cost	50	
DR	Accumulated depreciation	20	
CR	Revaluation reserve		70

Step 3 (b)

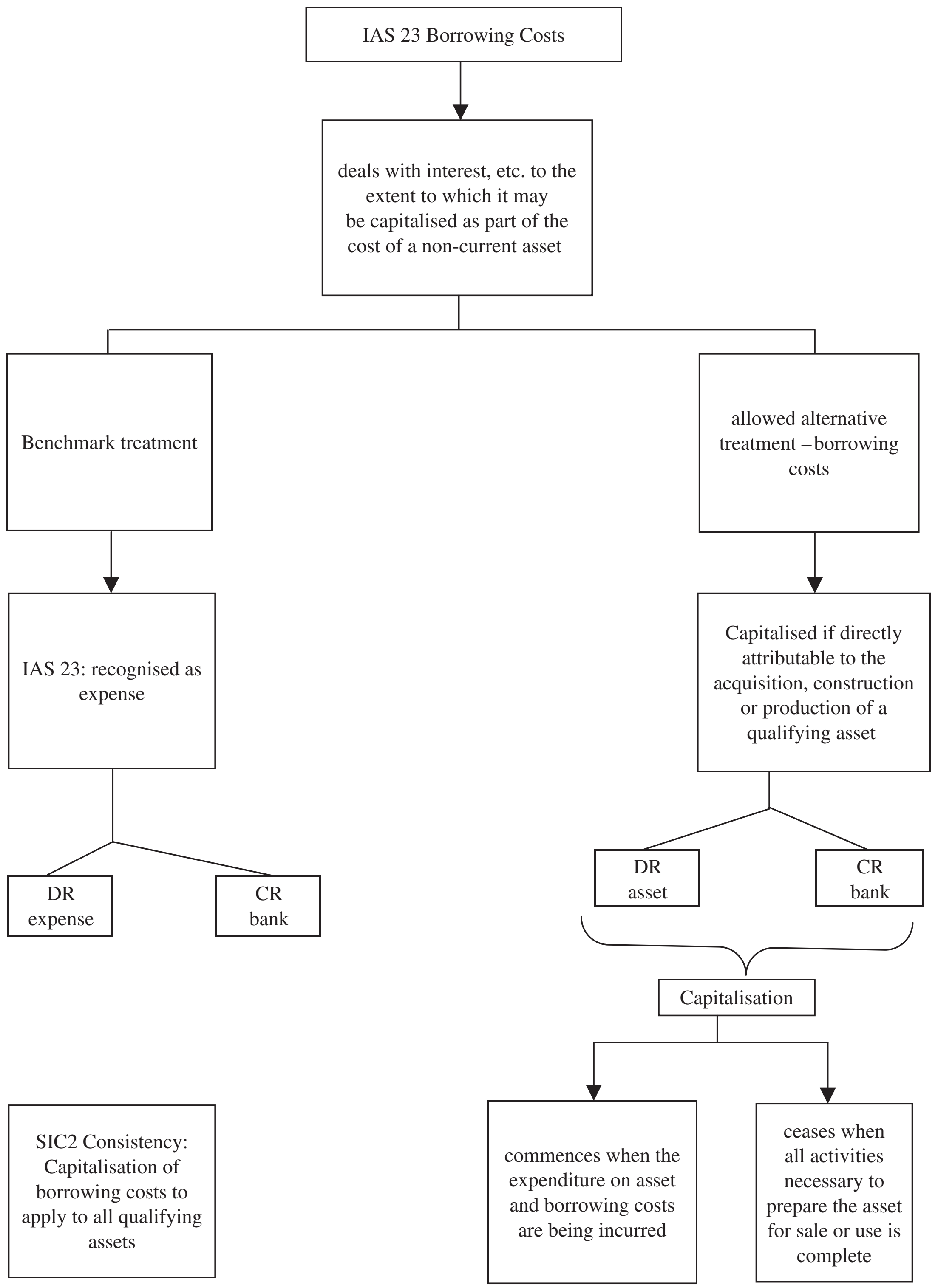
		$	$
DR	Accumulated depreciation	20	
CR	Cost		30
DR	Revaluation reserve	10	

Hence



Rules IAS 6

		Asset	*Revaluation reserve*	*Income statement*
Increase shall be credited directly to Equity under the Revaluation reserve	1.1.04	100		
	Revalued surplus	20	20	0
	31.12.04	120	20	0
The deficit is offset against the surplus in the Revaluation reserve balance	1.1.05	120	20	0
	Revalued deficit	(15)	(15)	0
	31.12.05	105	5	0
Again the deficit is taken to the surplus in the Revaluation reserve balance, any further balance is debited to the income statement as an expense	1.1.06	105	5	0
	Revalued deficit	(9)	(5)	4 DR
	31.12.06	96	nil	4 DR
That part of the surplus that reverses the previously expensed deficit (4) is taken to the income statement. The rest (11) is taken directly to equity.	1.1.07	96	nil	4 DR
	Revalued surplus	15	11	4 CR
	31.12.07	111	11	0


IAS 23 Borrowing Costs
deals with interest, etc. to the extent to which it may be capitalised as part of the cost of a non-current asset
Benchmark treatment
allowed alternative treatment – borrowing costs
IAS 23: recognised as expense
Capitalised if directly attributable to the acquisition, construction or production of a qualifying asset
DR expense
CR bank
DR asset
CR bank
Capitalisation
SIC2 Consistency: Capitalisation of borrowing costs to apply to all qualifying assets
commences when the expenditure on asset and borrowing costs are being incurred
ceases when all activities necessary to prepare the asset for sale or use is complete

? Questions

12.1 Recoverable amount is

A Lower of net realisable value and value in use
B Higher of net realisable value and value in use
C Amount obtained from disposal of assets after deducting estimated cost
D Lower of value in use and disposable value

(2 marks)

12.2 What is cost as per IAS 16

A Amount paid and fair value of other consideration given on asset at time of acquisition
B Amount paid and fair value of other consideration given to acquire an asset prior to acquisition
C Same as B except after acquisition
D Amount paid less any residual value

(2 marks)

12.3 Impairment loss as per IAS 16 is defined as

A Where the carrying amount exceeds recoverable amount
B Where carrying amount exceeds residual value
C Where cost exceeds recoverable amount
D Where cost exceeds residual value

(2 marks)

12.4 Which of the following tangible non-current assets are *not* usually depreciated?

A Plant and machinery
B Land
C Building
D Motor vehicles

(2 marks)

12.5 When accounting for depreciation, repairs and maintenance does not remove the need to provide depreciation under IAS 16. Is this statement

True or False

(2 marks)

12.6 Residual value and useful life must be reviewed at every year end and any changes will be treated as change in accounting estimates and treated accordingly under IAS 8. Is this statement

True or False

(2 marks)

12.7 Depreciation should be allocated systematically over useful economic life and charged as an expense in the income statement. Is this statement

True or False

(2 marks)

12.8 Tissiman purchases a specialised machine for $20,000 on 1 April 2000. The machine had an expected useful life of ten years and was depreciated using the straight-line method. Residual value was assumed to be zero. Tissiman decided to revalue their machine on 31 March 2003 to market value of $35,000.

Tissiman ceased production of a product line and no longer required the machine. They sold the machine for $32,000 on 31 March 2004.

On disposal of the machine Tissiman should:

(i) Transfer $21,000 from revaluation reserve to retained earnings
(ii) Credit gain on disposal of $2,000 to the income statement
(iii) Debit loss on disposal of $1,000 to income statement
(iv) Transfer $15,000 from revaluation reserve to retained earnings
(v) Credit gain on disposal of $23,000 to income statement

Which of the following are the correct entries to record the gain/loss on disposal?

A (i) and (iv)
B (iii) and (iv)
C (v) only
D (i) and (ii)

(2 marks)

12.9 Plant and machinery costing $50,000, was purchased on 1 April 2000. This was depreciated for two years at 20 per cent using the reducing balance method. On 1 April 2002 the machinery (original cost $25,000) was sold for $12,000. Replacement machines were acquired on the same date for $34,000. What was the net book value of plant and machinery at 1 April 2003?

A $39,000
B $43,200
C $40,800
D $40,000

12.10 Tiger purchased property costing $880,000 on 1 January 2000. The property is being depreciated over 50 years on a straight-line basis.

The property was revalued on 1 January 2004 at $1,040,000. The useful life was also reviewed at that date and is estimated to be a further 40 years.

(2 marks)

Requirement

Prepare the accounting entries to record the revaluation and calculate the depreciation charge that will apply from 1 January 2004.

(8 marks)

12.11 A property was purchased on 1 January 1998 for $1.6 million. The asset is used from the date of acquisition and its estimated useful economic life is 50 years. After five years of use, the asset is revalued on 1 January 2003 at $1.66 million.

As subsequent valuation was completed one year later, as the property valuations in that area were experiencing significant fluctuations, and the property valuation was $1.5 million.

Requirements

(i) Explain the treatment and prepare the accounting entries to record the revaluation on 1 January 2003.

(4 marks)

(ii) Explain the treatment and prepare the accounting entries to record the revaluation on 1 January 2004.

(6 marks)
(Total = 10 marks)

Answers

12.1 **B**

C is definition for recoverable value

A and D, no such definition exist.

12.2 **A**

B, C, D are there to confuse the student and are incorrect.

12.3 **A**

B, C, D are there to confuse the student and are incorrect.

12.4 **B**

All tangible assets with a finite useful life are depreciated. If the land was leasehold with a finite life then it would be depreciated. Here we assume that the land is freehold. Please note also that land such as mines, quarry, etc. are depreciated.

12.5 True

12.6 True

12.7 True

12.8 **D**

Cost \$20,000, Revalued to \$35,000, Depreciation: Life 10 years

$$\frac{\text{Cost} - \text{Residual value}}{\text{Estimated useful life}}$$

$$= \frac{20{,}000 - 0}{10} = \$2{,}000 \text{ per year for 10 years}$$

How to deal with revaluation:

Revalued amount − Cost
35,000 − 20,000 = 15,000

Depreciation in 3 years from 1 April 2000 to 31 March 2003, hence when revalued
\$2,000 × 3 = \$6,000

therefore

		\$	\$
DR	Cost	15,000	
DR	Depreciation	6,000	
CR	Revaluation reserve		21,000

hence (i) is correct.

12.9 **D**

			$
Year 1 (2000) Cost			50,000
Depreciation 20%			(10,000)
Year 2 (2001) Cost			40,000
Depreciation 20%			(8,000)
Net book value			32,000
Machine sold			
Cost	25,000		
Year 1 depreciation 20%	(5,000)		
Net book value	20,000		
Year 2 depreciation 20%	(4,000)		
Net book value	16,000	→	(16,000)
Remaining machine net book value			16,000
Additions			34,000
			50,000
Less:			
Depreciation 20%			(10,000)
Net book value of all machines to 1 April 2003			40,000

Depreciation charge will now be based on the remaining useful life which is revised to 40 years.

$520,000/40 = 13,000 per year for 40 years.

12.10

Cost $880,000, Life 50 years

hence depreciation will be

880,000/50 = $17,600 per year for 50 years

Purchased 1 January 2004, revalued on 1 January 2004 at $1,040,000

Revalued amount − Original cost
$1,040,000 − $880,000 = $160,000

Depreciation $17,600 × 4 = $70,400

therefore journals

	$
DR Cost	160,000
DR Depreciation	70,400
CR Revaluation Reserve	230,400

Note/Carrying value of asset is $809,600

why? Carrying value is cost − accumulated depreciation
880,000 − 70,400 = $809,600

Now to deal with Disposal

Fixed asset disposal account

(1)	Cost	X	(2)	Accumulated Depreciation	X
(4)	Profit (Balancing figure) or	X			
			(3)	Sales Proceeds	X
			(4)	Loss (Balancing figure) or	X
		XX			XX

Revised depreciation charge

$$\frac{\text{Cost} - \text{Residual value}}{\text{Remaining useful economic life}}$$

$$= \frac{35{,}000 - 0}{7} = \$5{,}000 \text{ per year for 7 years hence (ii) is correct.}$$

Machine disposal account

Cost	35,000	Accumulated Depreciation	5,000
Profit (balancing figure)	2,000	Sale Proceeds	32,000
	37,000		37,000

12.11 (i)

1 January 1998 Cost $1,600,000

Life 50 years

$$\frac{\text{Cost} - \text{Residual value}}{\text{Estimated useful life}}$$

$$= \frac{1{,}600{,}000 - 0}{50} = \$32{,}000 \text{ per year for 50 years}$$

Revalued 1 January 2003 to $1.66 million

Revalued amount − Cost = $1.66 million − $1.6 million
= $60,000 increase in cost

Depreciation 5 years
$32,000 × 5 = $160,000

hence

		$	$
DR	Cost	60,000	
DR	Accumulated depreciation	160,000	
CR	Revaluation reserve		220,000

Total life − Already used = Remaining life
50 − 5 = 45

Revalued amount $1.66 million

therefore, Depreciation per year $ 1.66 million/45 = $36,888 per year for 45 years.

(ii)

Revalued 1 January 2004 to $1.5 million
Revalued amount − Cost
1.5 million − 1.66 million = 160,000 Deficit

		$	$
CR	Cost		160,000
DR	Accumulated depreciation	36,888	
DR	Revaluation reserve	123,112	

This would be treated as an impairment deficit.

13 Accounting for Leases

IAS 17

Lessor → Person granting the lease

Lessee → Person leasing the asset

Lease

Lessor conveys to the lessee in return for a series of payments, the right to use an asset for an agreed period of time.

Types of leases

Finance lease → transfers all the risk and reward of ownership of an asset to the lessee

Operating lease → anything other than a finance lease

Lease term: Period over which the lessee has contracted to lease the asset with an option to extend the lease term with or without further payments.

Minimum lease payment: Payments over the lease term that the lessee is required to make, excluding costs for services and tax paid by and reimbursed by lessor.

Inception of lease:

Earlier of

- date of lease agreement

or

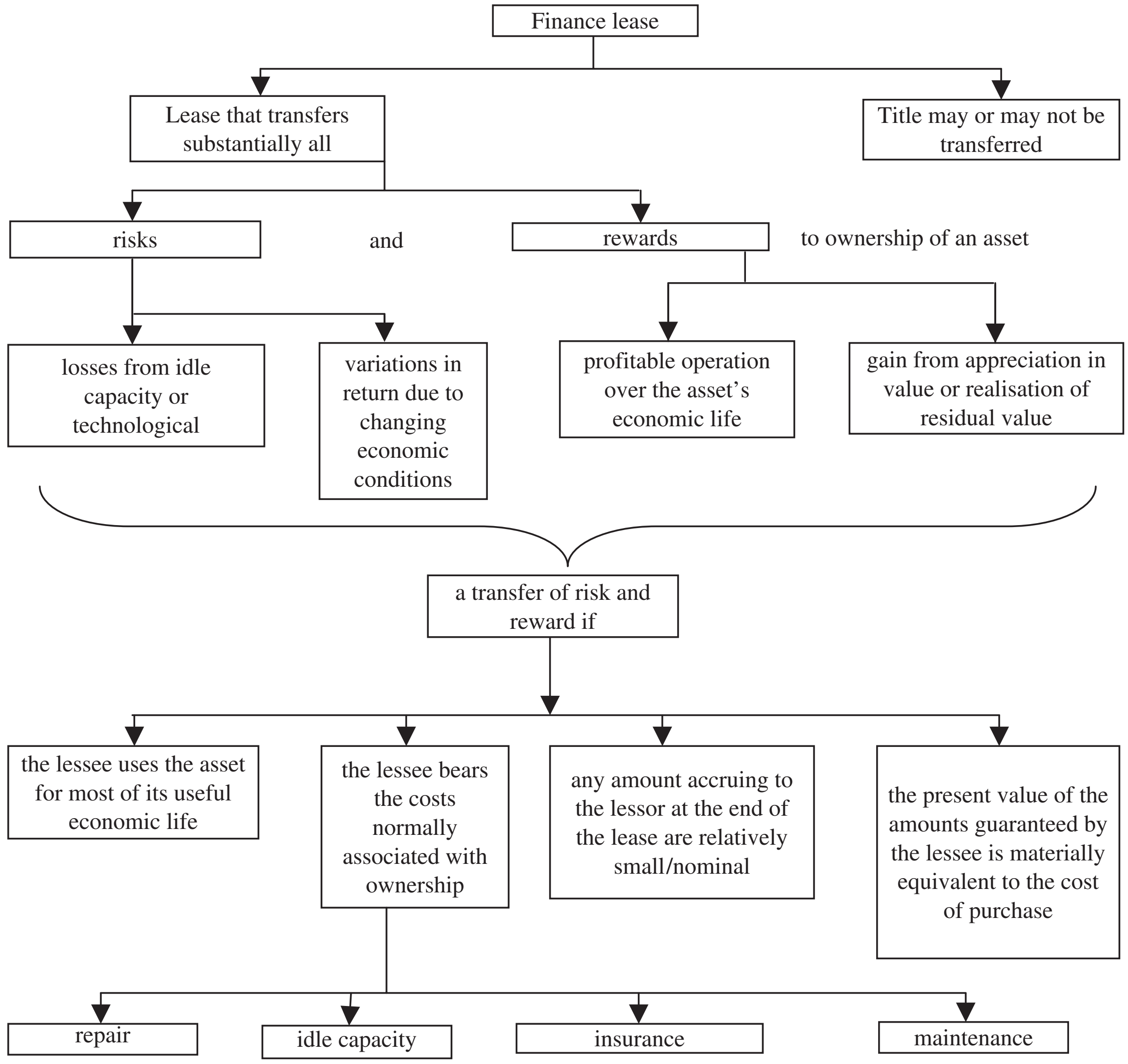
- a commitment by the parties to the principal provisions of the lease

Interest rate implicit in the lease

discounted rate of interest at inception causes the aggregate present value of

minimum lease payments and the unguaranteed residual value

to be equal to the fair value of the asset


Finance lease
Lease that transfers substantially all
Title may or may not be transferred
risks
and
rewards
to ownership of an asset
losses from idle capacity or technological
variations in return due to changing economic conditions
profitable operation over the asset's economic life
gain from appreciation in value or realisation of residual value
a transfer of risk and reward if
the lessee uses the asset for most of its useful economic life
the lessee bears the costs normally associated with ownership
any amount accruing to the lessor at the end of the lease are relatively small/nominal
the present value of the amounts guaranteed by the lessee is materially equivalent to the cost of purchase
repair
idle capacity
insurance
maintenance

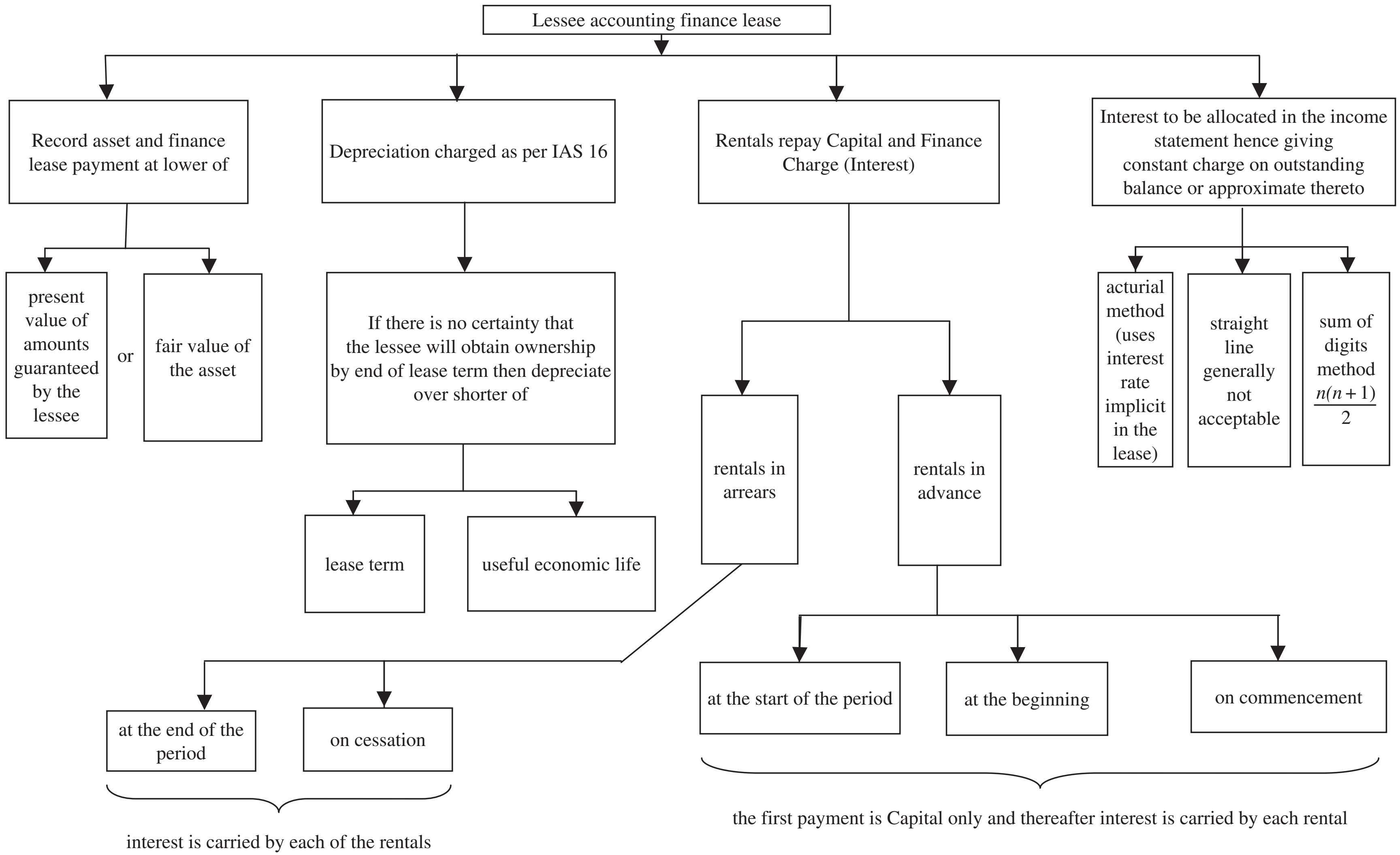
IAS 17 Classification of finance lease

- Lease transfers ownership to the lessee at end of lease term
- Lessee has option to purchase the asset at bargain price, this option being exercised at inception of lease
- Lease term is for the major part of the useful life of the asset even if title is not transferred
- Gains/losses from fluctuations in the fair value of a residual fall to the lessee
- At inception the present value of minimum lease payments is greater than or equal to substantially all of the fair value of the leased asset
- Leased assets are of specialised nature and only lessee can use them without major modifications
- The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market value
- If lessee cancels the lease, any losses associated are borne by the lessee

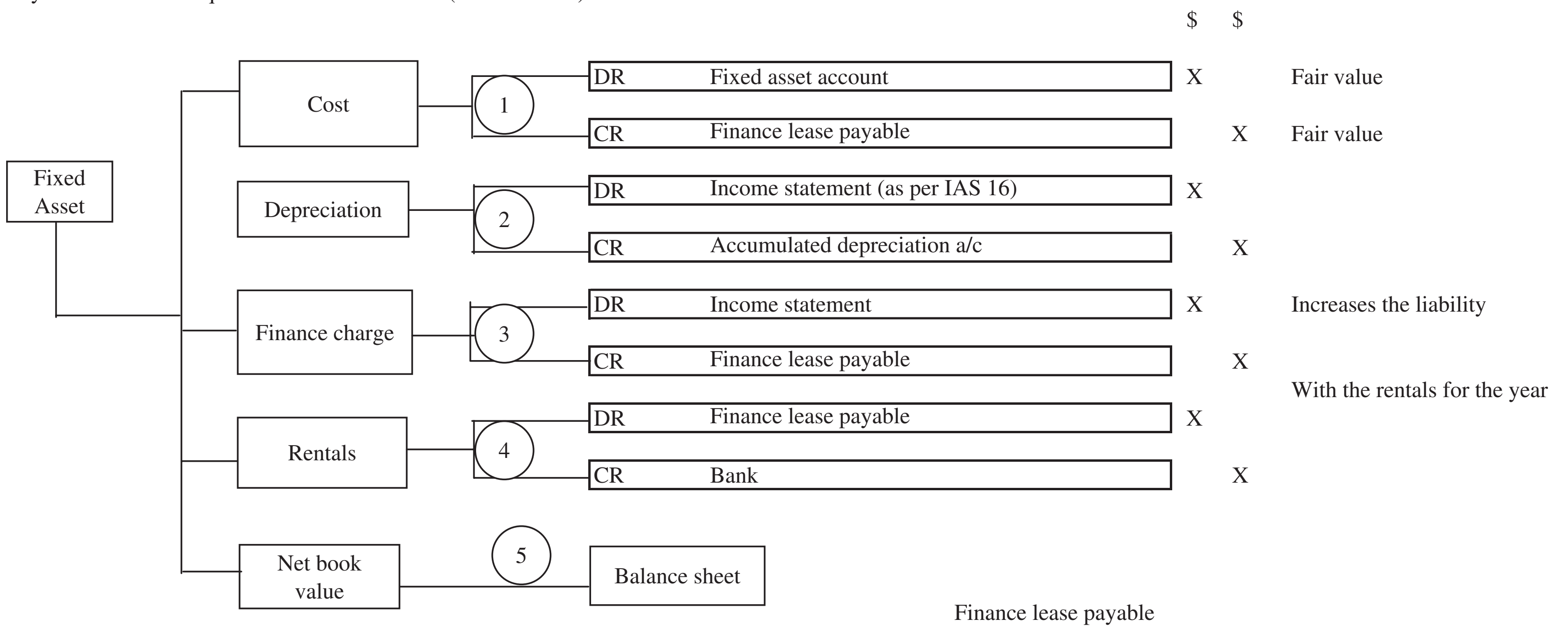
Comments on classification

who bears the capital cost, i.e. risk of purchase

- if lessee guarantees to bear all cost of purchase (Fair value) then treat as finance lease.
  Substantial = IAS 17 no definition however GAAP accepts 90% or more
- if lessee bears substantially all the cost then he would get all the use of the asset and hence he owns the asset


Lessee accounting finance lease
Record asset and finance lease payment at lower of
present value of amounts guaranteed by the lessee
or
fair value of the asset
Depreciation charged as per IAS 16
If there is no certainty that the lessee will obtain ownership by end of lease term then depreciate over shorter of
lease term
useful economic life
Rentals repay Capital and Finance Charge (Interest)
rentals in arrears
rentals in advance
at the end of the period
on cessation
interest is carried by each of the rentals
at the start of the period
at the beginning
on commencement
the first payment is Capital only and thereafter interest is carried by each rental
Interest to be allocated in the income statement hence giving constant charge on outstanding balance or approximate thereto
acturial method (uses interest rate implicit in the lease)
straight line generally not acceptable
sum of digits method $\frac{n(n+1)}{2}$

Layout to answer for questions on finance lease (Lessee books)



Finance lease payable

4 Rentals		1 Cost	X	Fair value
if annually	X	3 Finance charge if		
	X	annually	X	(one payment)
half-yearly	X	half-yearly	X	(two payments)
	X		X	
	X		X	
quarterly	X	quarterly	X	(four payments)
	X		X	
Balance c/d (total creditors)	X		X	
	XX		XX	
		Balance b/f (total creditors)	X	

		$
Total Creditor	<Less than 1 year (from question) (*)	x
	>More than 1 year (always balancing figure)	x
		xx

from the finance lease payable account.

Represented in the Balance sheet.

* If Question states lease terms are in advance then its easy to establish the >1 year creditors, if Question states lease terms are in arrears then you will need to slow down when calculating the >1 year creditors.

Sum of digits method

Step 1

	$
Total rentals	X
Less:	
Cash price of asset (Fair value)	(X)
Total interest	X

Step 2

allocate over lease term using $\frac{n(n+1)}{2}$

n = number of payments outstanding

if advance less 1 from n

say $n = 20$

$\begin{pmatrix} n-1 \\ 20-1=19 \end{pmatrix}$

if arrears then

$n = n$

$(n = n = 20)$

Disclosure requirements – finance lease

- Net carrying amount of assets shown for each class of asset in balance sheet
- Minimum lease payments * Present value
  - classified into
    - <1 Year
    - 1–5 Years
    - >5 Years
- All finance lease assets must be identified separately in the financial statements
- Liabilities should be classified into less than and more than one year
- Repayments and interest terms identified

Questions

13.1 A finance lease is

A where risk and rewards of ownership are transferred to the lessee
B where risk and rewards of ownership are transferred to lessor
C there are no risks and rewards of ownership
D None of the above

(2 marks)

13.2 What is the Journal to record the

(i) cost
(ii) depreciation
(iii) finance charge and
(iv) rentals

(2 marks)

under finance lease

(i)

A	DR Fixed asset CR Finance lease payable		C	DR Fixed asset CR Bank	
B	DR Finance lease payable CR Fixed asset		D	DR Bank CR Fixed asset	

(ii)

A	DR Income statement CR Accumulated depreciation	C	DR Income statement CR Fixed asset
B	DR Fixed asset CR Accumulated depreciation	D	DR Fixed asset CR Bank

(iii)

A	DR Income statement CR Bank	C	DR Income statement CR Fixed asset
B	DR Income statement CR Finance lease payable	D	DR Fixed asset CR Income statement

(iv)

A	DR Finance lease payable CR Bank	C	DR Asset CR Bank
B	DR Bank CR Finance lease payable	D	DR Bank CR Asset

13.3 Discuss the factors which offset the classification of finance lease.

(7 marks)

13.4 On 1 January 2004, Applebea leased asset with fair value of £400,000. He paid ten monthly instalments of £49,000, starting on 1 January 2004.

Requirement

Calculate the finance charge allocation, using both the actuarial and sum of digits methods.

(20 marks)

Guideline to Question 13.4

(i) Actuarial method

(Assumes interest accrues @ 5% per six monthly period.)

1.1.04	Cash price (fair value)	XX	Total income statement charge for 2004
1.1.04	First instalment	XX	
		XX	
1.1.04–30.6.04	Interest at 5%	XX	
		XX	
1.7.04	Second instalment	XX	
		XX	
1.7.04–31.12.04	Interest at 5%	XX	
		XX etc.	

(ii) Sum of digits method

$$\text{Sum of digits} = \frac{n(n+1)}{2} = Z$$

Total finance charge:

Ten instalments		XX
Cash price (fair value)		XX
	$	XX

Interest is then allocated:

1.1.04–30.06.04	= $	$\frac{\text{payment outstanding}}{Z} \times$ Total finance charge
1.7.04–31.12.04	= $	
1.1.05–30.06.05	= $ etc.	

Allocation methods

(a) Straight Line → inappropriate unless immaterial
(b) Actuarial → charge = Creditor at start of each credit period multiplied by interest rate in lease
(c) Sum of digits → usually reasonable approximation to actual.

Calculation of creditor and analysis

Finance lease payable

	$		$
		Fixed assets cost (Fair Value)	X
Rentals paid	X	Income Statement charges for period	X
c/f Total creditor (balancing figure)	X		
	X		X
		b/f Total creditor	X

	$	$
Creditor due within one year:		
Rentals to be paid within one year	A	
Less:		
Future periods' interest included in A	(X)	
	X	
		X
Creditor due after more than one year (balancing figure)		X
Total creditor (from T account above)		X

Note:

Creditor due with one year = capital element of rentals payable in next year + interest accrued at the balance sheet date but not paid.

Even if rentals are paid in advance, interest is paid in arrears as it accrues over the period for which the loan is outstanding. At start of lease, no interest has accrued. Payment at start of lease is all capital; all subsequent payments include interest for period immediately prior to payments.

13.5 A finance lease runs for five years, with annual payments in arrears of $50,000. The fair value of the asset was $180,000. Using the sum of digits method, what would the outstanding lease creditor be at the end of year 2.

A $94,000
B $122,000
C $125,000
D $80,000

(2 marks)

13.6 On 1 January 2003 Mike Woosnam leased a new machine from Kanu Montgomerie. The cost of the machine is $200,000. The asset has an estimated useful life of five years and has a nil residual value.

Under the terms of the three years lease, six half-yearly payments of $40,000 each are payable in advance, commencing 1 January 2003. At the end of the lease term, the asset has an estimated residual value of $40,000. Mike Woosnam is entitled to 95 percent of this should the asset be sold.

Requirements

(i) Explain, with reasons, why the above lease should be classified as an operating or finance lease.

(4 marks)

(ii) Using the sum of digits method of calculating implied finance charges on the lease, prepare all the relevant accounting entries to record this transaction in the financial statements of Mike Woosnam for the year ended 31 December 2003.

(10 marks)

(iii) Draft extracts from the accounts for the following account categories:
- non-current assets
- current liabilities
- non-current liabilities.

(6 marks)
(Total = 20 marks)

13.7 Hue entered into a finance lease on 1 January 2004. The terms of the lease were 20 payments of $100 in six monthly arrears. The cash price of the asset was $1,200.

The interest rate implicit in the lease is 5.5% (per six monthly period).

Requirements

(i) Show the interest allocation for the first six-month periods using
  (a) Sum of digits method
  (b) Actuarial method.

(ii) Show how the lease would be carried in the financial statements of Hue as at 30 June 2004 using the sum of digits to allocate interest.

(15 marks)

13.8 Same as Question 13.7 except the six monthly payments were in Advance and interest rate explicit is 6.1% (6 monthly).

(15 marks)

13.9 May 2003

BY prepares its financial statements to 31 March each year. The following information relates to the year ended 31 March 2003; the financial statements for the year 31 March 2003 have not yet been completed. There are some transactions regarding non-current assets that need to be clarified.

(a) Some of the cars used by BY's sales force needed replacing. Three new cars were acquired on 1 October 2002. The cars were leased from CarLease on the following terms:
- a non-cancellable 5-year lease;
- a total of 10 payments, made every six months in arrears;
- each installment to be $7,200 ($2,400 per car);
- the interest rate implicit in the lease was 3.5% per six-month period;
- the fair value of each car was $20,000. The present value of the lease payments equals the fair value of the cars at the inception of the lease;
- the residual value of each car at the end of the lease is assumed to be zero;
- BY will pay for all insurance, repairs and maintenance costs.

Requirements

(i) Explain the meaning of 'finance lease', using the above to illustrate your answer. Identify whether the lease on BY's cars should be treated as an operating lease or finance lease.

(8 marks)

(ii) Assuming that the lease is to be treated as finance lease, calculate the figures that will appear in respect of the lease in BY's income statement for the year ended 31 March 2003 and its balance sheet at that date.

(7 marks)

(b) A new type of delivery vehicle, when purchased on 1 April 2000 for $20,000, was expected to have a useful economic life of 4 years. It now appears that the original estimate of the useful economic life was too short, and the vehicle is now expected to have a useful economic life of 6 years, from the date of purchase.

All delivery vehicles are depreciated using the straight-line method and are assumed to have zero residual value.

Requirement

State how BY should record the delivery vehicle in the income statement for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate International Accounting Standards.

(5 marks)

(c) A new machine was purchased from a German enterprise during the year to 31 March 2003. The purchase contract provided for payment to be made in dollars. The following payments were detailed in the contract.

Basic cost of the machine	$
Upgrades and specific modifications to BY specifications	110,000
Shipping and transport charges payable in Europe ($ equivalent)	22,000
Total invoiced cost	3,200
Delivery, handling and installation charges	135,200
Total purchase price	900
	136,100

The contract provided for 10% of the invoiced cost to be paid when the contract was signed, 40% when the machine was despatched, and the balance one month after installation. The delivery, handling and installation charges were to be paid as incurred. All delivery, handling and installation charges were paid by 31 March 2003.

The contract was signed on 1 January 2003 and the machine was despatched on 1 February 2003. BY made both payments on the due date. Delivery was made and installation completed on 25 March 2003.

Requirement

State how BY should record the purchase of the machine in its income statement for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate International Accounting Standard.

(5 marks)
(Total = 25 marks)

13.10 S, a car dealer with a number of outlets, has expanded rapidly in recent years, but cash-flow problems worsened in the year to March 2003. On 1 April 2003, the management of S decided to make three major changes to its activities.

A trainee management accountant has prepared a set of draft financial statements for the year ended 31 March 2004 but unfortunately did not appreciate the need to apply the concept of 'substance over form' in the treatment of the various transactions involved.

Requirements

(i) Explain the meaning of the accounting concept of substance over form. You should refer to relevant International Accounting Standards in your answer.

(4 marks)

(ii)

Information for requirement (ii)

The three major changes made by S on 1 April 2003, and the way in which they have been treated in the draft financial statements for the year ended 31 March 2004, are as follows:

Change 1

S sold all of its land and buildings on a sale and lease-back agreement to P on 1 April 2003. The terms were as follows:

- The annual rental was agreed at $7.5 million.
- The agreed selling price was $50 million with an option for S to repurchase the land and buildings at any time in the next ten years.
- The repurchase price was set at $50 million plus interest at bank rate plus 5% per annum from the date of the sale.

At the time of the sale, the land and buildings had a net book value (and current market value) of $80 million. The draft financial statements have treated the transaction as a disposal of the land and buildings and record a loss on disposal of $30 million in the draft income statement.

(8 marks)

Change 2

S decided to acquire new cars direct from the manufacturer on consignment. The terms of the trading are:

- On delivery of the cars to S they are invoiced at 50% of the purchase price.
- The balance of the purchase price is payable when the cars are sold.
- If a car remains unsold for three months, it must be paid for or returned to the manufacturer.
- When a car is returned, the manufacturer refunds the deposit less a 20% administration fee.

At 31 March 2004, S had 500 new cars in its inventories; all had been in inventories less than three months. The combined purchase price of the cars was $6 million. The draft financial statements omit the new cars from inventories, as they have been treated as the inventory belonging to the manufacturer. The 50% of the purchase price paid has been debited to prepayments in the draft balance sheet.

(5 marks)

Change 3

S replaced the computerised equipment used in its repair workshops. The previous equipment was purchased outright, and had no value on disposal. The new equipment was acquired on a lease, with the following terms:

- lease term 6 years;
- useful economic life of the equipment 5 to 7 years;
- six equal payments of $1.5 million paid in advance commencing on 1 April 2003 and annually thereafter;

- the interest rate implicit in the lease is 7% per annum;
- the fair value of the equipment at the inception of the lease was $7,650,296;
  S will insure and maintain the equipment in good working order.

The draft financial statements record the lease payment of $1–5 million as an expense in the draft income statement.

(8 marks)

Requirement

For each of the changes above, explain how S should treat each transaction in its income statement for the year ended 31 March 2004 and its balance sheet at that date. Justify your answer by reference to relevant International Accounting Standards. Prepare any journal entries that are required to adjust the draft financial statements.

Note:

A descriptive narrative is not required for the journal entries. *(the breakdown of marks is shown against each change detailed above)*

(Total for requirement (b) = 21 marks)
(Total = 25 marks)

✓ Answers

13.1 **A**

B is operating lease
C and D are non-existant

13.2 (i) **A**
(ii) **A**
(iii) **B**
(iv) **A**

13.3

IAS 17 Classification of finance lease

- Lease transfers ownership to the lessee at end of lease term
- Lessee has option to purchase the asset at bargain price, this option being exercised at inception of lease
- Lease term is for the major part of the useful life of the asset even if title is not transferred
- Gains/losses from fluctuations in the fair value of a residual fall to the lessee
- At inception the present value of minimum lease payments is greater than or equal to substantially all of the fair value of the leased asset
- Leased assets are of specialised nature and only lessee can use them without major modifications
- The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market value
- If lessee cancel the lease, any losses associated are borne by the lessee

Comments on classification

who bears the capital cost i.e., risk of purchase

- if lessee guarantees to bear all cost of purchase (Fair value) then treat as finance lease.
  Substantial = IAS 17 no definition however GAAP accepts 90% or more
- if lessee bears substantially all the cost then he would get all the use of the asset and hence he owns the asset

13.4 (i) Actuarial method

		$
1.1.04	Cash Price (Fair Value)	400,000
1.1.04	First instalment	(49,000)
		351,000
1.1.04–30.06.04	Interest @ 5%	17,450
		368,450
1.7.04	Second instalment	(49,000)
		319,450
1.7.04–31.12.04		15,978
		335,428
	etc.	

Total charge to profit and loss for 2004

(ii) Sum of digits method

Since paying in advance, interest accrues over 9 six monthly periods.

Therefore Sum of digits $= n(n + 1)/2 = (9 \times 10)/2 = 45$

Total finance charge:

Ten instalments	490,000
Cash price paid (Fair value)	400,000
	90,000

Interest is then allocated:

		$
1.1.04–30.06.04	$9/45 \times 90{,}000$	= 18,000
1.7.04–31.12.04	$8/45 \times 90{,}000$	= 16,000
1.1.05–30.06.05	$7/45 \times 90{,}000$	= 14,000
	etc.	

Calculation of Creditor at 31.12.2004 using sum of digits method

Obligation under finance lease

	$		$
1.1.04 Rentals	49,000	Fixed asset	400,000
1.7.04 Rentals	49,000	1.1.04 Finance Charge	18,000
Balance c/f	336,000	1.7.04 Finance Charge	16,000
	434,000		434,000
		Balance b/f	336,000

Split of creditors:

	$
Credits <1 Year	
Accrued interest at 31.12.04	16,000
Capital to be repaid in 2005	
1.1.05: 49,000 − 16,000	33,000
1.7.05: 49,000 − 14,000	35,000
	84,000
Credits >1 year (balancing figure)	252,000
total creditor	336,000

13.5 **B**

If payments in arrears $n = n$
If payments in advance $n = n - 1$

where n = number of payments outstanding

In our case, $n = 5$ and in arrears hence $n = 5$

$n(n + 1)/2 = 5(5 + 1)/2 = 15$

	$
Total payments $50,000 × 5	250,000
Less:	
Fair value	180,000
Hence Interest/Finance charge	70,000

Allocation of interest of finance charge

		$
Year 1	5/15 × 70,000	= 23,333
Year 2	4/15 × 70,000	= 18,667

Allocation of interest/Finance charge

	$		$
Rental Year 1	50,000	Cost (Fair value)	180,000
Rental Year 2	50,000	Year 1 Finance charge	23,333
Total creditor	122,000	Year 2 Finance charge	18,667
Balancing figure			
	222,000		222,000
		Total creditors b/f	122,000

hence B is the correct answer

13.6

(i) The lease is a finance lease due to the following reason.

Definition of finance lease is where the risk and rewards of ownership transfer to the lessee. In our case, this is clearly noticed that Mike Woosman will be responsible for all the risks and rewards of ownership.

Reasons:
1 On disposal, 95% of the proceeds will accrue to lessee.
2 Lease term in 3 years and useful life is 5 years where the agreement is for majority of the lease term hence finance lease.
3 Minimum lease payments is >90% of the fair value that is, $40,000 × 6 = $240,000
90% × $240,000 = $216,000
$216,000 > $200,000 (fair value)

(ii) Sum of digits

If payments in arrears $n = n$
If payments in advance $n = n - 1$
n = number of payments outstanding
n in our case is 6 and in advance $n = n - 1 = 6 - 1 = 5$

$n(n + 1)/2 = 5(5 + 1)/2 = 15$

		$
Total payments	$6 \times \$40{,}000 =$	240,000
Less: Fair value		200,000
Total interest/Finance charges		40,000

Allocation of interest

	$		$
1.1.03	$5/15 \times 40{,}000$	=	13,333
1.7.03	$4/15 \times 40{,}000$	=	10,667
1.1.04	$3/15 \times 40{,}000$	=	8,000

(always calculate one extra payment)

Finance lease payable

		$			$
			Cost (Fair value)		200,000
1.1.03	Rentals	40,000	1.1.03	Finance charge	13,333
1.7.03	Rentals	40,000	1.7.03	Finance charge	10,667
Total credit		144,000			
		224,000			224,000
Split of creditors			Total creditors b/f		144,000

	$
Credits <1 year	
Accrued interest at 1.12.03	10,667
Capital to be repaid in 2004	
1.1.04: 40,000 − 10,667	29,333
1.7.04: 40,000 − 8,000	32,000
	72,000
Credits >1 year (balancing figure)	72,000
Total creditors (from finance lease payable a/c)	144,000

Journals

Remember

Leased Fixed assets always consider the answer in following order.

(1) Cost

(2) Depreciation

(3) Finance Charge

(4) Rentals

(5) Net book value

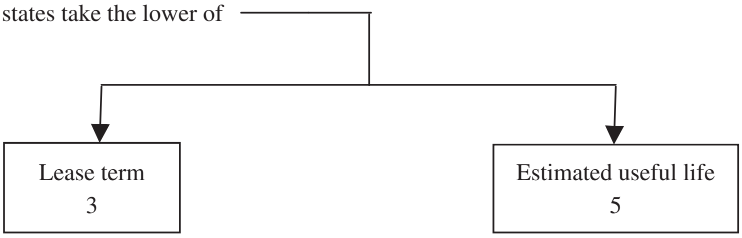
			$	$
(1) Cost	DR	Fixed asset (Fair value)	200,000	
	CR	Finance lease payable		200,000
(2) Depreciation	DR	Income statement	54,000	
	CR	Accumulated depreciation		54,000

$$\frac{\text{Cost} - \text{Residual value}}{\text{Estimated useful life}}$$

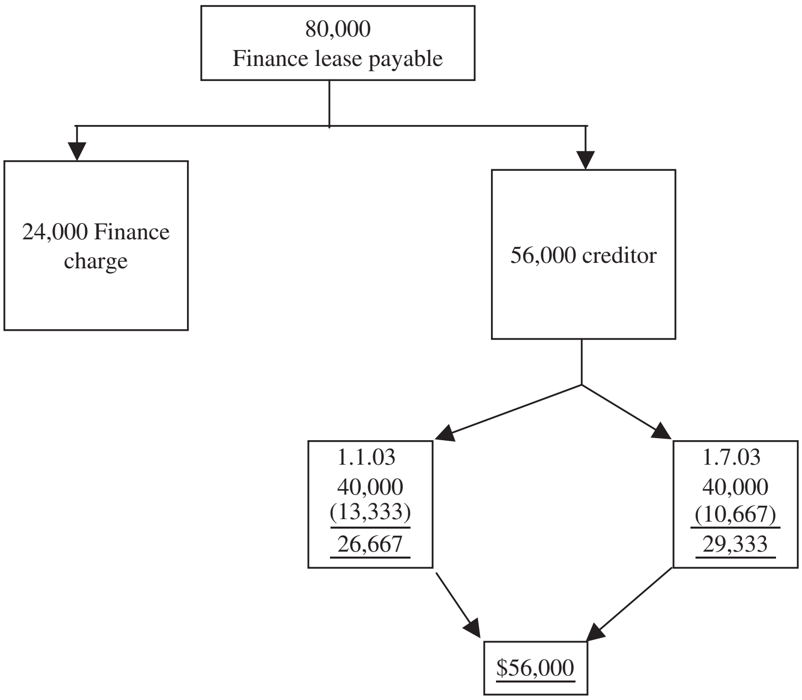
However we are retaining 95% of the value of the asset therefore, $\dfrac{200{,}000 - (40{,}000 \times 95\%)}{3} = 54{,}000$

why 3 and not 5

IAS 17 states take the lower of



				$	$
(3)	Finance charge	DR	Income statement	24,000	
		CR	Finance lease payable (13,333 + 10,667)		24,000
(4)	Rentals	DR	Finance lease payable	80,000	
		CR	Bank		80,000



(5)	Cost	200,000
	Depreciation	(54,000)
	Net book value	146,000

(iii)

Extracts from accounts

Mike Woosnam year ended at 31.12.03

	$
Non-current assets	
Plant and machinery	146,000
Bank	80,000

Current liabilities	
<1 year (10,667 + 29,333 + 32,000)	72,000
>1 year (144,000 − 72,000)	72,000

13.7 (i) (a) Sum of digits method

Step 1 Total finance charge:

Total payments	2,000	(20 × \$100)
Cash price of asset	(1,200)	
Total finance charge (interest)	800	

Step 2 Allocation of finance charge (Interest)

$$\frac{n(n+1)}{2}$$

n = number of payments outstanding

In our case payments are in arrears hence $n = n$

$n = 20$

hence, $\dfrac{20(20+1)}{2} = \dfrac{420}{2} = 210$

Period	*Fraction*	*Finance charge*
		\$
1.01.04–30.06.04	20/210 × 800	76
1.07.04–31.12.04	19/210 × 800	72
1.01.05–30.06.05	18/210 × 800	68
1.07.05–31.12.05	17/210 × 800	64

always, do one extra payment.

Never calculate interest for the full term unless the question states for full term.

(i) (b) Actuarial method

Simply use the interest rate implicit provided. Read the question carefully in the exam if payments are half yearly. Normally the interest rate will be for half yearly period as in this question. Please DO NOT DOUBLE the interest rate to get the annual figure.

You must learn the following table layout for this method.

Question stops @ December 2004

Period	**Amount saved at the start of the period** \$	**Interest @ 5.50%** \$	**Rental** \$	**Amount owed at the end of the period** \$
1.01.04–30.06.04	1,200	66	(100)	1,166
1.07.04–31.12.04	1,166	64	(100)	1,130
1.01.05–30.06.05	1,130	62	(100)	1,092

always, do one extra payment

Notes:

Points to consider:

1 The interest calculation in ADDED since it is an extra cost on lease.

2 The rentals are DEDUCTED as they will reduce the lease payments.

(ii) Finance lease payable

	$			$
	$			$
(4) Rentals				
30.6.04	100	(1)	1.1.04	1,200
31.12.04	100	(3)	30.6.04	76
			31.12.04	72
Balance total creditors	1,148			
	1,348			1,348

Fixed asset
- (1) Cost
- (2) Depreciation
- (3) Interest
- (4) Rentals
- (5) NBV

No effect on finance lease payable account

$\frac{\$1{,}200}{10 \text{ years}} \times 6/12 = \$60/\text{six monthly}$

Non-current assets NBV $1,140 (1,200 − 60)

Balance sheet	$
Creditors less than 1 Year	148
Creditors more than 1 Year (balancing figure)	1,000
Total creditor (from finance lease payable a/c)	1,148

13.8 (i) (a) Sum of digits method

Step 1 Total finance charge:

	$
Total rentals (20 × $100)	2,000
Cash price of asset	(1,200)
Total interest for the period	800

Step 2 Allocate the finance charge (Interest)

$\frac{n(n+1)}{n}$ n = number of payments outstanding

In our case the payments are in *advance* hence

$n = n - 1 = 20 - 1 = 19$

$$\frac{n(n+1)}{2} = \frac{19(19+1)}{2} = 190$$

Period	*Fraction*	*Finance charge* $
01.01.04–30.06.04	19/190 × 800	80
01.07.04–31.12.04	18/190 × 800	76
01.01.05–30.06.05	17/190 × 800	72
01.07.05–31.12.05	16/190 × 800	67

(i) (b) Actuarial method

Table layout changes in that if payments are in advance then before calculating the interest rate, deduct the rentals.

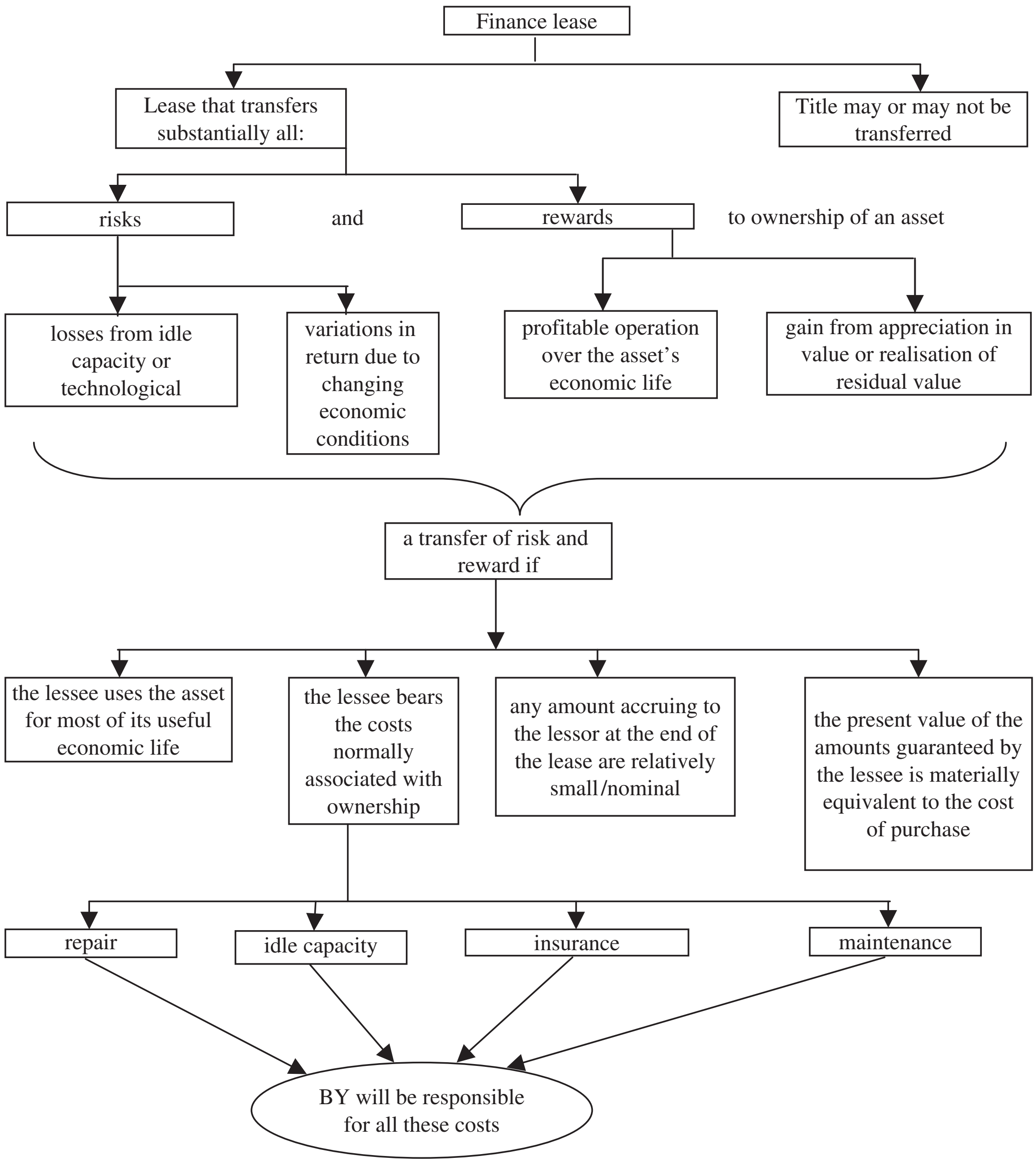
Period	Amount owed at start of period	Rental	Balance	Interest 6.10%	Balance @ end of period
$	$	$	$	$	$
1	1,200	(100)	1,100	67	1,167
2	1,167	(100)	1,067	65	1,132
3	1,132	(100)	1,032	63	1,095
4	etc.				

(ii)

Finance lease payable

	$		$
(4) Rentals 30 June	100	(1) Cost	1,200
		(3) Finance charge 30 June	80
C/f Total creditors	1,180		
	1,280		1,280
		b/f total creditors	1,180

13.9 (a) (i)


Finance lease
Lease that transfers substantially all:
Title may or may not be transferred
risks
and
rewards
to ownership of an asset
losses from idle capacity or technological
variations in return due to changing economic conditions
profitable operation over the asset's economic life
gain from appreciation in value or realisation of residual value
a transfer of risk and reward if
the lessee uses the asset for most of its useful economic life
the lessee bears the costs normally associated with ownership
any amount accruing to the lessor at the end of the lease are relatively small/nominal
the present value of the amounts guaranteed by the lessee is materially equivalent to the cost of purchase
repair
idle capacity
insurance
maintenance
BY will be responsible for all these costs

13.9 (a) (i)

IAS 17 Classification of finance lease

- Lease transfers ownership to the lessee at end of lease term
- Lessee has option to purchase the asset at bargain price, this option being exercised at inception of lease
- Lease term is for the major part of the useful life of the asset even if title is not transferred
  - Cars are leased for substantially all their economic life
- Gains/losses from fluctuations in the fair value of a residual fall to the lessee
- At inception the present value of minimum lease payments is greater than or equal to substantially all of the fair value of the leased asset
  - In BY's case, the present value of minimum lease payment are 100% of the fair value of the cars at the inception of lease
- Leased assets are of specialised nature and only lessee can use them without major modifications
- The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market value
- If lessee cancel the lease, any losses associated are borne by the lessee
  - BY will bear the risk of asset becoming obsolete

Comments on classification

who bears the capital cost, i.e. risk of purchase

- if lessee guarantees to bear all cost of purchase (Fair value) then treat as finance lease.
  Substantial = IAS 17 no definition however GAAP accepts 90% or more
- if lessee bears substantially all the cost then he would get all the use of the asset and hence he owns the asset

Hence, BY should treat the lease as a finance lease.

(a) (ii)

Cost of car = \$20,000

Three cars will be 3 × \$20,000 = \$60,000

Since the interest rate implicit in the lease of 3.5% per six-month period is given we will use actuarial method.

Useful life of asset is expected to be 6 years, however lease term is 5 years

IAS 17 states

↓

take lower of

Useful life or Lease term

6 Hence 5 years 5

$$\text{Depreciation} = \frac{\text{Cost} - \text{Residual value}}{\text{Lease term}} = \frac{60{,}000 - 0}{5}$$

$$= \$12{,}000/\text{year}$$

therefore 1/2 year will be \$6,000

Period	*Balance b/f* \$	*Interest* 3.5%	*Rental* \$	*Balance c/f* \$
1.10.02 to 31.03.03	60,000	2,100	(7,200)	54,900
1.04.03 to 31.09.03	54,900	1,922	(7,200)	49,622
1.10.03 to 31.03.04	49,622	1,737	(7,200)	44,159

always do one extra payment

always add interest

always less rentals

Balance Sheet figures to 31 March 2003

	\$	\$
Non-current assets		
Motor vehicles	60,000	
Depreciation (half a year)	(6,000)	54,000
Current liabilities		
(<1 year)		
Finance lease creditor (54,900 − 44,159)	10,741	
Non-current liabilities		
(>1 year)		
Finance lease creditor	44,159	

Finance lease creditor

	$		$
Rental	7,200	Cost	60,000
C/f Total creditor (balancing figure)	54,900	Finance lease	2,100
	62,100		62,100
		b/f Total creditor	54,900

Balance sheet

Creditors < 1 Year

		$
Capital to be repaid in 2004		
1.4.04	7,200 Instalment − 1922 Interest	5,278
1.10.04	7,200 Instalment − 1737 Interest	5,463
	(<1 year) creditor	10,741
	>1 year creditor − Balancing figure	44,159
Total creditor (from above finance lease payable a/c)		54,900

13.9 (c)

All expenditure is getting a non-current asset to the place and condition and location where it can be used can be capitalised as the cost of the asset as per IAS 16.

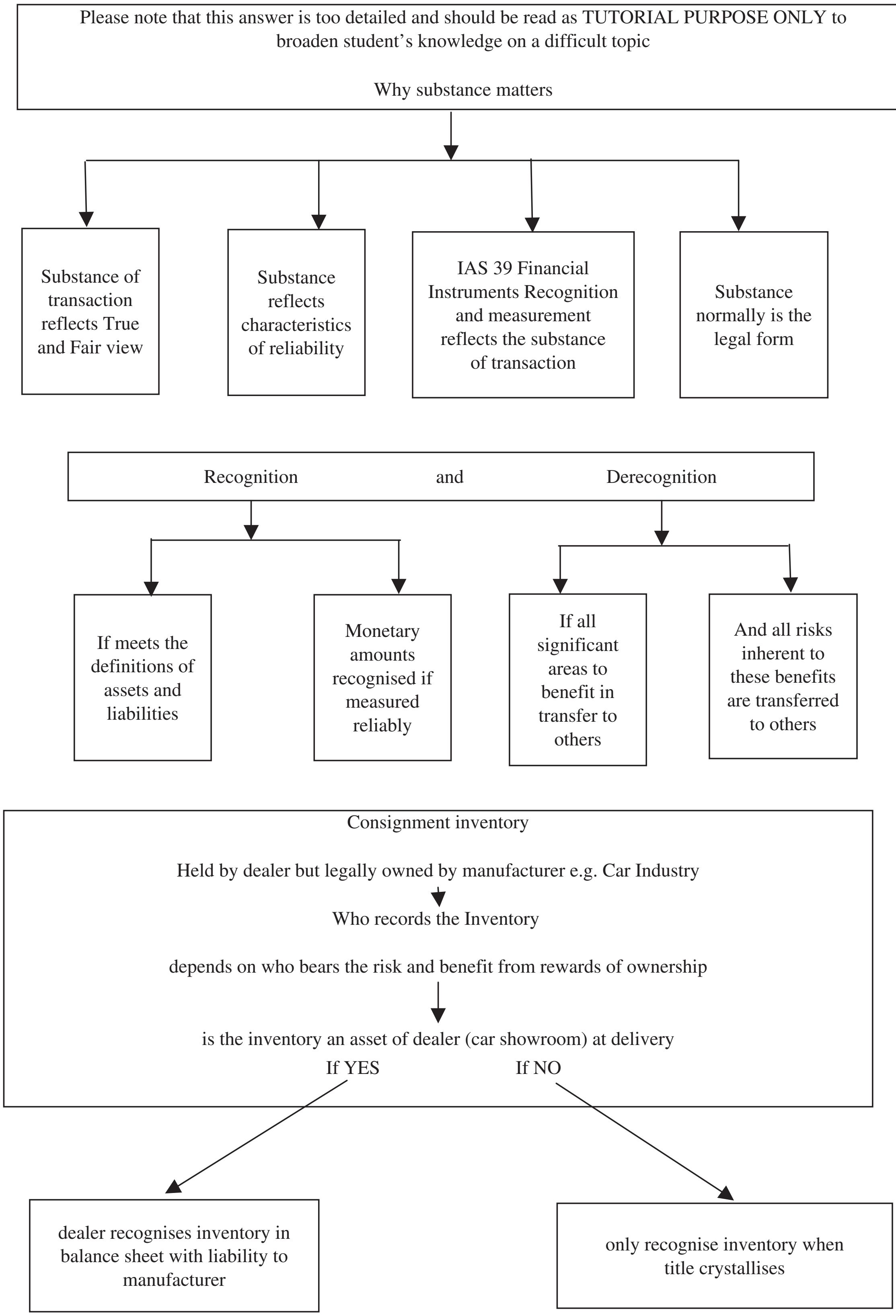
The total purchase cost of $136,100 is made up of various expenditures and all are permitted to be included as the cost of the asset under IAS 16/38.

Hence for the year ended 31 March 2003, the balance sheet will show the total amount as the installation is completed and ready for use on 25 March 2003 which is prior to year end.

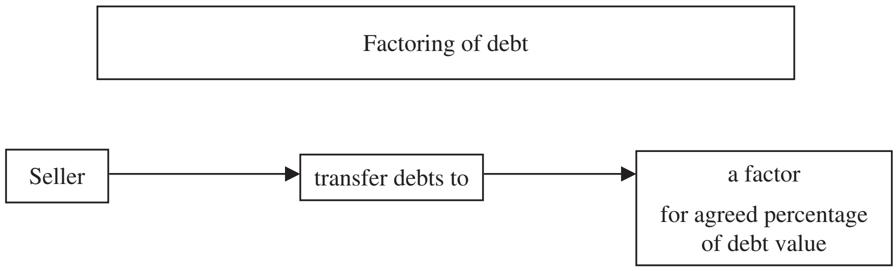
BY Balance sheet extract for the year ended 31 March 2003

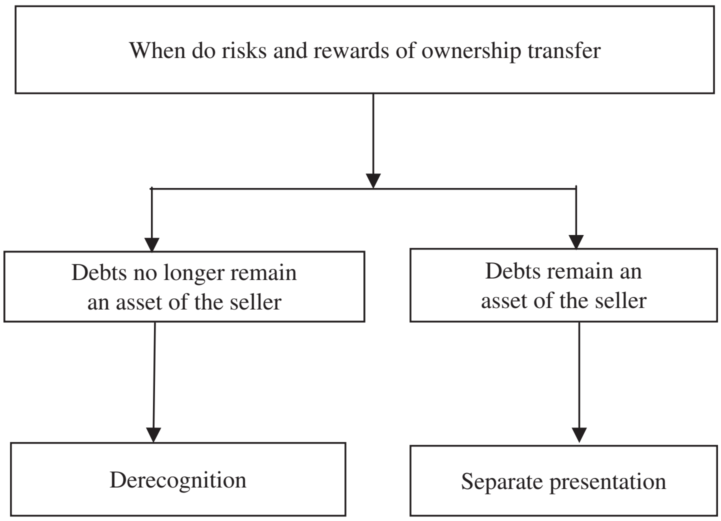
	$
Non-current assets	
Plant and equipment	136,100
Less:	
Depreciation	X
Current liabilities	
Creditors (unpaid balance) (135,200 × 50%)	67,600

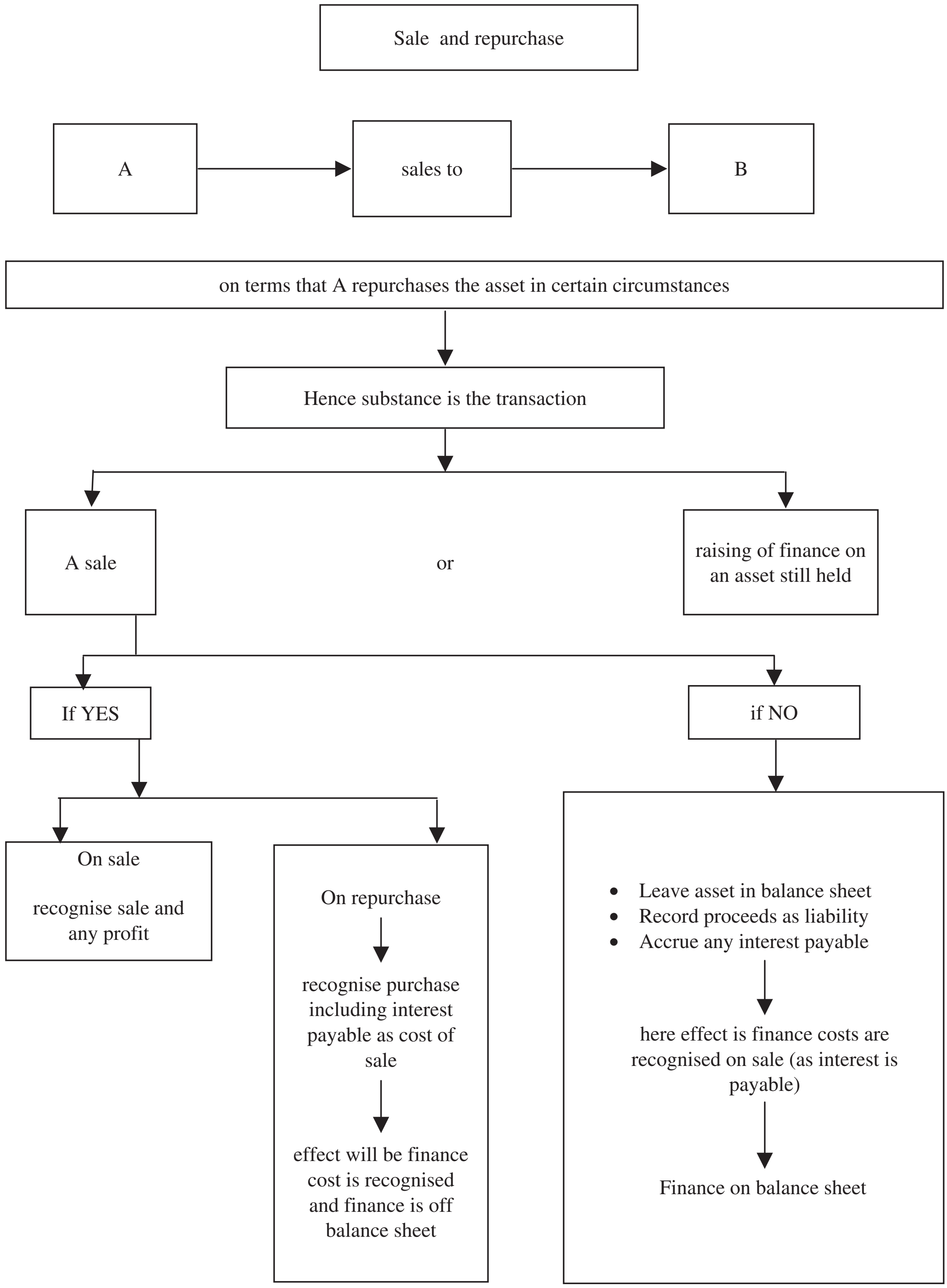
13.10 (i)



Please note that this answer is too detailed and should be read as TUTORIAL PURPOSE ONLY to broaden student's knowledge on a difficult topic
Why substance matters
Substance of transaction reflects True and Fair view
Substance reflects characteristics of reliability
IAS 39 Financial Instruments Recognition and measurement reflects the substance of transaction
Substance normally is the legal form
Recognition and Derecognition
If meets the definitions of assets and liabilities
Monetary amounts recognised if measured reliably
If all significant areas to benefit in transfer to others
And all risks inherent to these benefits are transferred to others
Consignment inventory
Held by dealer but legally owned by manufacturer e.g. Car Industry
Who records the Inventory
depends on who bears the risk and benefit from rewards of ownership
is the inventory an asset of dealer (car showroom) at delivery
If YES
If NO
dealer recognises inventory in balance sheet with liability to manufacturer
only recognise inventory when title crystallises


Factoring of debt
Seller
transfer debts to
a factor
for agreed percentage of debt value


When do risks and rewards of ownership transfer
Debts no longer remain an asset of the seller
Debts remain an asset of the seller
Derecognition
Separate presentation


Sale and repurchase
A
sales to
B
on terms that A repurchases the asset in certain circumstances
Hence substance is the transaction
A sale
or
raising of finance on an asset still held
If YES
if NO
On sale
recognise sale and any profit
On repurchase
recognise purchase including interest payable as cost of sale
effect will be finance cost is recognised and finance is off balance sheet
• Leave asset in balance sheet
• Record proceeds as liability
• Accrue any interest payable
here effect is finance costs are recognised on sale (as interest is payable)
Finance on balance sheet

(ii) *Change 1*

The sale of building at $50 million is well below the market value at time of sale $80 million and this implies that the transaction is in favour of S as it is clearly not carried out at arms length (negotiated at current market value/fair value).

Furthermore the repurchase agreement is in terms of original selling price plus interest based on that price again in favour of S.

This would mean that the interest will be charged on $50 million rather than $80 million or even more especially if property price increase.

In addition to this the rental charges are excessive.

All above indicates that there is possibility of repurchase and hence this implies that S is financing its current cash-flow problems against the security of the land and building. Hence it should keep the land and building as non-current assets in the balance sheet and then the cash received as liabilities.

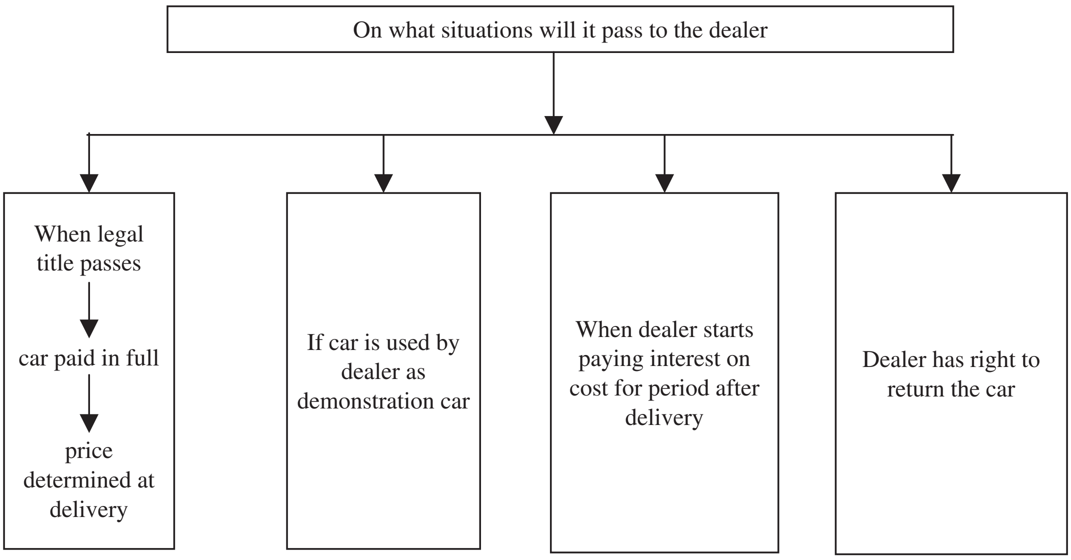
The interest should also be reflected in the income statement annually. Finally the disposal will need to be reversed likewise the loss that arose on disposal will also be reversed.

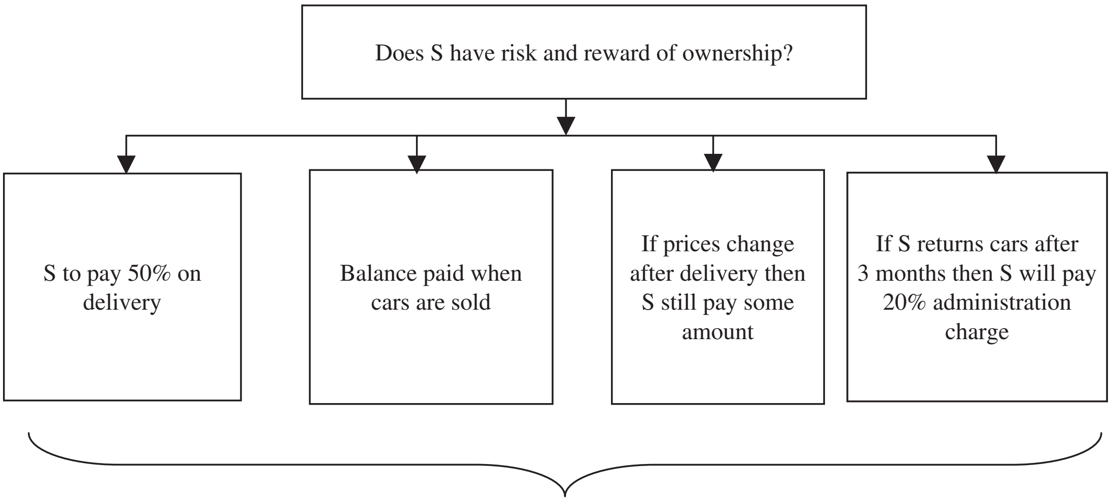
Change 2

Consignment inventory

Points to consider in Exam Question:

Ask yourself *has risk and reward passed*?





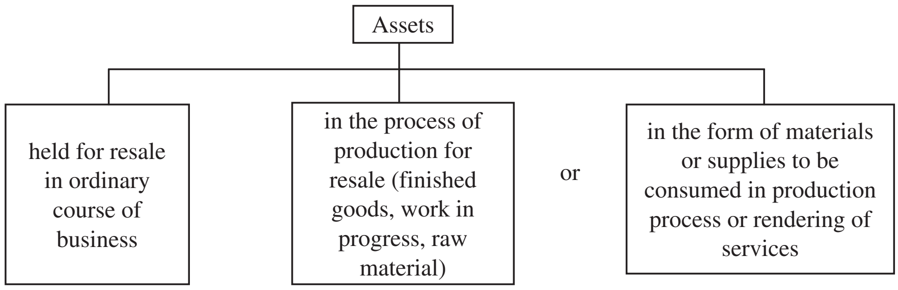
All these are classic cases of risk and reward of ownership that has been passed to S.

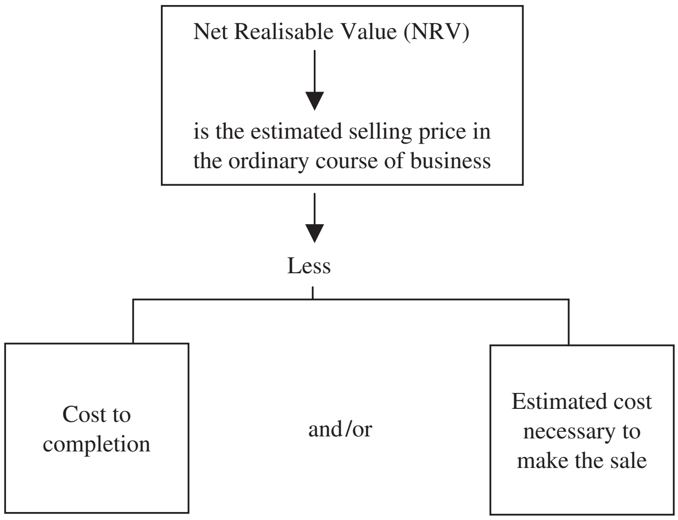
Hence economic substance S is the owner and should treat the car in its balance sheet as its inventories at the year end. And trade payable will need to be set up.

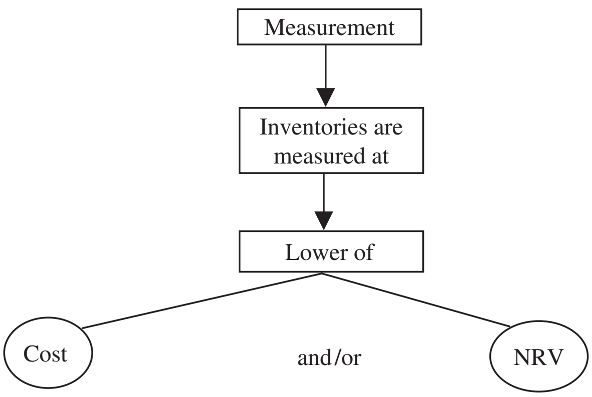
		$m	$m
DR	Inventories (balance sheet)	6	
CR	Closing Inventories (income statement)		6
DR	Purchases	6	
CR	Prepayment		3
CR	Trade payments		3

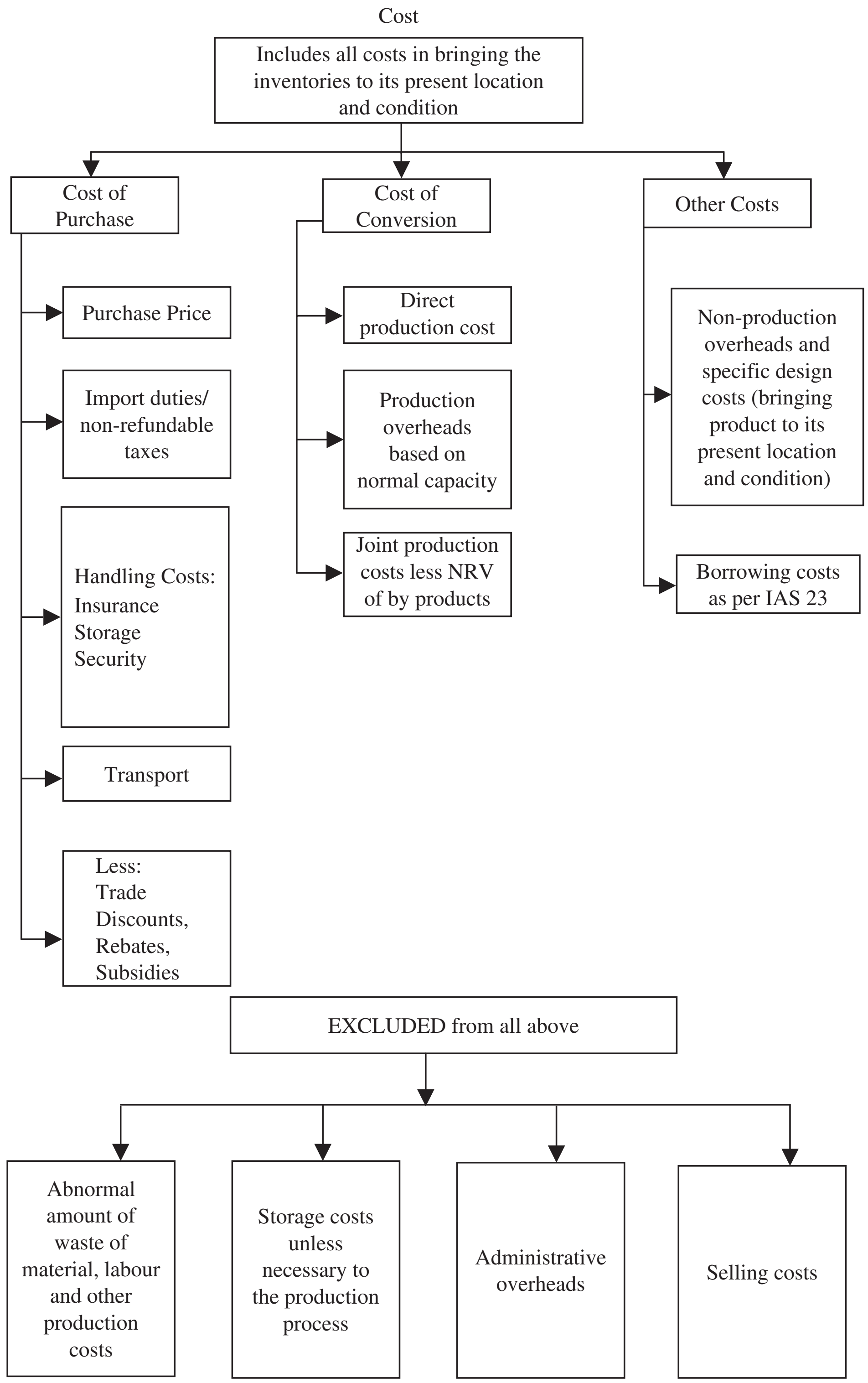
14 Inventories and Construction Contracts

IAS 2 INVENTORIES

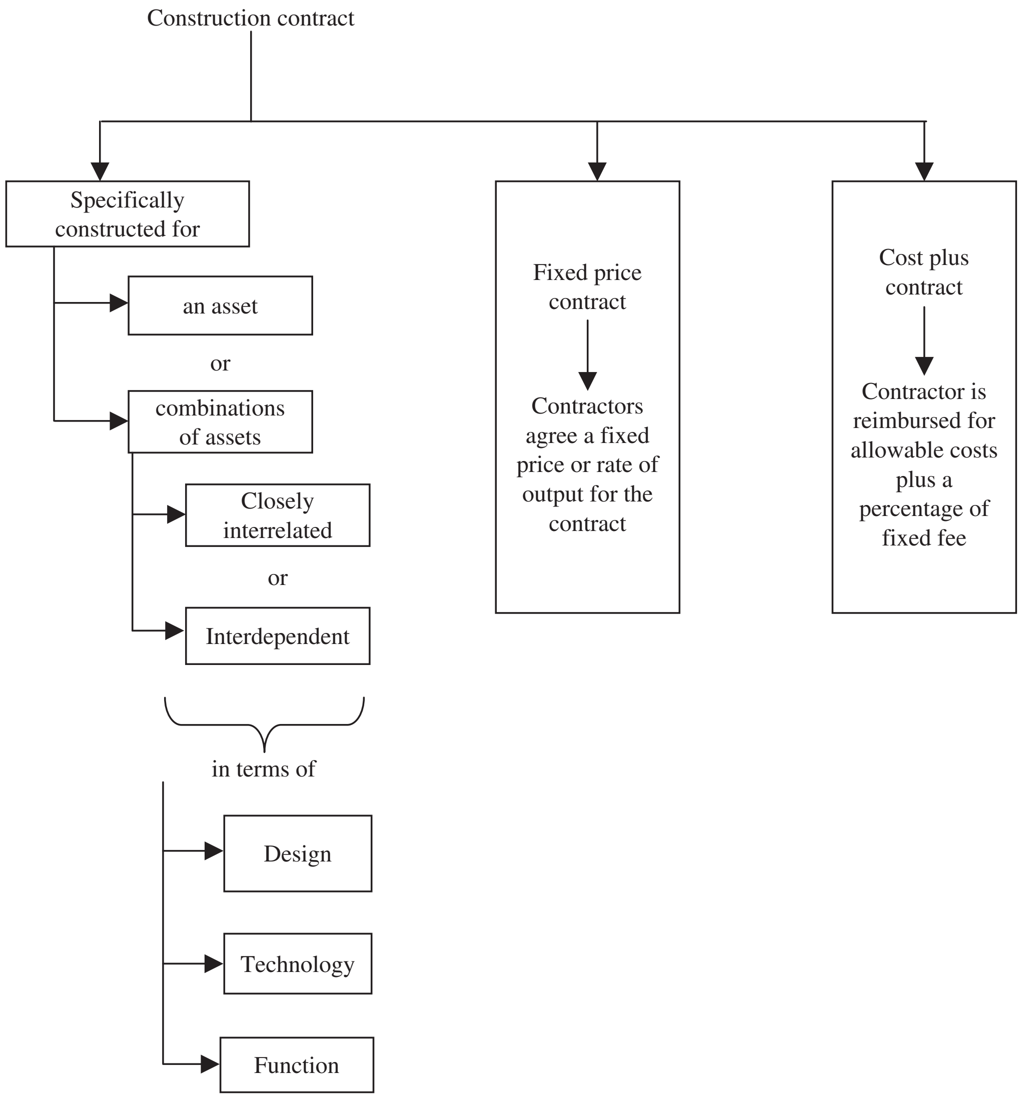


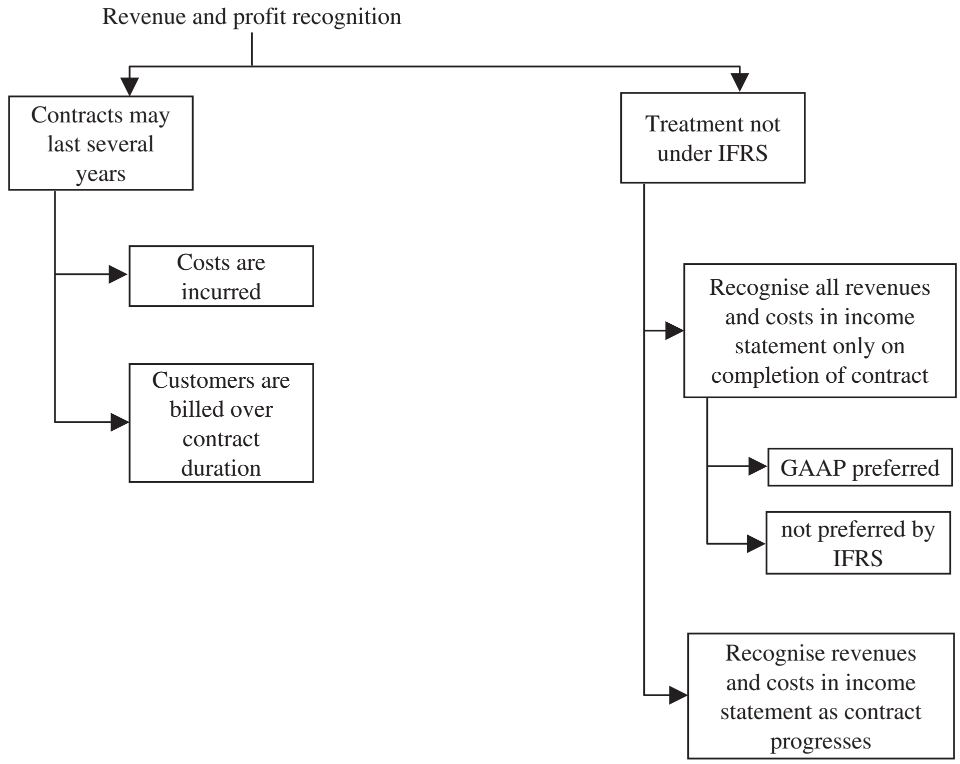


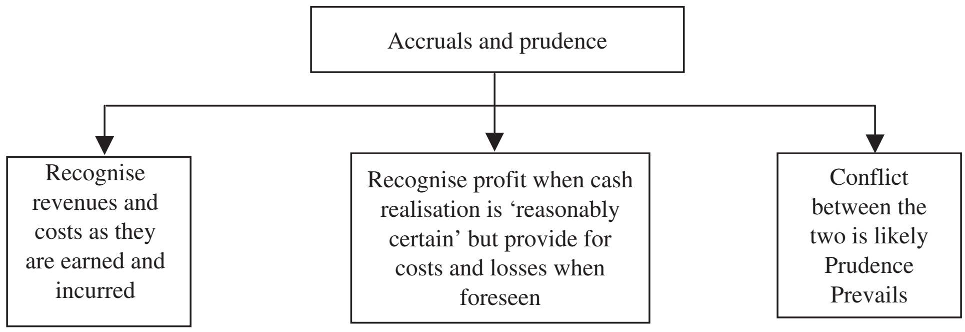




Cost
Includes all costs in bringing the inventories to its present location and condition
Cost of Purchase
Cost of Conversion
Other Costs
Purchase Price
Import duties/ non-refundable taxes
Handling Costs: Insurance Storage Security
Transport
Less: Trade Discounts, Rebates, Subsidies
Direct production cost
Production overheads based on normal capacity
Joint production costs less NRV of by products
Non-production overheads and specific design costs (bringing product to its present location and condition)
Borrowing costs as per IAS 23
EXCLUDED from all above
Abnormal amount of waste of material, labour and other production costs
Storage costs unless necessary to the production process
Administrative overheads
Selling costs


Construction contract
Specifically constructed for
an asset
or
combinations of assets
Closely interrelated
or
Interdependent
in terms of
Design
Technology
Function
Fixed price contract
Contractors agree a fixed price or rate of output for the contract
Cost plus contract
Contractor is reimbursed for allowable costs plus a percentage of fixed fee





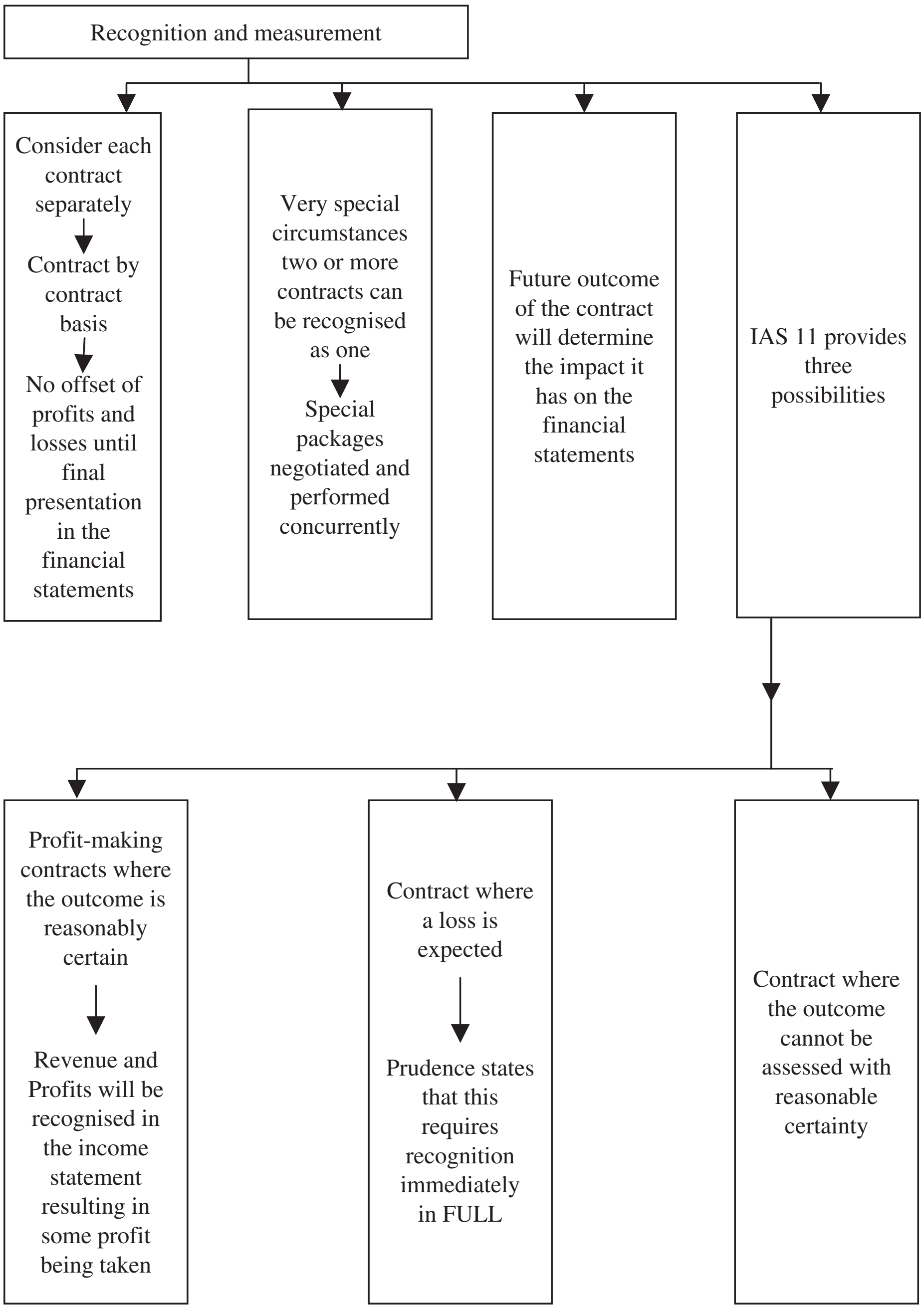
IAS 11 requires costs and revenues should be recognised in the income statement as the contract activity progresses hence adopts the above Accrual and Prudence concept.

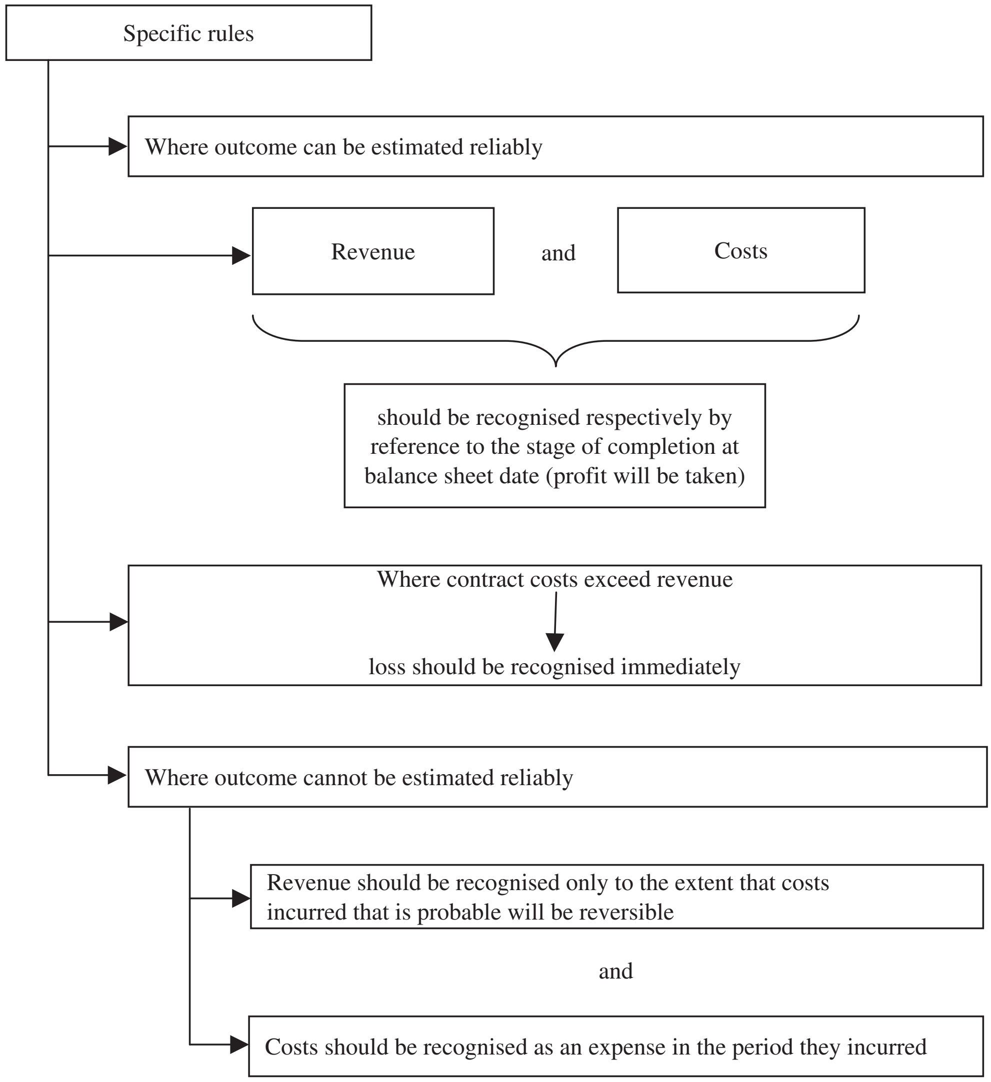
Revenue comprises

- Initial amount of revenue agreed in the contract.
- Variations in work, claims and incentive payments.
- Contract revenue is measured at the fair value of the consideration received or receivable discounted if deferred (If present value of amount receivable).
- Measurement is effected by uncertainties depending on future outcome. Hence estimated need to be reviewed regularly hence revenue may increase or decrease from period to period.
  - Contractors and customers may agree variation or claims that increase or decrease the revenue of the contract.
  - Fixed price contracts revenues may increase due to cost escalation clauses.
  - Revenue may decrease due to penalties arising from delays.
  - Contract revenue increases as the number of units are increased in the output of contract.

Contract costs

- Comprises of
  - directly related to Specific contract
  - costs that can be allocated to the contract
  - costs that are specifically chargeable to customer under the terms of the contract
- Specific, direct costs include
  - site labour costs (Supervisor included)
  - hiring costs
  - material costs
  - design costs and technical assistance that are directly related to the contract
  - depreciation of plant and machinery used in the contract
  - claims from third party
  - cost of rectification and guarantee work including expected warranty costs
  - moving of plant, machinery and materials from one site to another


Recognition and measurement
Consider each contract separately
Contract by contract basis
No offset of profits and losses until final presentation in the financial statements
Very special circumstances two or more contracts can be recognised as one
Special packages negotiated and performed concurrently
Future outcome of the contract will determine the impact it has on the financial statements
IAS 11 provides three possibilities
Profit-making contracts where the outcome is reasonably certain
Revenue and Profits will be recognised in the income statement resulting in some profit being taken
Contract where a loss is expected
Prudence states that this requires recognition immediately in FULL
Contract where the outcome cannot be assessed with reasonable certainty


Specific rules
Where outcome can be estimated reliably
Revenue
and
Costs
should be recognised respectively by reference to the stage of completion at balance sheet date (profit will be taken)
Where contract costs exceed revenue
loss should be recognised immediately
Where outcome cannot be estimated reliably
Revenue should be recognised only to the extent that costs incurred that is probable will be reversible
and
Costs should be recognised as an expense in the period they incurred

Calculation

Step 1

Contract by Contract basis

↓

Do not offset a profit by making contract with a loss-making contract.

Step 2

Calculate *total expected profit/(loss)*

	$
Contract price	X
Less: All costs	
Cost to date	(X)
Cost to completion	(X)
Total expected profit/loss	X/(X)

Step 3

Calculate the *stage of completion*

Sales basis

↓

$$\frac{\text{Value of work done to date}}{\text{Total sales value}}$$

Cost basis

↓

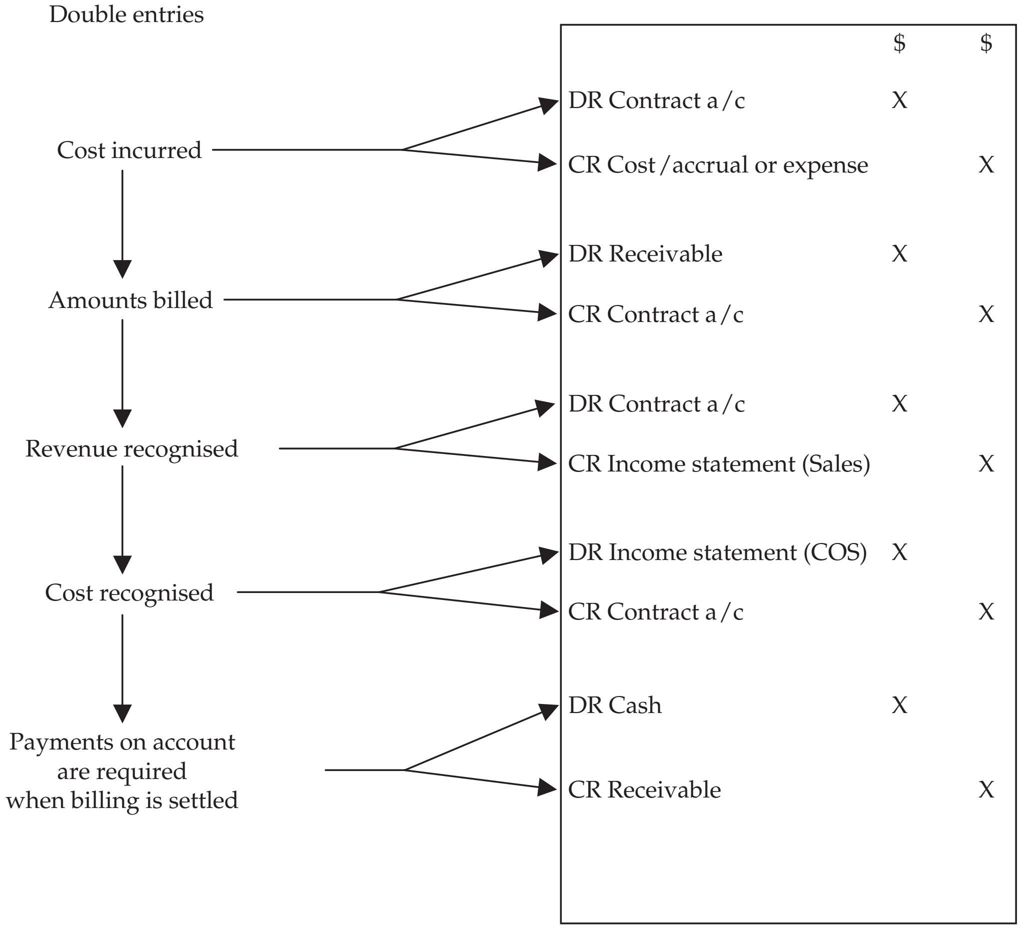
$$\frac{\text{Cost to date}}{\text{Total Costs}}$$

Step 4

Calculate revenue and costs for the year

- Calculate revenue and costs to date (using proportion above)
- Deduct any revenue and costs taken in earlier periods (income statement)
- If cannot, prudently, recognise profit, include some amount in income statement for both revenue and costs of sales to give NIL profit.

Double entries



? Questions

14.1 Indicate which of the following sentences are true and which are false:

(i) Insurance spares of property, plant and equipment form part of inventories.
(ii) Net realizable value is determined with reference to the price of the item prevailing at the balance sheet date.
(iii) Administrative expenses are excluded from the cost of inventories.
(iv) Costs to transport an item of inventory to its normal place of sale are included in the cost of inventories.
(v) Fixed production overheads are allocated to each unit of production based on the actual use of production facilities.
(vi) Costs of inventories of interchangeable items should be assigned using the FIFO, LIFO, or weighted average cost formula.
(vii) Retail method for inventory valuation can be used for convenience only if the results cost approximate.
(viii) Although benchmark treatment in International Accounting Standards does not permit capitalization of borrowing costs, cost of producing wine usually includes borrowing costs.
(ix) A new assessment is made of net realizable value in each subsequent period.
(x) Material and other supplies are always carried at cost.

(15 marks)

14.2 Fill in the blanks

(i) Samson Limited (SL) is engaged in manufacturing and selling sugar. It closes its accounting year on 31 December. The closing stock of sugar on 31 December 2004 was 1,000 metric ton (mt.). The selling price on that date was $750 per mt. After the balance sheet date, but before the approval of financial statements by the board of directors, SL sold 200 mt. of sugar at the rate of $750 per mt. and 300 mt. of sugar at the rate of $700 per mt. The price prevailing on the date of approval of financial statements was $680 per mt. Assuming that there is no direct selling expense, the net realizable value (NRV) of the closing stock of 1,000 mt. of sugar was $———.
(ii) A firm manufactures a product 'X' by using one unit of raw material 'B'. The estimated conversion cost for producing 'B' is $15 per unit. The raw material B was purchased at $3 per unit. The replacement cost of B at the balance sheet date was $2 per unit. The expected NRV of X at the balance sheet date was $15 per unit. B should be carried in financial statements at $———per unit.
(iii) The cost of the beginning inventory of an item was $10,000 (retail price $20,000). The cost of purchase during the year was $60,000 (retail price $96,000). Sale during the year was $90,000. The firm uses the retail method and FIFO cost formula for the valuation of inventories. The cost assigned to the closing inventory should be $———.
(iv) Delta Limited (DL) produces 'Y'. The unit cost of 'Y' is $1,500. Alpha Limited (AL) earns normal profit of 20 per cent on the selling price. The selling price and the selling expenses of 'Y' have been estimated at $1,500 and $100. 'Y' should be carried at $———per unit.

(v) Lee Limited (LL) is engaged in manufacturing and selling of cricket bats, balls and stumps. Costs and net realizable values (NRV) of items in the closing inventory as at 31 December 2004 are as follows:

	Bats	*Balls*	*Stumps*	*Total*
Cost ($)	10,000	4,000	6,000	20,000
NRV ($)	9,500	4,500	6,800	20,800

The total value of inventories on the balance sheet of LL as at 31 December 2004 should be $———.

(vi) Serena Limited (SL) is engaged in manufacturing and selling of fast moving consumer goods. It produces goods in its facilities located near London. It sells its products all over the Europe through its retail outlets. In the context of inventory valuation, it includes costs of transporting goods to the normal place of sale in the cost of inventories. In November–December 2004, in pursuance to a market research report, it redistributed its stock of goods available with various retail outlets. The estimated costs of redistribution allocated to items in stock as at 31 December 2004 is $100,000. The cost of inventories, excluding costs of redistribution, is $10,000,000. The net realizable value of each item in stock is higher than its cost, including costs of redistribution allocated to it. Inventories should be carried on the balance sheet of SL as at 31 December 2004 at €———.

(vii) Gamma Alloys Limited (GAL) is engaged in manufacturing and selling alloy steel of a particular grade. On 31 December 2004 (the balance sheet date) it has a stock of 1,000 metric ton (mt.). It expects to sell the stock in the domestic market at $80 per mt., net of selling expenses. However, on the balance sheet date, it has a firm export order for 500 mt. at a price of $90 per mt., net of selling expenses. It expects to receive a repeat order for another 500 mt. from the same customer at the same terms and conditions. GAL should carry the stock of 1,000 mt. of alloy steel on its balance sheet as at 31 December 2004 at $———.

(viii) Alpha Limited (AL) is engaged in manufacturing and selling equipment against firm orders. In the year 2003, one of its customers (DL) cancelled an order for sophisticated tailor-made special equipment due to its difficult financial situation. AL carried the equipment at $10,000, being the estimated net realizable value, on its balance sheet dated 31 December 2003. The cost of the equipment was $100,000. In view of a possible takeover of DL by AL, it had not sold the equipment as scrap. AL took over DL on 15 January 2004 and immediately placed a firm order on AL for the equipment at a price of $120,000. The board of directors of AL will consider financial statements for approval on 28 February 2005. The reversal of the write down of ($100,000 − $10,000) or $90,000 should be presented in the income statement for the year 2004 as———.

(15 marks)

14.3 Net realizable value (NRV) is determined with reference to the estimated selling price in the 'ordinary course of businesses'.

Elucidate the phrase 'ordinary course of businesses'.

(3 marks)

14.4 IAS-2 does not permit use of the 'last-in-first-out' (LIFO) cost formula for valuation of inventories. Write a brief note supporting the accounting principle.

(3 marks)

14.5 In the context of valuation of inventories explain the rationale behind the accounting principle that 'the allocation of fixed production overheads to the costs of conversion should be based on the normal capacity of the production facilities'.

(3 marks)

14.6 In the context of inventory valuation, discuss the principles for the allocation of 'Joint costs'.

(3 marks)

14.7 Inventories are usually written down to NRV on an *item-by-item* basis. However, in some circumstances it may be appropriate to group similar or related items. Explain the factors that should be considered in grouping items of inventory for the purpose of valuation.

(3 marks)

14.8 Solomon Limited (SL) is engaged in manufacturing and selling variety of products. It has decided to introduce 'Activity Based Costing' (ABC) system to determine product cost. Mr. Smith, the Finance Director of SL is not sure whether it can use ABC to determine the product cost to be used for inventory Valuation. Advise Mr. Smith.

(3 marks)

14.9 Alpha Limited (AL) is engaged in manufacturing and selling machines and machine tools. It expects an order from one of its customers for three standard sophisticated large machines. If the order materializes, machines will have to be delivered at a site difficult to reach. Although, usually AL dispatches machines only against firm orders, in order to earn bonus by delivering machines much in advance of the likely delivery date and to vacate factory space occupied by those machines, it transported the machines to a location very close to the site and kept the same in a rented warehouse. AL seeks your opinion whether the transportation cost and warehouse charges should be included in costs of those machines for the purpose of inventory valuation.

(15 marks)

14.10 Chiang Limited (CL) follows the following accounting policy:

> 20 percent depreciation should be provided on raw materials and finished goods not moved for more than a year, 30 percent depreciation should be provided on raw materials and finished goods not moved for more than two years, and 50 percent depreciation should be provided on raw materials and finished goods not moved for more than three years.

You are required to comment on whether the accounting policy is consistent with accounting principles stipulated in International Accounting Standards (IAS)-2, Inventories.

(15 marks)

14.11 Sigma Mines Limited (SML) is engaged in the business of diamond mining. The following process is involved in manufacturing diamonds:

(i) The RON (run of mine) is extracted from the mine which is open cast mine.
(ii) The good quality of RON called as 'tuff' is mined and transported by dumpers and brought near to the plant and kept as a stock (work-in-process) for further processing after weathering, say, for a period of six months or so.
(iii) The weathered tuff is fed to crushing plant and treated in the plant to get the finished product viz., diamond which is sold in the market at prevailing prices.

The company is not sure whether the valuation of tuff should be in accordance with stipulations of IAS-2. Advise the management of SML on this issue.

(7 marks)

14.12 Gamma Limited (GL) is in the business of manufacturing and selling fertilizers. It maintains stock of different varieties of fertilizers in warehouses located in different parts of the country. GL transfers fertilizers from one location to another during the peak season to match demands in different parts of the country. The transfers are based on demand estimates by field salesmen. GL includes all transportation costs in the cost of inventories.

Requirement

Comment on the accounting policy of GL.

(7 marks)

14.13 Delta Limited (DL) is engaged in the fabrication of large and complex steel structures. At present the capacity of DL and the industry in which DL operates is underutilized. Mr. John, the Finance Director of DL proposes to use budgeted production for a particular financial year as the normal capacity for assigning fixed overheads to inventories.

Requirements

(i) Discuss the concept of normal capacity in the context of inventory valuation.
(ii) Advise Mr. John whether budgeted capacity can be used as normal capacity for inventory valuation.
(iii) Advise Mr. Smith whether normal capacity should be determined for each work station (Cost centre) separately.

(7 marks)

14.14

(i) Explain the concept of net realizable value (NRV) in the context of inventory valuation.
(ii) Alpha Limited (AL), located in Birmingham, is engaged in manufacturing and selling white goods. It sells a part of goods manufactured in the domestic market. It exports balance of goods produced to different countries

within and outside the European Union. Functional currencies of many of the countries are different. AL sells products to different countries at differential prices.

Requirement

Advise how AL should determine the NRV.

(7 marks)

14.15

Bulldozer Ltd has three long-term contracts in progress in the year ending 31 December 2003, the details of which are as follows:

	Castle	*Holmes*	*Builder*
	$'000	$'000	$'000
Contract price	3,000	2,400	3,000
Costs to date	1,700	2,000	2,200
Estimated costs to complete	1,000	600	400
Work certified	2,000	1,600	2,400
Amounts invoiced	1,800	1,700	2,600

Digger Ltd calculates attributable profit by reference to work certified as a proportion of contract price. Holmes and Builder commenced in the current year. Castle has commenced in the 2002, the value of work certified at 31 December 2002 being $400,000. It was not considered prudent to recognise any profit on castle on 2002.

Requirements

Calculate the amounts to be included in the Income Statement and Balance Sheet on Bulldozer for the year ending 31 December 2003.

Step 1

Determine which contract is profit making and which is loss making.

Step 2

Attribute total profit from step 1 by use of sales or cost formula (Depending on one requested by examiner).

If loss making contract allocate *FULL* LOSS. DO NOT apply formula to any loss making contract – Prudence states account for *FULL* loss immediately.

Step 3

Use the table for income statement to determine cost of sales		$
Given in question or needed to calculate ⟶	Turnover	X
Always balancing figure ⟶	Cost of sales	(X)
From step 2 ⟶	Gross Profit	X

If first year of contract

then layout is simple

	$
Turnover	X
Cost of sales	(X)
Gross profit	X

If middle year i.e., year 2 and there after then split each into three section

	$
Cumulative turnover	X
Turnover previous year(s)	X
Current year turnover	X
Cost of sale cumulative	X
Cost of sale previous year(s)	X
Cost of sale current year	X
Gross profit / loss cumulative	X
Gross profit / loss previous year(s)	X
Current year gross profit	X

Step 4

Balance sheet

Guideline to Question 14.15

Step 1

Expected total profit or loss

	Castle $'000	*Holmes* $'000	*Builder* $'000
Contract price			
Less:			
Costs to date			
Estimated costs to complete			
Total estimated profit or loss			

Step 2

Attributable profit or forseeable loss

Contract 1 =

Contract 2 =

Contract 3 =

* use sales or cost formula to attribute the Total estimated profit from Step 1.

* If loss in Step 1 the account for FULL Loss immediately.

Step 3

Income statement

		Castle $'000	*Holmes* $'000	*Builder* $'000	*Total* $'000
	Turnover				
Given in question or calculate	Turnover to date				
	Less: Certified last year				
	Turnover (2003)				
	Cost of sales				
Balancing figure	Cumulative (see W4)				
	Less: In the profit and loss account last year				
	Cost of Sales (2003)				
	Gross profit / loss				
If profit answer from step 2 / If loss from step 1 take full loss	Attributable profit or Forseeable loss to date				
	Less: Recognised previously				
	Gross profit (2003)				

If 1st year of contract then the above layout is simplified to

Turnover	X	
Cost of Sales	X	Balancing figure
Gross Profit / Loss	X / (X)	

Step 4

Balance sheet

(Underlined text indicates headings in balance sheet and notes)

(i)

		Castle	*Holmes*	*Builders*	*Total in financial statement*
		$'000	$'000	$'000	$'000
Revenue account					
Cumulative turnover (W3)	**(1)**				
Less:					
Amounts Invoiced	**(2)**				
Receivables Amounts Recoverable on contracts (if >0)	**(3)**				
Excess billing (if <0)	**(4)**				
Net off in W4 (ii)	**(9)**				
Payables:					
Payments received on account	**(10)**				
Trade Receivables					
Costs account					
Cost incurred to date	**(5)**				
Less:					
Cost of sales					
To date (W3)	**(6)**				
Net cost less foreseeable Losses (if >0)	**(7)**				
Less:					
Applicable payments On account [W4 (i)]	**(8)**				
Inventories: Long-term contract Balances (≥0 for each contract)	**(11)**				
Provision or accruals (if <0)	**(12)**				

Order in which the answers should be presented.

14.16

S is a shipbuilder which is currently working on two contracts:

	Deep sea fishing boat	*Small passenger ferry*
	$'000	$'000
Contract price (fixed)	3,000	5,000
Date work commenced	1.10.2000	1.10.01
Proportion of work completed during year ended 30.9.01	30%	Nil
	$'000	$'000
Invoiced to customer during year ended 30.9.01	900	Nil
Cash received from customer during year ended 30.9.01	800	Nil
Costs incurred during year ended 30.9.01	650	Nil
Estimated cost to complete at 30.9.01	1,300	
Proportion of work completed during year ended 30.9.01	25%	45%
	$'000	$'000
Invoiced to customer during year ended 30.9.01	750	2,250
Cash received from customer during year ended 30.9.01	700	2,250
Cost incurred during year ended 30.9.02	580	1,900
Estimated cost to complete at 30.9.02	790	3,400

S recognised revenue and profit on long-term contracts in relation to the proportion of work completed.

Requirement

Calculate the figures that will appear in S's income statement for the year ended 30 September 2002 and its balance sheet at that date in respect of each of these contracts.

(14 marks)

✓ Answers

14.1

(i) False
(ii) False
(iii) True
(iv) True
(v) False
(vi) False
(vii) True
(viii) True
(ix) True
(x) False

14.2

(i) ($750 × 200 + $700 × 300 + $680 × 500) = $700,000
(ii) B should be written down by ($3 + $15 − $14) that is, by $4 per unit. Thus, the item B should be carried in financial statements at ($3 − $4), that is, at *negative* $1 per unit.
(iii) The cost-to-retail ratio under FIFO method is ($60,000/$96,000) that is 62.5 per cent. The sale value of the closing inventory based on the retail price is ($20,000 + 96,000 − 90,000) or $26,000. The cost of the closing inventory would be $26,000 × 62.5% that is $16,250.
(iv) 'Y' should be carried at NRV that is at €1,400 per unit.
(v) ($9,500 + $4,000 + $6,000) = $19,500
(vi) Inventories should be carried on the balance sheet of SL as at 31 December 2004 at $10,000,000, because redistribution costs represent an abnormal expenditure, which should not be included in the cost of inventories.
(vii) GAL should carry the stock of 1,000 mt. of alloy steel on its balance sheet as at 31 December 2004 at ($90 × 500 + $80 × 500) = $85,000.
(viii) The reversal of the write down of ($100,000 − $10,000) or $90,000 should be presented in the income statement for the year 2004 as *reduction on the amount of inventories recognized as an expense*.

14.3

The phrase 'ordinary course of businesses' implies the net realizable value (NRV) is the amount that the enterprise expects to realize by selling the asset in the normal course of business. The accounting principle for inventory valuation is based on the fundamental accounting principle that assets should not be carried in excess of amounts expected to be realized from their sale or use. Therefore, an enterprise should estimate amount expected to be realized from the sale of items included in inventories based on the purpose for which the inventory is held, firm sales contracts, enterprise's experience about price recovery of similar items, and available evidence about fluctuations of prices. For example, if an enterprise normally sells its products below list prices, list prices do not form the basis for determining the NRV. The rate of discount that the enterprise usually offers should be considered in determining the NRV. Similarly, if an enterprise sells an item in different markets at differential prices, it should estimate the proportion of sales in different markets to calculate the weighted average NRV, which should be used to value inventories.

Transactions and events occurred between the balance sheet date and the date when the board of directors approves financial statements should be considered to estimate amounts that inventories would realize.

Thus, the phrase 'in the normal course of business' implies that an enterprise should estimate amounts that inventories would realize under normal business conditions.

14.4

Last-in-first-out (LIFO) assumes that raw materials, components or finished goods produced or purchased last are issued first to the production process or to customers. *LIFO allows the matching of current cost with current income*. Thus, it provides the best measure of periodic income. However, it misstates the value of ending inventory because under this cost formula inventory usually consists of costs from earlier periods. Therefore, it is not consistent with the accounting approach that focuses on the balance sheet, adopted by the 'Framework for the preparation and presentation of financial statements'.

14.5

Fixed production overheads should be assigned to inventories based on the *normal capacity* of the production facilities. The actual level of production may be used if it approximates normal capacity. Total amount of fixed overheads for a period remain constant irrespective of the volume of production achieved during the period. Fixed overheads may be viewed as the capacity created by the firm. The loss resulting from underutilization of capacity should be recognized in the period in which the capacity is underutilized. This result is achieved by assigning fixed overheads to items in inventory when the production is below the normal capacity. If actual production is used to assign fixed overheads to a part of the loss arising from under utilization of capacity is carried to the next or subsequent years. However, if actual production is substantially higher than the normal capacity, fixed overheads are assigned to items in inventory based on actual production, because the cost of inventory should not exceed the actual cost of production.

14.6

A production process may result in simultaneous production of two or more products, which are designated as joint products or by-products. The common cost of the process is allocated between the joint products on a rational and consistent basis. For example, the common cost may be allocated on the relative sales value of each produce either at the stage in the production process when the products becomes separately identifiable, or at the completion of production.

Most by-products as well as scraps or waste materials, by their nature, are immaterial. Therefore, they are often measured at NRV and this value is deducted from the cost of the main product.

14.7

Inventories are usually written down to NRV on an *item-by-item* basis. However, items of inventory may be grouped together for comparing the cost and the NRV provided:

(i) they relate to the same product line and having similar purposes or end uses;
(ii) they are produced and marketed in the same geographical area; and
(iii) they cannot be practically evaluated separately from other items in that product line.

Let us take a couple of examples. An enterprise manufacturing electrical equipments may group transformers based on their capacity because they have same purposes and end users, they fetch similar prices in the domestic market. However, if the enterprise exports transformers to different countries at differential prices, it should form separate groups for transformers allocated for sale to different countries. Similarly, an enterprise engaged in manufacturing and selling food products in different types of packages at differential prices should not group all types of packages together.

An enterprise should consider materiality aspect before taking a decision on grouping of different items for inventory valuation.

14.8

The International Accounting Standards (IAS)-2, which deals with inventory valuation, does not prescribe any particular cost accounting method that should be used to determine the product cost. Therefore, use of ABC system is not prohibited by the Standard. However Mr. Smith should keep in mind two important stipulations in the Accounting Standard. First, fixed manufacturing over heads should be assigned to items in inventories based on the normal capacity. Second, techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Usually the cost of revising 'cost assigned to different activity-pools' based on actual expenses for an accounting period is significantly high. In absence of revision results obtained by the use of the ABC method may not approximate the actual cost. Moreover, to establish normal capacity for each activity-pool, to the satisfaction of auditors, is difficult. Therefore, in most situations it is appropriate to use a conventional cost accounting system to determine product cost for the purpose of inventory valuation.

14.9

International Accounting Standards (IAS)-2 stipulates that the cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. It also stipulates that storage costs should not be included in the cost of inventories unless those costs are necessary in the production process before a further production stage. In view of above stipulations transportation costs should be included in the cost of those machines, but warehouse charges should be excluded from the same. Warehouse charges should be recognized as an expense in the income statement for the period in which it is incurred.

14.10

IAS-2 stipulates that inventories should be measured at the lower of cost and net realizable value (NRV). It further stipulates that materials and other supplies held for use in the production of inventories should not be written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realizable value, the materials are written down to NRV. In such circumstances, the replacement cost of the material may be the best available measure of their NRV.

In view of above stipulations in IAS-2, the accounting policy of CL, which requires ad hoc provisioning for depreciation for non-moving items, is not appropriate. However, if available evidence and experience of the industry suggests that the reduced cost of finished goods represent a fair estimate of NRV, CL may continue the accounting policy for finished goods. It is unlikely that the depreciated costs of raw materials represent their respective replacement costs or the depreciation amount represents the estimated loss on sale of finished goods that will be produced by the use of those materials. Therefore, the accounting policy, to the extent it relates to raw materials, is inconsistent with the requirements under IAS-2.

14.11

IAS-2 is not applicable to mineral and mineral products to the extent they are measured at net realizable value in accordance with well-established practices in that industries. The valuation of tuff within the scope of IAS-2. It should be valued in accordance with accounting principles stipulated in IAS-2, because the weathering and treatment of tuff is not an integral part of the mining operation. Tuff is processed on surface, and therefore, it is not covered under exemptions provided in IAS-2.

14.12

IAS-2 requires that all costs incurred to bring the material to its present location and condition should be included in the cost of inventory. In view of this stipulation, all transport costs should be included in the cost of inventory. However, abnormal costs and wastes should be excluded from the cost of inventories. Therefore, if the transfer of the stock of fertilizers from one location to another is not normal to the business, transportation cost incurred for such transfers should be excluded from the cost of inventories. In this case, it appears that such transfers are normal to the business. Therefore, the accounting policy of GL is consistent with accounting principles stipulated in IAS-2.

14.13

(i) Normal capacity is the volume of production that the entity expects to achieve on an *average over a number of periods or seasons under normal circumstances*, taking into account the loss of capacity resulting from plant maintenance.

Installed capacity is not the normal capacity. Cost accountants use *'theoretical capacity'* to denote the production level that can be achieved by producing at full efficiency all the time. Theoretical capacity is theoretical in the sense that it does not allow for any plant maintenance, any normal interruption or any other loss of time, which is normal in the production process. They also use the term *'practical capacity'* to denote the capacity, which is determined by reducing theoretical capacity by unavoidable operating interruptions and also by loss of time which is normal in the production process. Examples of such interruptions are interruptions for scheduled maintenance, and shut downs for holidays,

An entity determines normal capacity taking into account the practical capacity and average customer demand over a long period (3 to 5 years) covering seasonal and cyclical fluctuations.

An enterprise determines the normal capacity taking into account:

(a) the designed or installed capacity;
(b) the practical capacity;
(c) normal level of efficiency that is expected to be achieved considering the actual working conditions in normal circumstances;
(d) estimated loss of production due to planned maintenance; and
(e) secular demand.

Normal capacity cannot change from year to year. However it is revised with structural or long-term changes in the business environment.

(ii) Usually Budgeted production cannot be considered normal capacity for the purpose of inventory valuation. Budget is an annual plan. It does not reflect the average capacity utilization over a number of periods or seasons under normal circumstances. It can be used only if it represents expected average capacity utilization over next three to five years. At present the capacity of DL and the industry in which DL operates is underutilized. The management of DL should review the expected average capacity utilization, if there are signals in the business environment that there is a possibility of change in demand in next couple of years.

(iii) DL fabricates steel structures of different sizes and complexities. Therefore, it is required to use multiple overhead absorption rates for equitable allocation of overheads to production units. It should determine normal capacity for each cost centre separately.

14.14

(i) Net realizable value (NRV) is the estimated selling price in the *ordinary course of business* less the estimated costs of completion and the costs necessary to make the sale. In other words, NRV is the amount the enterprise expects to realize by selling the item in the ordinary course of business. The estimate should not take into consideration new marketing strategy unless the management is committed to the same.

The NRV of work-in-progress (WIP) is the estimated selling price of the end product in the ordinary course of business less expenses *necessarily to be incurred* in order to make the sale and further costs required to complete the production. In other words the NRV of WIP is determined by deducting further costs required to complete the production from the NRV of the complete product.

The NRV should be estimated based on the most reliable evidence available *at the time the estimates are made* for the NRV. This estimate should take into consideration events occurring after the balance sheet date, if they provide additional information on conditions existing at the balance sheet date. For example, actual amounts realized by selling the whole or a part of the inventory should be considered in determining the NRV of the inventory. Similarly, a Government notification setting the price of a product covered under an administered price mechanism issued after the balance sheet date should be considered in determining the NRV. The objective is to estimate the amount most likely to be realized by the enterprise by selling the inventory.

Estimates of NRV should take into consideration the purpose for which the inventory is held. For example, if the quantity of inventory is held to satisfy firm sales or service contracts, the NRV is the contract price. If the inventory quantity is in excess of the quantity covered in firm sales and service contracts, the NRV of the excess inventory should be based on general selling prices.

NRV should be based on the list price, if the enterprise sells the goods covered in the inventory at list prices. In case the firm generally offers discount over list prices, the discounted prices should be considered to determine the NRV.

Replacement cost is the best measure of NRV of a material to be consumed in the course of production.

(ii) AL should notionally allocate inventories for different markets (countries) based on expected market mix in the period over which inventories will be sold. NRV of inventories allocated to each market should be determined separately. NRV of inventories allocated to a particular market should be based on the expected selling price in that market, in terms of the functional currency of that market. The NRV in foreign currency should be translated in the functional currency of AL using the exchange rate on the balance sheet date.

14.15

Bulldozer Ltd

Step 1 Expected total profit or loss

	Castle 1 \$'000	*Holmes* 2 \$'000	*Builder* 3 \$'000
Contract price	3,000	2,400	3,000
Less:			
Cost to date	(1,700)	(2,000)	(2,200)
Estimate cost to complete	(1,000)	(600)	(400)
Total estimate Profit/loss	300	(200)	400

Step 2 Attributable profit/Foreseeable loss

Even though Holmes is not yet complete, we must recognise the full expected loss of \$200,000 in the Income Statement this year.

For Castle and Builder the attributable profit to date will be calculated as:

$$\frac{\text{Work certified}}{\text{Contract price}} \times \text{Total estimated Profit}$$

$$\text{Castle } 300{,}000 \times \frac{2{,}000}{3{,}000} = \$200{,}000$$

$$\text{Builder } 400{,}000 \times \frac{2{,}400}{3{,}000} = \$320{,}000$$

Note:

As no profit was recognised in Castle in 2002, the full \$200,000 Attributable profit will be recognised in the profit and loss in 2003.

Step 3

Income Statement

			Castle	*Holmes*	*Buildings*	*Total in financial statements*
			$'000	$'000	$'000	$'000
(1)	Turnover					
	Work certified to date		2,000	1,600	2,400	
	Less:					
	Certified last year		(400)	–	–	
			1,600	1,600	2,400	5,600
(2)	Cost of Sales (Balancing figure)					
	Cumulative (W4)	①	1,800	1,800	2,080	
	Less:					
	In last year Income Statement	②	(400)	–	–	
		③	1,400	1,800	2,080	5,280
(3)	Gross Profit					
	Attributable profit (foreseeable loss)	①	200	(200)	320	
	Less:					
	Recognised previously	②	–	–	–	–
	Gross Profit	③	200	(200)	320	320

Explanation of answer

	(1)	Turnover	2,000	
therefore	(1)	Cost of sales	(1,800)	Balancing figure
	(1)	Gross profit	200	
	(2)	Turnover	400	
therefore	(2)	Cost of sales	(400)	Balancing figure
	(2)	Gross profit	Nil	
	(3)	Turnover	1,600	
therefore	(3)	Cost of sales	(1,400)	Balancing figure
	(3)	Gross profit	200	

for Castle (Balance Sheet)

(1) from the Question, always given 2,000

(2) from the Question, always given 1,800

(3) or **(4)** Difference between **(1)** and **(2)** if **(1)** less **(2)** greater than zero then difference goes to **(3)**. If **(1)** less **(2)** is less than zero then difference goes to **(4)**.

2,000 less 1,800 = 200 this is greater than zero hence answer goes to **(3)** and not **(4)** to represent receivables recoverable in balance sheet.

(5) from the question it is always provided, Castle $1,700.

(6) This is the only figure that will come from the income statement (step 3). Please note it is cumulative cost of sales hence *NOT* bottom figure but always top i.e., in our case

	Castle	
cost of sales to date	1,800	← will go to (6) in Balance Sheet
previous period	(400)	
current period	1,400	← never take this figure as this represents current year only

(5) less **(6)** if greater than zero the difference will either go to **(7)** or **(11)**. However if **(5)** less **(6)** is less than zero then difference will go straight to box **(12)** to represent accruals or provisions.

In case of castle **(5)** less **(6)** will be

1,700 less 1,800 = (100) this is less than zero hence will represent accruals and provisions in the balance sheet and go straight to (12).

If the difference between **(5)** and **(6)** is greater than zero then difference will go to **(7)** see Holmes.

(5) and **(6)** is 2,000 − 1,800 = 200 which is greater than zero therefore 200 will go to **(7)**.

Next steps are off sets.

If there is a figure in **(4)** above then the figure in **(7)** will be offset against that in **(4)**

Holmes:

(4) has (100)
(7) has 200

the maximum that can be offset against **(4)** is 100 hence

(7)	200	goes to **(4)** →	**(4)**	(100)
(8)	(100)		**(9)**	100
(11)	100		**(10)**	NIL

(10) represents payables

(11) represents inventories stocks

Now go and try Builder using the same procedures as above just follow the steps **(1)–(12)** in order of occurance and you will be able to answer IAS 11 within 15 minutes.

Step 4
Balance Sheet

		Castle	*Holmes*	*Builders*	*Total in F/S*
		$'000	$'000	$'000	$'000
(i)					
Revenue account					
Cumulative turnover (W3)	**(1)**	2,000	1,600	2,400	
Less: Amounts Invoiced	**(2)**	(1,800)	(1,700)	(2,600)	
Receivables Amounts Recoverable on contracts (if >0)	**(3)**	200	N/A	N/A	200
Excess billing (if <0)	**(4)**	Nil	(100)	(200)	
Net off in W4 (ii)	**(9)**	Nil	100	120	
Payables: Payments received on account *Trade Receivables*	**(10)**	0	0	(80)	(80)
(ii)					
Costs account					
Cost incurred to date	**(5)**	1,700	2,000	2,200	
Less: Cost of sales	**(6)**	(1,800)	(1,800)	(2,080)	
To date (W3) Net cost less foreseeable Losses (if >0)	**(7)**	N/A	200	120	320
Less: Applicable payments On account [W4 (i)]	**(8)**	Nil	(100)	(120)	(220)
Inventories: Long-term contract Balances (≥0 for each contract)	**(11)**	Nil	100	Nil	100
Provision or accruals (if <0)	**(12)**	100	Nil	Nil	(100)

Summary

	$'000
Receivables amounts recoverable	200
Payables	80
Inventories	100
Provisions or accruals	100
	480

14.16

Step 1 Expected total profit or loss

	Boat	*Boat*	*Ferry*
	1.10.2000	1.10.01	1.10.01
Contract price	3,000	3,000	5,000
Less:			
Cost 2002 →		(580)	(1,900)
Cost 2001 →	(650)	(650)	(3,400)
Estimated costs to complete →	(1,300)	(790)	
Total estimated profit or loss 2001/2002	1,050	980	(300)

Step 2 Attributable profit or forseeable loss 1.10.2000

Boat $1,050 \times 30\% = 315$
Boat $980 \times 55\% = 539$

Step 3 Income Statement

	Boat 01.10.2000	*Boat* 01.10.01	*Ferry* 01.10.01	*Total in financial statements*
	$'000	$'000	$'000	$'000
		3,000 × 55%		
1 **Turnover**				
Work Certified to date 3,000 × 30%	900	1,650	2,250	5,000 × 45%
Less:				
Certified last year	–	(900)	–	
Turnover 2002	900	750	2,250	
Balancing figure				
Cost of Sales (Balancing figure)				
Cumulative (W4) 900 − 315	585	1,111	2,550	
Less:				
In last year Income Statement	0	(585)	–	
	585	526	2,550	3,661
2 **Gross Profit**				
Attributable Profit or foreseeable loss to date	315	539	(300)	
Less:				
Recognised previously	–	(315)	–	–
Gross Profit	315	224	(300)	239

Turnover	3,000
Cost of Sales	3,076
Gross Profit	(76)

Step 4 Balance Sheet

		Boat 2000	*Boat 2001*	*Ferry 2001*	*Total in financial statements*
		$'000	$'000	$'000	$'000
Revenue account					
Cumulative turnover (W3)	**(1)**	900	1,650	2,250	
Less: Amounts Invoiced	**(2)**	(900)	(1,650)	(2,250)	
Receivables Amounts Recoverable on contracts (if >0)	**(3)**	0	0	0	Nil
Excess billing (if <0)	**(4)**	0	0	0	
Net off in W4 (ii)	**(9)**	0	0	0	
Payables: Payments received on account *Trade Receivables*	**(10)**	100	50	0	150
(ii)			650 + 580		
Costs account					
Cost incurred to date	**(5)**	650	1,230	1,900	
Less: Cost of sales	**(6)**	(585)	(1,111)	(2,550)	
To date (W3) Net cost less foreseeable Losses (if >0)	**(7)**	65	119	650	834
Less: Applicable payments On account [W4 (i)]	**(8)**	0	0	(650)	(650)
Inventories: Long-term contract Balances (≥0 for each contract)	**(11)**	65	119	0	184
Provision or accruals (if <0)	**(12)**	0	0	650	650

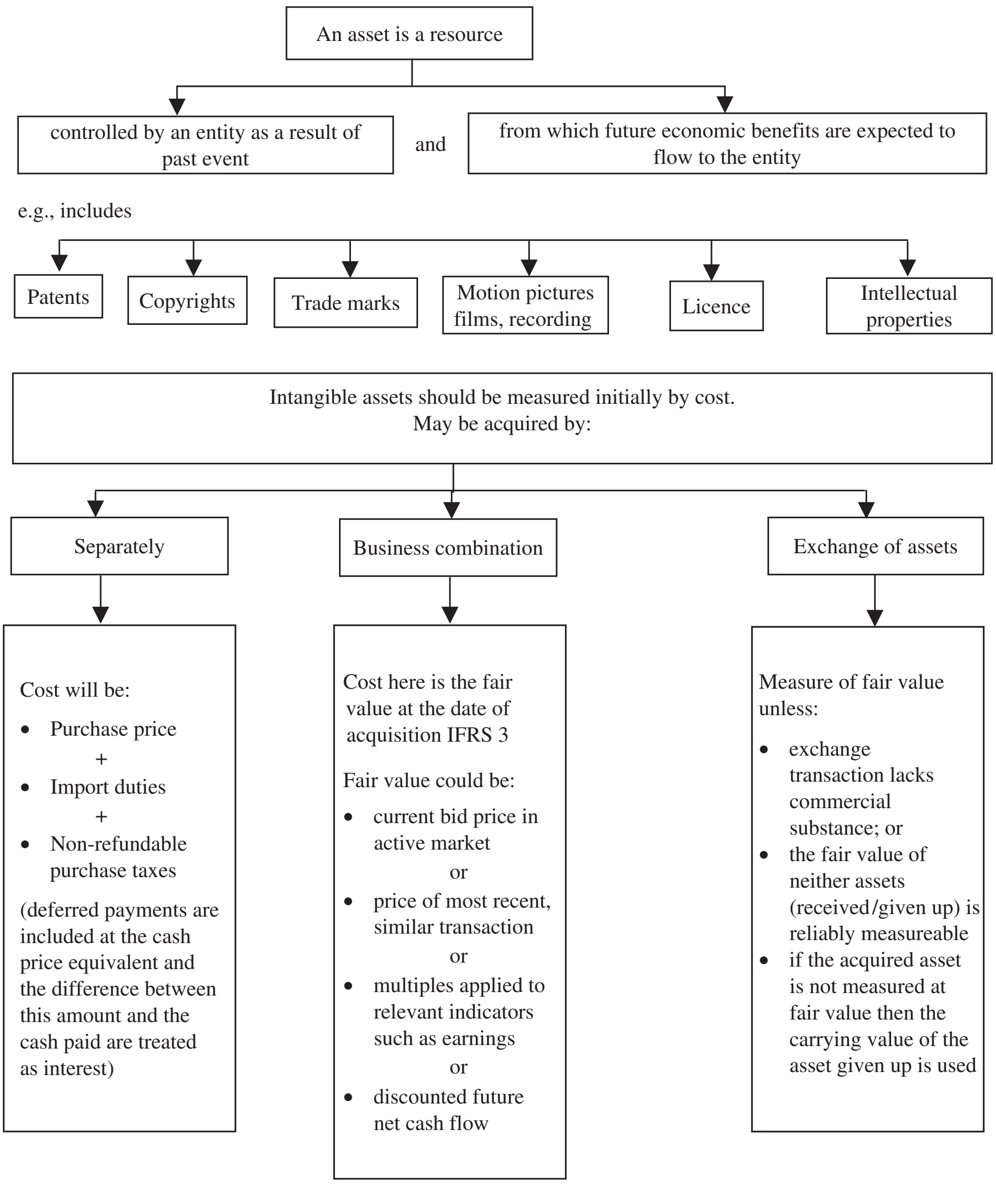
Summary		**Balance Sheet**	
Receivables amounts recoverable	Nil	Gross amount due from customers (119 + 150)	269
Payables	150		
Inventories	184	Gross amount due to customers	650
Accruals or Provision	650		

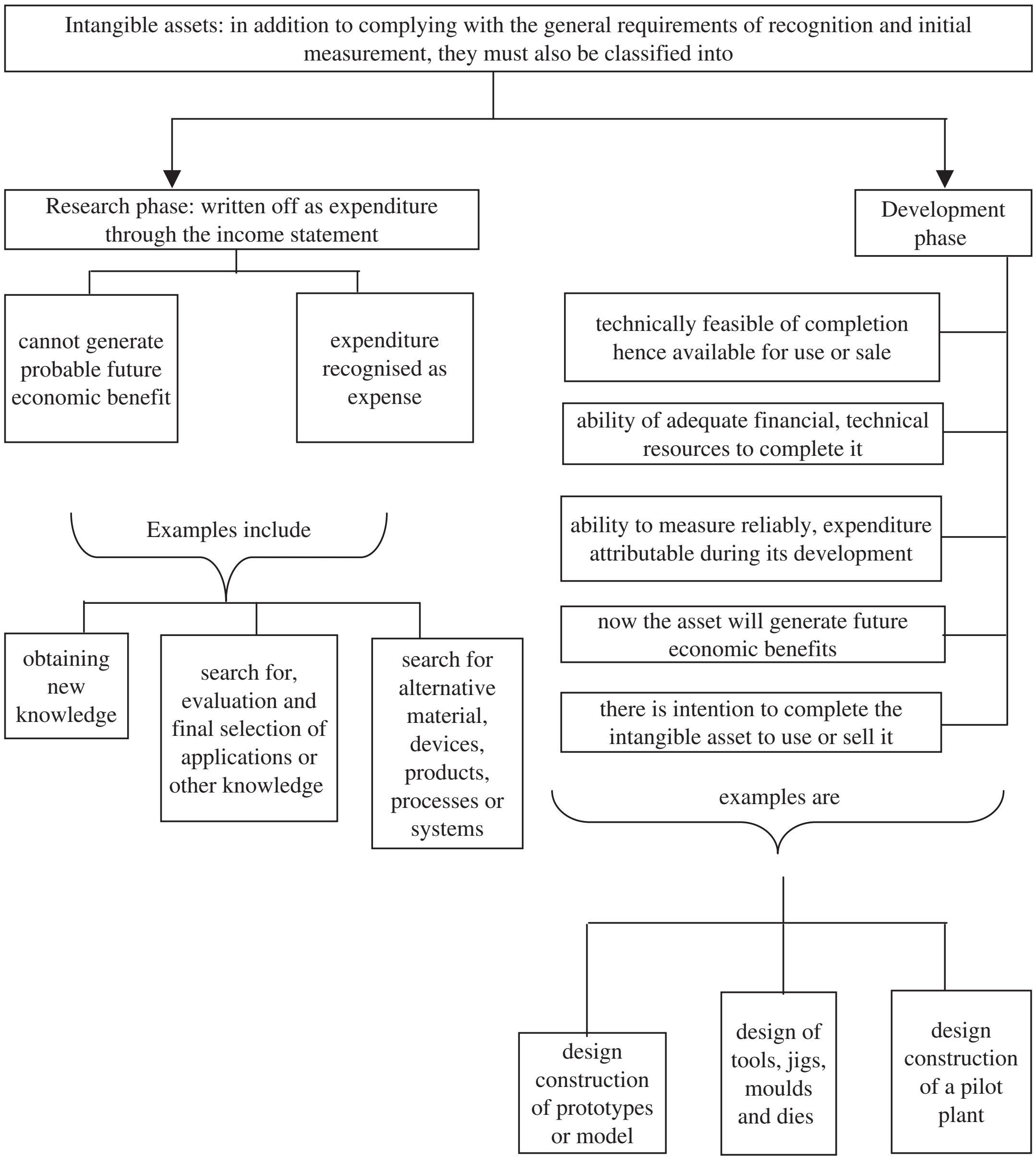
Non-current Intangible Assets 15

IAS 38: Intangible assets

These are assets that are identifiable non-monetary assets without physical substance.

Judgement has to be made to determine which element is more significant, the intangible or tangible asset e.g., software in a floppy disk embedded within the hardware.




Intangible assets: in addition to complying with the general requirements of recognition and initial measurement, they must also be classified into
Research phase: written off as expenditure through the income statement
cannot generate probable future economic benefit
expenditure recognised as expense
Examples include
obtaining new knowledge
search for, evaluation and final selection of applications or other knowledge
search for alternative material, devices, products, processes or systems
Development phase
technically feasible of completion hence available for use or sale
ability of adequate financial, technical resources to complete it
ability to measure reliably, expenditure attributable during its development
now the asset will generate future economic benefits
there is intention to complete the intangible asset to use or sell it
examples are
design construction of prototypes or model
design of tools, jigs, moulds and dies
design construction of a pilot plant

Recognition of cost and expenses

recognised when incurred unless

- if forms part of intangible assets that meets the recognition criteria
- item is acquired in a business combination and cannot be recognised as an intangible asset

Examples of costs/expenses

- material and services used
- fees to register a legal right
- salaries, wages and other employment costs
- other directly attributable costs
- depreciation used in development phase on equipment
- overhead costs that can be generated reasonably on consistent basis
- amortisation of patents, royalties to generate intangible asset

Costs not included of an internally generated intangible

- selling, distribution and other general overhead costs
- identified inefficiencies and initial operating losses
- costs that have already been expenses during research phase
- training expenses

Expenditure incurred to provide future economic benefit for which no intangible asset can be recognised is expensed when incurred:

- research cost
- pre-opening costs for new facilities
- plant set-up costs except if capitalised IAS 16
- legal and secretarial costs in setting up legal entity
- advertising and related costs
- training costs involved in running a business of product line

Questions

15.1 Classify each of the following assets as either tangible or intangible.

(i) Operating system of a computer
(ii) An off the shelf integrated publishing software package
(iii) Specialised software embedded in computer controlled machine tools
(iv) A 'firewall' controlling access to restricted sections of an internet website

(4 marks)

15.2 Kumar enterprises is developing a new production process. The amount of expenditure to 31 December 2004 is as follows:

	$
1 January–30 September	4,320
1 October–31 December	480
	4,800

On 1 October, the entity was able to demonstrate that the production process met the criteria for recognition as intangible asset. The amount estimated to be recoverable from the process (including future cash outflows to complete the process before it is available for use) in $2,400.

Expenditure in 2005 is $9,600. At 31 December 2005, the amount estimated to be recoverable from the process (including future cash outflow to complete the process before it is available for use) is $9,000.

Requirements

Discuss whether the production process is recognised as an intangible asset or as an expense in December 2004.

In December 2005, discuss the position of impairment.

(10 marks)

15.3 On 1 January 2004 Riteman Ltd established a new research and development unit to acquire scientific knowledge about use of synthetic chemicals for pain relief. The following expenses were incurred during the year ended 31 December 2004.

(i) Purchase of building for $200,000. Depreciation at rate of 4% per annum on cost
(ii) Staff wages and salaries (research staff) $1,177,500
(iii) Equipment costing $30,000 depreciated reducing balance at 50% per annum

Requirements

Calculate the amount of research and development to be recognised as an expense in the year ended 31 December 2004.

(7 marks)

15.4 Riteaim Ltd incurred the following expenditure as research and development, non-related to purchase of plant, property or equipment.

(i) $6,000 on successfully devising process to convert sap extracted from rubber plants into chemical MUCK, AVON and DALE
(ii) $30,000 on developing an Analgesic medication based on chemical DALE

No commercial uses have yet been discussed for MUCK and AVON.

Commercial production and sales on Anolgesic commenced on 1 December 2004 and are expected to produce steady profitable income during five year period before being replaced.

Adequate resources exist in Riteaim to achieve this. Year end is 31 March 2005.

Requirement

Determine the maximum amount of development expenditure that may be carried at 31 March 2005 under IAS 38.

(6 marks)

15.5 Mitsu Ltd on 31 December was successfull in a bid to acquire the exclusive rights to a patent that had been developed by Bishi Ltd.

The amount payable was $300,000 immediately and $200,000 in one years time.

Mitsu incurred legal fees of $43,500 and a stamp duty of $500 for the registration of patent rights.

Requirements

Calculate the cost of the patent right on initial recognition. Mitsu cost of capital is 10%.

(6 marks)

15.6 Micro Ltd paid $5,000,000 for a 100% interest in Soft Ltd.

At the date of acquisition, the net assets of Soft are shown in its balance sheet which had a fair value of $3,000,000 in addition to the following rights.

(i) The brand name 'Byte' which Soft had considered the sale of this brand first prior to its acquisition by Micro. 'Byte' has been revalued at $150,000 by a reputable firm of valuation specialists.
(ii) Sole distribution rights to a product 'Doswin' estimated future cash flows generated by this right will be $125,000 per anum for the next six years @ 10%. Annuity factor is 4.36.

(6 marks)

Requirements

Calculate Goodwill arising on acquisition.

15.7 Which of the following are intangible assets

(i) Building
(ii) Patent
(iii) Copyrights
(iv) Motion pictures films recording
(v) Farm land
(vi) Trademark
(vii) Licence
(viii) Short-term investments
(ix) Intellectual properties

A (i), (ii), (iii), (iv), (vi), (vii), (viii) and (ix)
B (ii), (iii), (iv), (vi), (vii), (viii) and (ix)
C (i), (ii), (iii), (iv), (vii), (viii) and (ix)
D (i), (iv), (v), (vi), (vii), (viii) and (ix)

(2 marks)

15.8 In a business combination, the fair value could *not* be:

A Current bid price in active market
B Price of most recent, similar transaction
C Discounted future net cash flow
D Present value of minimum lease payment

(2 marks)

✓ Answers

15.1 (i) Operating system e.g., Windows is tangible as it is an integral part of a hardware and hence should be treated as normal plant and equipment under IAS 16.

(ii) Off-the-shelf integrated publishing software packages, e.g. SAGE line 50 is not an integral part of the hardware and hence intangible.

(iii) Software package embedded in the computer machine tends to 'reboot' and hence is tangible similar to (i) above.

(iv) Firewall restricting access to internet websites can be sold to other companies and hence intangible.

15.2 The production process is recognised as an intangible asset at a cost of $480 (expenditure incurred since 1 October when the recognition criteria were met).

The intangible asset is carried at this cost, reason being it is less than the amount expected to be recoverable of $2,400.

The $4,320 expenditure incurred prior to 1 October is recognised as an expense since the recognition criteria were not met. Therefore the $4,320 will never be part of the cost of production process recognised in the balance sheet.

At 31 December 2005.

The cost of production is $10,080 ($480 + $9,600).

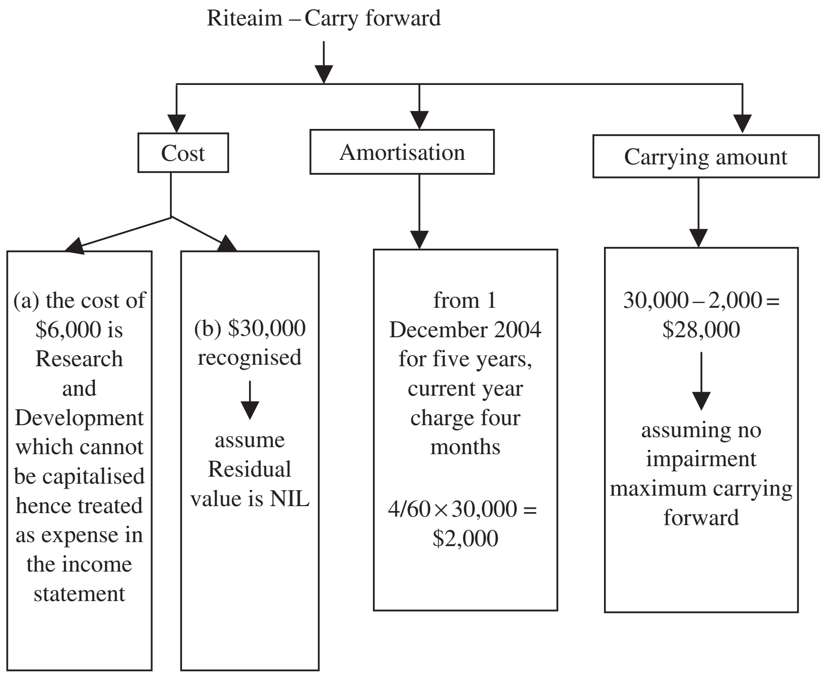
Kumar will recognise impairment loss of $1,080 to adjust the carrying amount before impairment loss $10,000 to its recoverable amount of $9,000.

The impairment loss will be reversed in subsequent period if the requirements for reversal are met (IAS 36).

15.3 Riteaim Ltd: Research and Development write off

	$
Building depreciation (200,000 × 4%)	8,000
Equipment depreciation (30,000 × 50%)	15,000
Staff wages and salaries	1,775,500
	1,798,500

15.4



15.5 Mitsu Limited

Cost of patent	$
Purchase price	300,000
Deferred consideration (200,000 × 1/1.1)	181,818
Legal fees	43,500
Stamp duty	500
Cost of patent	525,818

15.6 Micro Limited

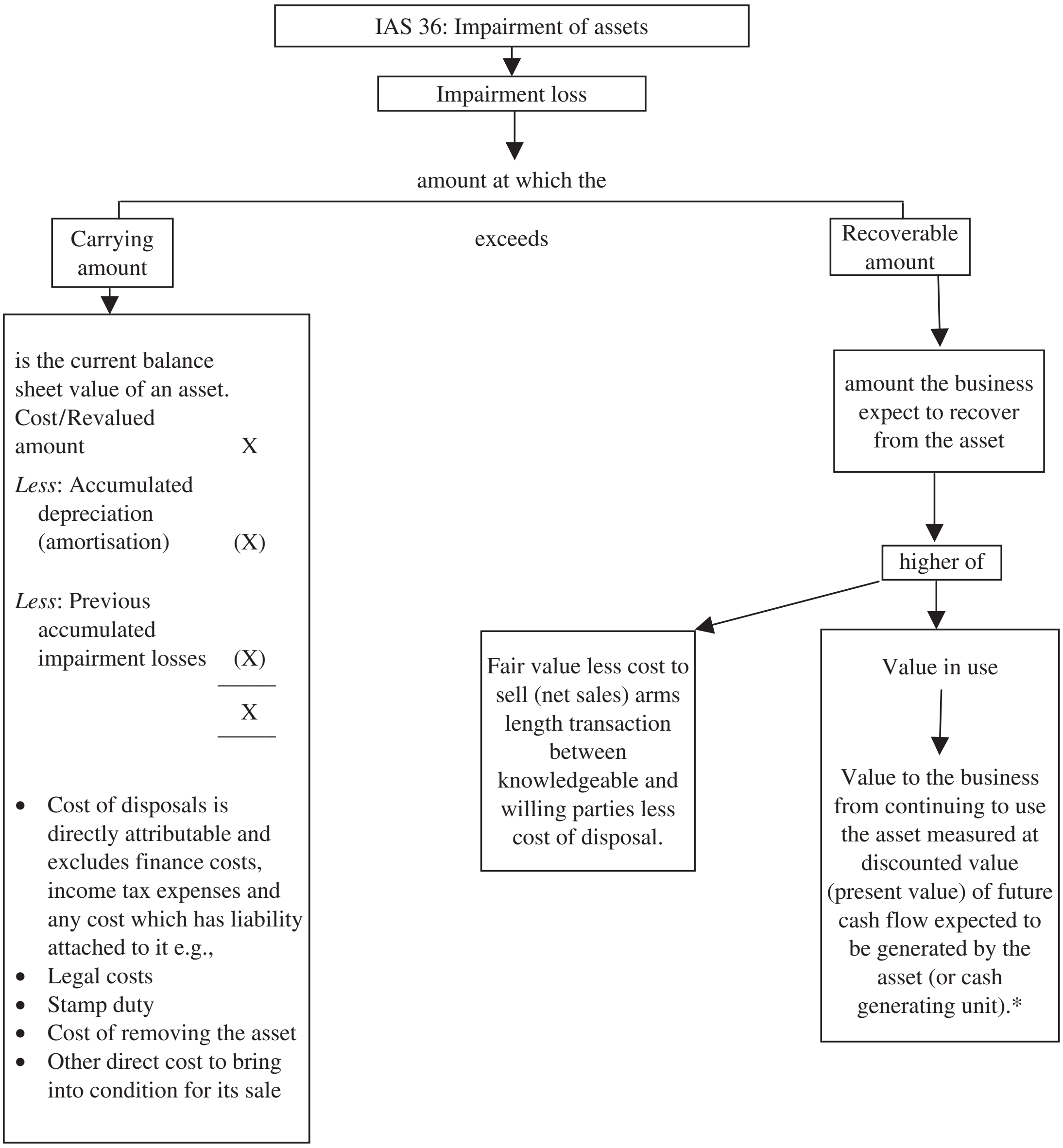
The two intangibles will be allocated as a business combination IFRS 3.

	$	$
Cost		5,000
Less:		
Net assets in soft	3,000	
Brand acquired	150	
Distribution rights (125,000 × 4.36)	545	(3,695)
Goodwill on acquisition		1,305

15.7 **B**

15.8 **D**

This is part of IAS 17 and not IAS 38.



* Cash generating unit: Sometimes it may not be possible to identify the recoverable amount of an asset individually as it may be part of a group of assets which together generate the cash. This under IAS 36 refers to as a cash generating unit which is the smallest identifiable group of assets that together generate cash flow for the business.

Illustration

Recoverable amount is greater of:

Value in use	Fair value	Therefore recoverable amount is	Carrying amount	Comments
$450	$525	$525	$500	No impairment as the carrying amount does NOT exceed recoverable amount.
$450	$490	$490	$500	Impairment loss of $10 must be recognised. The carrying value of the asset is written down to $490.
$480	$460	$480	$500	Impairment loss of $20 must be recognised. The carrying value of the asset is written down to $480.

Fair value less cost to sell

Tuske operates in leased premises operating a bottling plant situated in a single factory unit, and are sold periodically as complete asset.

Professional valuers have estimated the place might be sold for $200,000, they have charged a fee of $2,000 for their valuation report.

Tuske would need to dismantle the asset and ship it to the buyers. Dismantling shipping would cost $10,000. Specialist packaging would cost in further $8,000 and legal fees $3,000.

Fair value less cost to sell would be:

	$
Sales price	200,000
Dismantling and shipping	(10,000)
Packaging	(8,000)
Legal fees	(3,000)
Fair value less cost to sell	179,000

Professional valuers fees of $2,000 would not be included in the fair value less cost to sell as this is not directly attributable cost of selling the asset.

Value in use

Gustor owns a patent on a golf ball. The patent expires in 5 years. During the period, the demand for the golf ball is forecasted to grow at 5% per annum.

Experience shows that competitors will flood the market with generic versions of a profitable golf ball as soon as it is no longer protected by the patent. Hence Gustor does not expect the patent to generate significant cash flow after 5 years.

Net revenue for sales of the golf ball were \$100 million last year.

Gustor has decided that 15.5% is an appropriate discount rate for the appraisal of the cash flows associated with the product.

Time	*Cash flow* \$m	*Discount factor* *@ 15.5%*		*Present value* \$m
1	$100 \times 1.05 = 105$	0.86580		91
2	$100 \times 1.05^2 = 110.3$	0.74961		83
3	$100 \times 1.05^3 = 115.8$	0.64901		75
4	$100 \times 1.05^4 = 121.6$	0.56192		68
5	$100 \times 1.05^5 = 127.6$	0.48651		62
			Value in use	379

Cash generating unit

An entity owns a dry dock with a large crane to support its activities. The crane could only be sold for scrap value and cash inflows from its use cannot be identified separately from all the operations directly connected with the dry dock.

It is not possible to estimate the recoverable amount of the crane because its value in use cannot be determined, therefore, the entity estimates the recoverable amount of the cash generating unit to which the crane belongs, that is, the day dock as a whole.

? Question

Dickibird railways operates in several areas of the country notably the Northeast of England. It has a contract with the local government authority of Yorkshire to provide a minimum service on each of its ten separate routes. Assets (trains) are devoted to each route and the cash flow from each route can be separately identified. One of the routes which leads to the seatown of Whitley Bay is operating at a significant loss. What is the cash generating unit that should be tested for impairment?

✓ Answer

If Dickibird railways had the option to shut down the Whitley Bay route then the lowest level of identifiable cash generating unit would be the asset on each individual Railway route.

However, the Railways company is required to operate all ten routes.

The assets of the ten Railway routes is therefore the cash generating unit that should be tested for improvement.

Cost valuation model $\left.\right\}$ Cost – Accumulated amortisation + Accumulated impairment losses

Revaluation model

Revalued amount (Fair value)	X
Less: Any subsequent accumulated amortisation	X
Less: Any accumulated impairment losses	X
	X

does not allow

- revaluation of intangible assets that have not previously been recognised as assets
- the initial recognition of intangible assets at amounts other than costs

Revaluation as with other assets

- Surplus → to Equity → may be transferred to retained earnings when surplus is realised (on retirement or on disposal)
- Deficit is expressed → Unless covered by previously recognised surplus
- All intangibles in the class must be revalued

Amortisation

- Charged on revalued amount
- Original cost

difference is transferred to retained earnings.

Share Capital Transactions

16

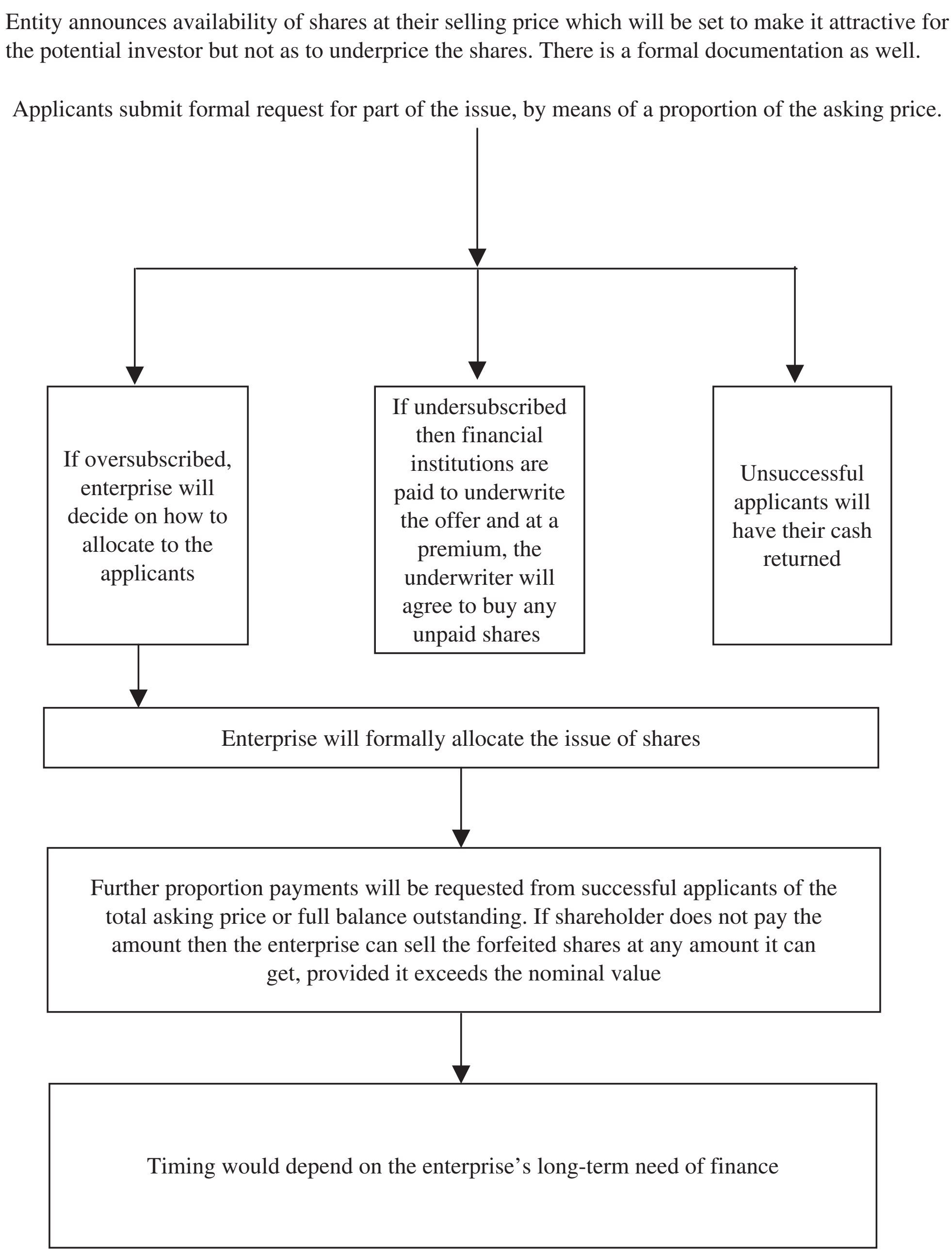
Different types of shares

General differences

Ordinary shares		Preference shares
Payment of dividends is NOT fixed and fluctuations depending on profits made and management decisions	Fixed percentage	Issued as fixed percentage hence dividend payment is fixed according to percentage
Dividend payment necessary	If entity makes a profit	Must pay a dividend
Dividends do not have to be declared	If entity makes a loss	Must pay a dividend
More common	Which are more common	Less common
Paid after preference	On liquidation	Have preference over ordinary
Contain rights to vote	Voting rights	No right to vote
Owners of company	Ownership	Investors in company

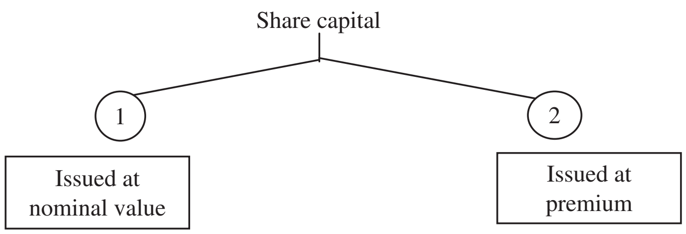
Issue of shares

General procedures

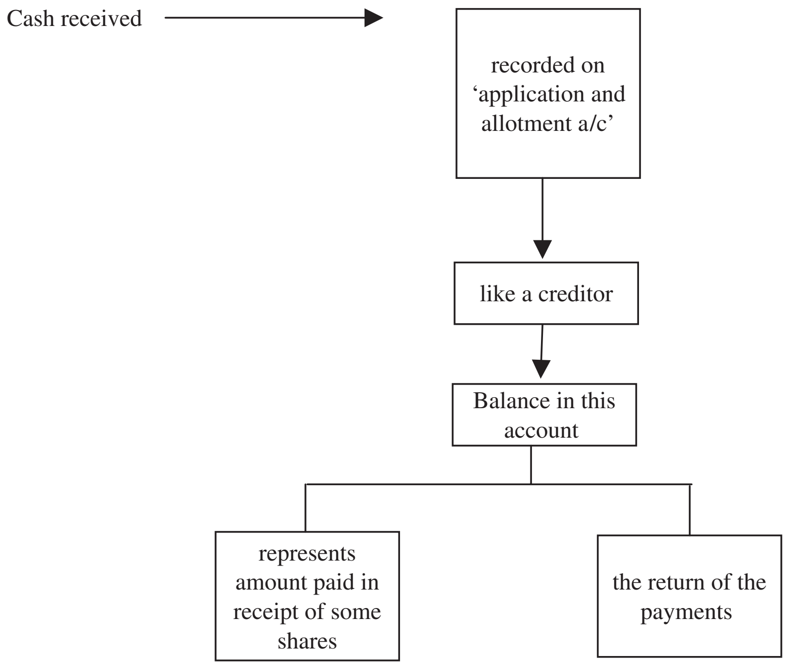


Accounting issues

(i)



(ii)



Application entries

(1)	**Debit**	Bank
	Credit	Application or allotment account

(Being recording of monies received on application of new shares.)

(2)	**Debit**	Application on allotment account
	Credit	Bank

(Being return of monies to unsuccessful applicants.)

(3)	**Debit**	Application of allotment account
	Credit	Share Capital
	Credit	Share Premium

(Being transfer of application monies to share capital and share premium (if issued at a premium) on allotment of shares.)

Application and Allotment

(2) Cash returned to unsuccessful applications	(1) Cash received with applications
	(3) Being transferred to share capital

Request for further payments

(4)	**Debit**	Application and allotment account
	Credit	Share Capital
	Credit	Share Premium

(Being amounts due on allotment.)

(5)	**Debit**	Bank
	Credit	Share Capital
	Credit	Share Premium

(Being allotment monies received.)

(6)	**Debit**	Investment in own shares
	Credit	Application and allotment account
(Being transfer of balance of allotment monies due but not received.)		

Application and Allotment Account

(4) Amount requested on allotment	(5) Cash received (6) Balance transfer to investments in own shares

Further Calls: Will result in similar entries to above except in call account.

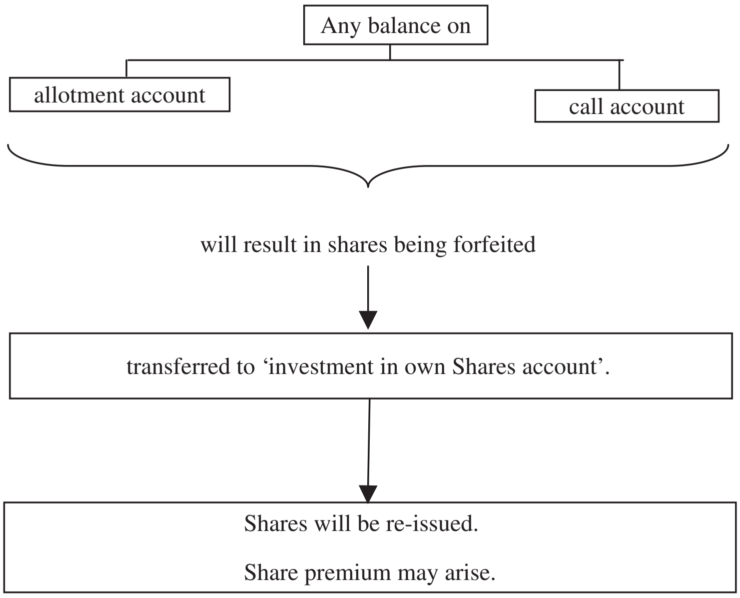
(7)	**Debit**	Call Account
	Credit	Share Capital
(Being amount due on call.)		

(8)	**Debit**	Bank
	Credit	Call account
(Being amounts received in call.)		

(9)	**Debit**	Investment in own shares
	Credit	Call account
(Being transfer of balance of call monies due but not received.)		

Call account

(7) Amount requested on call	(8) Cash received (9) Balance transferred to investment in own shares

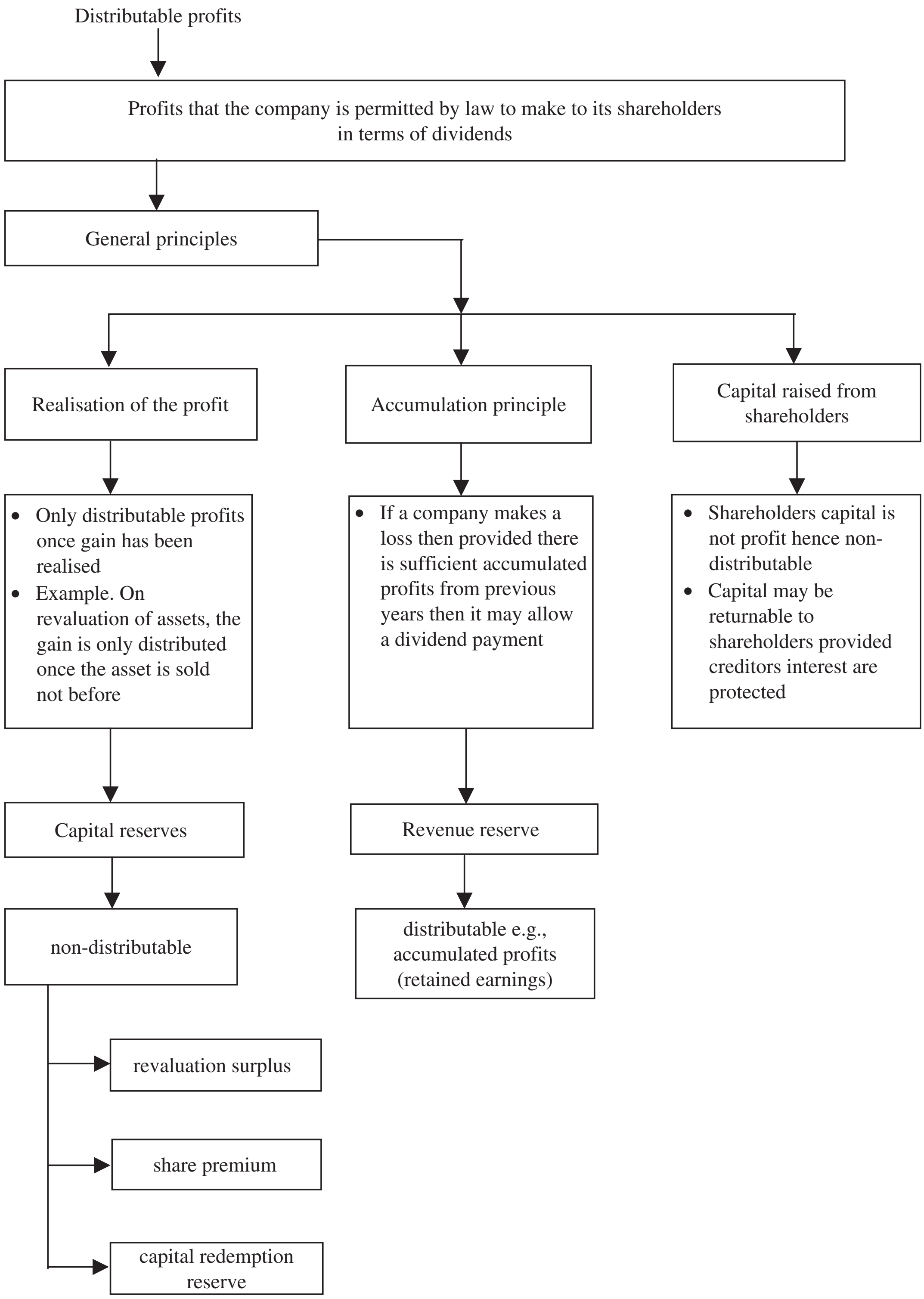


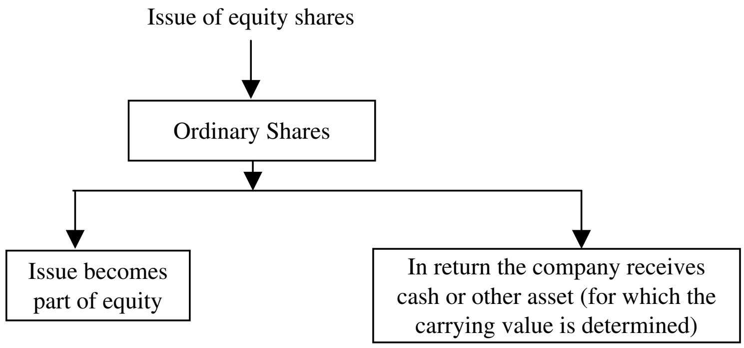
(10) **Debit** Bank
Credit Investment in own shares
(Being amounts received on issue of forfeited shares.)

(11) **Debit** Investment in own shares
Credit Share Premium
(Being transfer of balance to share premium.)

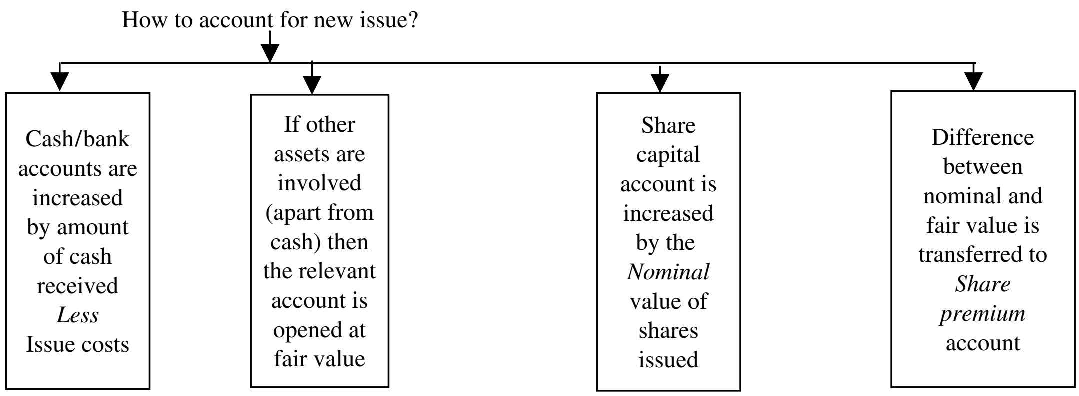
Investment in own shares

(6) Balance transferred from application and allotment	(10) Cash received from new shareholders
(9) Balance transferred from call	(11) Balance transferred to Share Premium


Distributable profits
Profits that the company is permitted by law to make to its shareholders in terms of dividends
General principles
Realisation of the profit
Accumulation principle
Capital raised from shareholders
• Only distributable profits once gain has been realised
• Example. On revaluation of assets, the gain is only distributed once the asset is sold not before
• If a company makes a loss then provided there is sufficient accumulated profits from previous years then it may allow a dividend payment
• Shareholders capital is not profit hence non-distributable
• Capital may be returnable to shareholders provided creditors interest are protected
Capital reserves
Revenue reserve
non-distributable
distributable e.g., accumulated profits (retained earnings)
revaluation surplus
share premium
capital redemption reserve



Every share when first issued has a face, nominal or part value.
Normally the issue price is greater than the nominal value.



IAS 32 specifically states that any transaction costs should be deducted from equity.

Appleby issues 600,000 new ordinary shares @ $1.00 each at a price of $4.50 per share.

Share issue costs were $80,000.

State the effect on the balance sheet of Appleby.

		$'000	$'000
DR	Cash	2,700	
CR	Share capital		600
CR	Share premium		2,100

Check
[Issue price − Nominal value × Share price]
($4.50 − $1.00) × 600,000 = $2,100,000

However, IAS 32 states all issue costs must be deducted from equity.

Hence

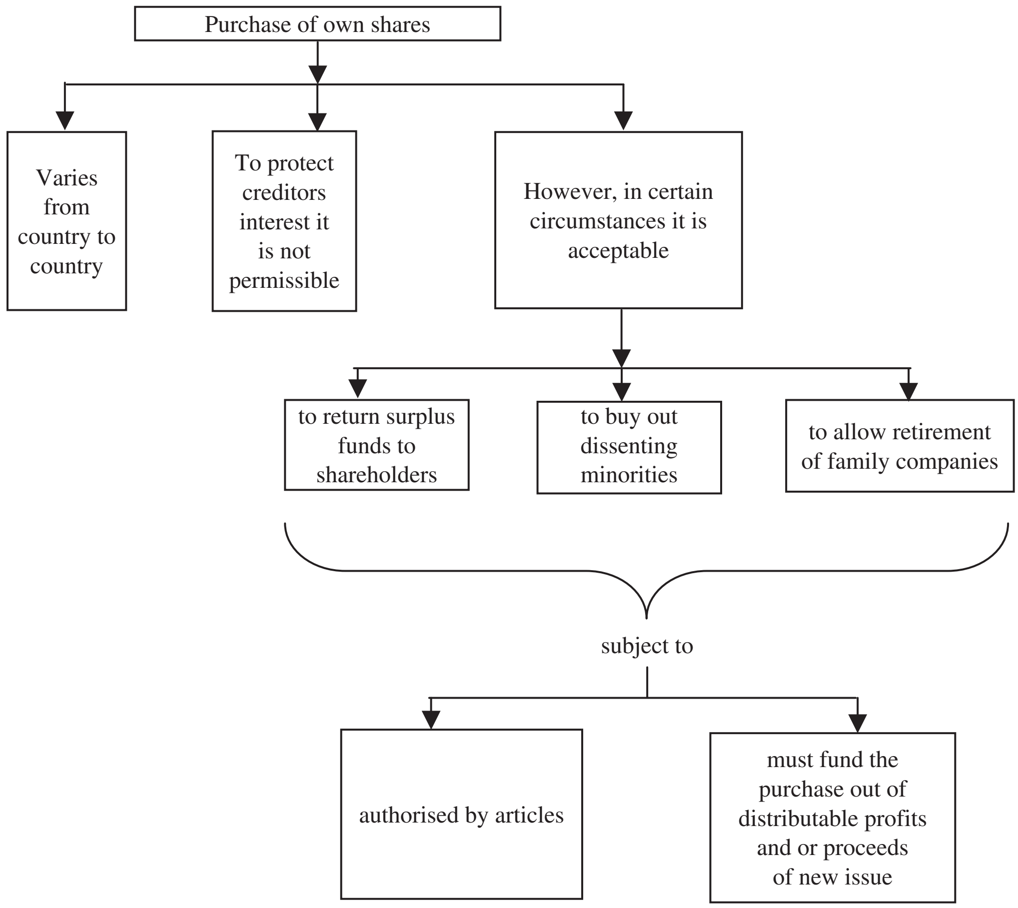
Assets		
Cash		2,700
less		(80)
		2,620
Equity		
Share capital		600
Share premium	2,100	
Less:		
Issue costs	(80)	
Increase in share premium	2,020	2,020
Increase in equity		2,620

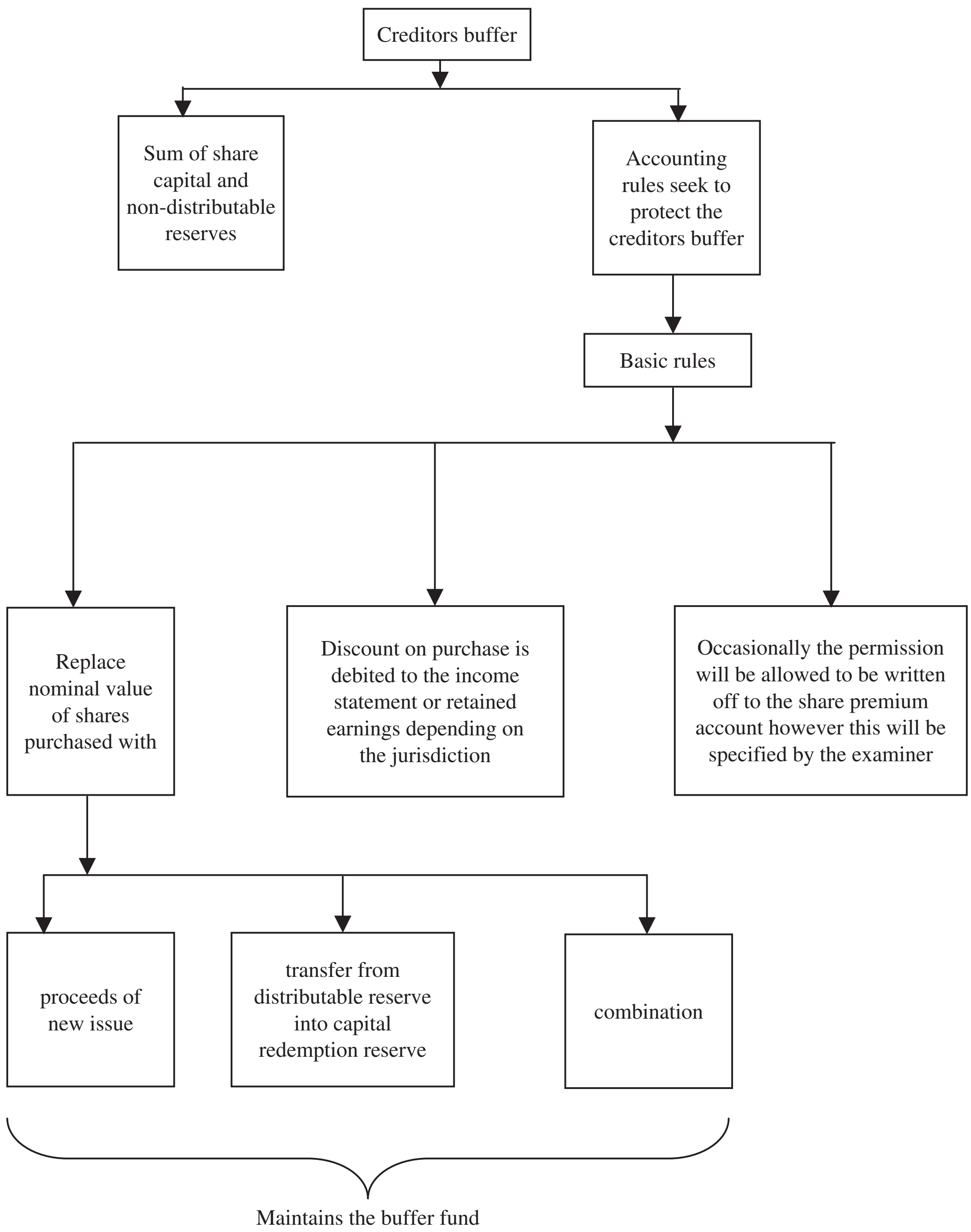
Bonus issues

Company converts some of its reserves into share capital, and issues the new bonus shares to existing shareholders in proportion to their existing shareholding.

No finance is raised by the company instead the company's reserves are reduced.

DR Retained earnings	X	
CR Share capital		X




Creditors buffer
Sum of share capital and non-distributable reserves
Accounting rules seek to protect the creditors buffer
Basic rules
Replace nominal value of shares purchased with
Discount on purchase is debited to the income statement or retained earnings depending on the jurisdiction
Occasionally the permission will be allowed to be written off to the share premium account however this will be specified by the examiner
proceeds of new issue
transfer from distributable reserve into capital redemption reserve
combination
Maintains the buffer fund

Repurchase out of capital

Sometimes companies are allowed to reduce out of creditors buffer. Achieved by not replacing the whole of the nominal value of the shares purchased.

It is subject to strict rules and must be *Learned*.

Applies only to *Private* companies.

Allowed to reduce the creditors buffer by the Permissible capital payment (PCP)

Cost of purchase	X
Less/Proceeds of new issue	(X)
Distributable reserve	(X)
PCP	X

Journal entries

(1) Repurchase

DR Share capital	X	
DR Income statement	X	
CR Bank/Cash		X

(2) New issue

DR Cash	X	
CR Share capital		X
CR Share premium		X

(3) Transfer

Workings

Nominal value of shares purchased (the amount to be replaced)	X
Less//PCP	(X)
The amount actually replaced	X
Less//Proceeds of new issue	(X)
Transfer	X/(X)

DR Income statement	X	
CR CRR (Capital redemption reserve) (non-distributable reserve)		X

DR non-distributable reserve	X	
CR Income Statement		X

Distributable profit

- Cash payment of a dividend
- Legislation states that distribution can only be made out of 'profit available for distribution'
- S263 Private Companies may only distribute accumulated realised profits (i.e., can make a distribution in a period when it made a loss provided the previous periods profits are sufficient to absorb the current loss and still retain a credit balance of retained earnings)

Realised

- When there is a transfer of economic benefit (usually cash) or there is reasonable certainty to result in such a transfer
- Normally profits taken to income statement are treated as realised e.g., profit under construction contracts as per IAS 11
- *Exception*: Net unsettled gains on a long-term monetary item taken to income statement as per IAS 21. These are treated as unrealised when calculating distributable profits

Impact of revaluation on distributable profits

- Add back to distributable profits any 'excess' depreciation charge because asset was revalued upwards
- If an asset is sold, any remaining balance in the revaluation reserve account relating to that asset becomes realised

? Questions

16.1 Ordinary shares are also known as:

A Equitable shares
B Equity shares
C Equality voting shares
D Non-equity shares

(2 marks)

16.2 Ireland Blyth plc has announced a rights issue of one share for every four shares held. The subscription price is \$2.50. The current-cum-rights price per share is \$4.10. What is the theoretical value of the right for each existing share?

A \$0.08
B \$0.32
C \$1.99
D \$1.02

(2 marks)

16.3 A participating preference share is a type of share which:

A grants the right of conversion into equity shares at some future date
B entitles the shareholder not only to a fixed dividend rate but also to a share of residual profits and surpluses on liquidation
C carries forward the right to preferential dividends, if unpaid, from one year to another
D guarantees the shareholder a fixed rate of dividend

(2 marks)

16.4 A bonus issue of shares is also called:

A a capitalisation issue
B a compensation issue
C an additional share issue to loyal shareholders
D a rights issue as it is an issue based on the existing shareholders' rights

(2 marks)

16.5 Loan notes and bonds are:

A financial liabilities and will appear as such in the balance sheet
B promissory notes and written agreements signed by debtors and accepted by creditors in home and international trade
C drafts issued by banks to lenders as evidence of loans borrowed and contracts agreed
D legal tenders utilised in lieu of bank notes and cheques by traders in the European Common Market

(2 marks)

16.6 Share issue costs incurred by a limited company are:

A written off against goodwill on acquisition
B added to the general overheads at the accounting year end
C set against the share premium account
D written off over a number of years

(2 marks)

16.7 What is a rights issue?

A the exercise of a shareholder's right requesting the company to issue him shares
B the grant of the right to issue new shares to the current shareholders
C an offer of new shares to existing shareholders in proportion to their shareholdings
D a bonus issue which allows current shareholders to impose their rights on the ownership of the company

(2 marks)

16.8 Holders of company notes or bonds are:

A owners of the company
B guarantors of the company
C debtors of the company
D creditors of the company

(2 marks)

16.9 A company might want to buy back its own shares for a number of reasons:

(i) to provide an exit route for shareholders who want to dispose of their investments
(ii) to buy out dissident shareholders
(iii) to return surplus cash to the shareholders
(iv) to convert the company into a one-man business
(v) to re-issue them to loyal shareholders and employees
(vi) to decrease its obligations to shareholders in an eventual liquidation
(vii) to guarantee minority protection and majority rule

(2 marks)

16.10 When a company buys back its shares, it is usually required that its equity capital is maintained. This is achieved by making a transfer from distributable reserves to a reserve that is usually classified as non-distributable. This reserve could be called:

A buy-back reserve
B equity buy-back reserve
C capital redemption reserve or capital reserve
D non-distributable reserve

(2 marks)

16.11

(i) W is an expanding enterprise. The Directors decided to offer 1 million new \$1.00 ordinary shares for sale at an issue price of \$1.20 per share. At that time, the enterprise had balances of \$4 million on issued capital and \$1.25 million on share premium.

Applicants were required to pay \$0.25 per share with their application. Applications were received for 2.1 million shares.

The Directors rejected a number of smaller applications for a total of 100,000 shares. The remainder of the applicants were each allotted one share for every two applied for, deemed \$0.50 per share paid.

Applicants were asked to pay \$0.40 per share on allotment, which was deemed to include the share premium. One applicant holding 2,000 shares did not pay this installment by the due date and the shares were forfeited.

The forfeited shares were reissued for $0.60 per share and were thereafter treated as having the same rights as the other shares in the issue.

A final call was made for the remaining $0.30 per share. All shareholders paid the final call by the due date.

Requirements

Prepare the following accounts:

(a) issued capital
(b) share premium
(c) application and allotment
(d) investment in own shares
(e) call.

(8 marks)

(ii) X is a listed enterprise which is considering a bonus issue of new shares, financed out of distributable profits.

Requirement

Identify the effects that this issue would have on the enterprise's capital structure. Your answer should explain how the bonus issue would affect the interests of the enterprise's shareholders and lenders.

(6 marks)

(iii) The issued capital section of some balance sheets is complicated by the fact that it is possible to issue a range of different types of share, some of which are more like loan instruments than ordinary shares. Preferred shares are a relatively simple example of this.

Requirement

Explain why certain types of share capital should be classified separately.

(6 marks)
(Total = 20 marks)

16.12 Hass Sutton on 1 January 2004 revalued an asset which had a net book value of $220,000 to $350,000. The asset is to be written off in equal instalments over 20 years. Retained profit for the year was $1,800,000.

Calculate the distributable profit for the year.

(7 marks)

Answers

16.1 **B**

16.2 **B**

16.3 **B**

16.4 **A**

16.5 **A**

16.6 **C**

16.7 **C**

16.8 **D**

16.9 **D**

16.10 **C**

16.11

(i)

(a) Issued capital

	$		$
		Balance b/d	5,000,000
		Application and allotment	500,000
		Application and allotment	200,000
Balance c/d	5,000,000	Call	300,000
	5,000,000		5,000,000
		Balance b/d	5,000,000

(b) Share premium

	$		$
		Balance b/d	1,250,000
		Application and allotment	200,000
Balance c/d	1,450,400	Investment in own shares	400
	1,450,400		1,450,400
		Balance b/d	1,450,400

(c) Application and allotment

	$		$
Bank	25,000	Bank	525,000
Issued capital	500,000		
	525,000		525,000
Issued capital	200,000	Bank	399,200
Share premium	200,000	Investment in own shares	800
	400,000		400,000

(d) Investment in own shares

	$		$
Application and allotment	800	Bank	1,200
Share premium	400		
	1,200		1,200

(e) Call

	$		$
Issued capital	300,000	Bank	300,000

(ii) The enterprise will reduce its distributable profits. This might constrain its ability to make dividend payments. The lenders might be slightly reassured by the fact that these reserves can no longer be distributed: The bonus issue – will require the recalculation of EPS.

The shareholders will have more shares, but their market value should fall in proportion so that they are no better off. Stock markets sometimes react favourably to a bonus issue because it can signal a dividend increase in the future. This might tend to increase the overall value of the shares.

(iii) It is important that the shareholders understand the risks and rewards attached to their investment. Issuing different classes of shares with different rights attached to them will have an effect on the returns available to the ordinary shareholders. For example, the existence of preference shares will mean that a fixed amount of profit will be committed to the preference shareholders every year. That could mean that the enterprise will be unable to pay any dividends to the ordinary shareholders in poor years because the preference shareholders have first call on the profits. It could also mean that the preference shareholders will have rights which affect the ordinary shareholders in the event of the enterprise failing. The existence of these classes of shares can have virtually the same effect on the ordinary shareholders' returns as debt. Indeed, the formula for the gearing ratio often includes preference shares as debt rather than as equity.

16.12

	$	$
Retained Profit		1,800,000
Add back: Excess Depreciation		
$\frac{350,000}{20}$	17,500	
$\frac{220,000}{20}$	(11,000)	
	6,500	6,500
Distributable Profit		1,806,500

Events after Balance Sheet Date

17

IAS 10: Events after balance sheet date

looks at both favourable and unfavourable events that occur between balance sheet date and the date on which the financial statements are authorised for issue

Two types

Adjusting events:

Provides evidence of conditions that existed at balance sheet date

Hence financial statements should be adjusted

Examples:

- *Receivables*: amounts owing by customers or insolvencies
- *Inventories and work-in-progress*: proceeds from sales after balance sheet date results in below cost
- *Property*: valuation resulting in permanent diminution in value
- *Obligation*: settlement of court case after balance sheet date
- Non-current assets: determination of purchase price or proceeds of sale of assets purchased or sold before the year end
- *Discoveries*: of errors which were found incorrect
- *Taxation*: receipt of information regarding rates of taxation
- *Investments*: receipt of information on unlisted company providing evidence of permanent diminution in value of investment

Receivables
Inventories
Property
Obligations
Non-current assets
Discoveries
Taxation
Investments

Non-adjusting events:

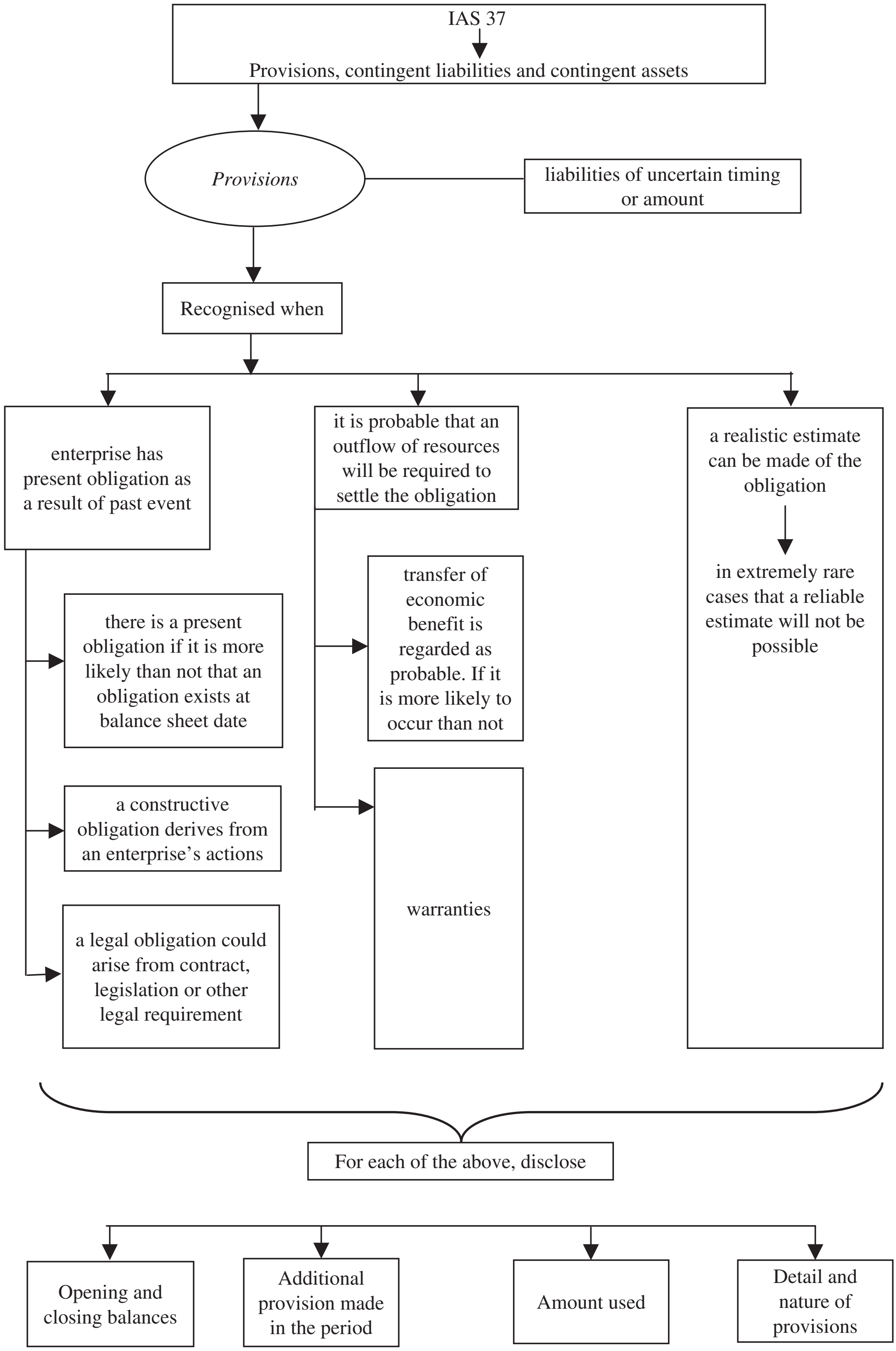
Conditions that occurred after balance sheet date and did not exist at the balance sheet date

Disclosed in notes to the accounts

Examples:

- Mergers and acquisitions
- Reconstructions
- Issues of shares/debentures
- Purchase/sale of investment
- Losses of inventories due to catastrophe – e.g. fire
- Opening/closing of significant trading activities
- Decline in investment if proved occurred after balance sheet date
- Government action, e.g. nationalisation
- Strikes or labour disputes
- Documentation of pension benefits

Mergers and acquisitions
Reconstruction
Decline in investment
Issue of shares
Government action
Stocks
Purchase/sale of investment
Losses on Investment
Closure of activities


IAS 37
Provisions, contingent liabilities and contingent assets
Provisions
liabilities of uncertain timing or amount
Recognised when
enterprise has present obligation as a result of past event
there is a present obligation if it is more likely than not that an obligation exists at balance sheet date
a constructive obligation derives from an enterprise's actions
a legal obligation could arise from contract, legislation or other legal requirement
it is probable that an outflow of resources will be required to settle the obligation
transfer of economic benefit is regarded as probable. If it is more likely to occur than not
warranties
a realistic estimate can be made of the obligation
in extremely rare cases that a reliable estimate will not be possible
For each of the above, disclose
Opening and closing balances
Additional provision made in the period
Amount used
Detail and nature of provisions

Likelihood of occurrence	Material contingent asset	Material contingent liability
Remote (0–5%)	No disclosure allowed	No disclosure
Possible (5–50%)	No disclosure allowed	Disclosure by note
Probable (50–95%)	Disclosure allowed by note	Make provision
Virtually certain	Accrual	

Note:

Prudence dictates that gains are treated with more caution than losses.

Disclosure by note:

- Nature of contingency
- Estimate of financial effect

IAS 24

Related parties

(a) have direct or indirect

- control
- are controlled by
- are under common control
- have significant influence over
- or have a joint venture over

the entity

(b) are associates of the entity (IAS 28)

(c) joint venture in which the entity is the venturer (IAS 31)

(d) key management personnel

(e) close family members of all ((a) to (d))

Substance of relationship must be considered.

Not merely legal form.

Consider *Control* and *Significant influence* over the other party in making financial and operating decision.

Related party *Transaction* is transfer of resources or obligation between parties regardless of price charged.

Control: Power to govern the financial and operating activities of the entity to gain benefit from its activities.

NOT deemed related party

Two companies with directors or other key members common in both unless:

- they are *Key Management Personnel*
- can exercise control and exert *significant influence*
- have *significant voting power*

Providers of

- Finance
- Trade union
- Agencies
- Government departments
- Public utilities

- Customers
- Franchisers
- Distributors
- Suppliers

Questions

17.1 May 2002

L is an enterprise which sells gaming cards to retailers, who then resell them to the general public. Customers who buy these cards scratch off a panel to reveal whether they have won a cash prize. There are several different ranges of cards, each of which offers a different range of prizes.

Prize-winners send their winning cards to L and are paid by cheque. If the prize is major, then the prize-winner is required to telephone L to register the claim and then send the winning card to a special address for separate handling.

All cards are printed and packaged under conditions of high security. Special printing techniques make it easy for L to identify forged claims and it is unusual for customers to make false claims. Large claims are, however, checked using a special chemical that takes several days to take effect.

The directors are currently finalising their financial statements for the year ended 31 March 2002. They are unsure about how to deal with the following items:

(a) A packaging error on a batch of 'Chance' cards meant there were too many major prize cards in several boxes. L recalled the batch from retailers, but was too late to prevent many of the defective cards being sold. The enterprise is being flooded with claims. L's lawyers have advised that the claims are valid and must be paid. It has proved impossible to determine the likely level of claims that will be made in respect of their error because it will take several weeks to establish the success of the recall and the number of defective cards.

(b) A prize-winner has registered a claim for a \$200,000 prize from a 'lotto' card. The financial statements will be finalised before the card can be processed and checked.

(c) A claim has been received for \$100,000 from a 'Winner' card. The maximum prize offered for this game is \$90,000 and so the most likely explanation is that the card has been forged. The police are investigating the claim, but this will not be resolved before the financial statements are finalised. Once the police investigation has concluded, L will make a final check to ensure that the card is not the result of a printing error.

(d) The enterprise received claims totalling \$300,000 during the year from a batch of bogus 'Happy' cards that had been forged by the retailer in Newton. The police have prosecuted the retailer and he has recently been sent to prison. The directors of L have decided to pay customers who bought these cards 50% of the amount claimed as a goodwill gesture. They have not, however, informed the lucky prize-winners of this yet.

Requirements

(i) Identify the appropriate accounting treatment of each of the claims against L in respect of (a) to (d) above. Your answer should have due regard to the requirements of IAS 37 – Provisions, contingent liabilities and contingent assets.

(3 marks for each of items (a) to (d), making a total of 12 marks)

(ii) It has been suggested that readers of financial statements do not always pay sufficient attention to contingent liabilities even though they may have serious implications for the future of the enterprise.

(a) Explain why insufficient attention might be paid to contingent liabilities.

(4 marks)

(b) Explain how IAS 37 prevents enterprises from treating as contingent liabilities those liabilities that should be recognised in the balance sheet.

(4 marks)

(Total = 20 marks)

17.2 May 1993

D is a large paper manufacturing company. The company's finance director is working on the published accounts for the year ended 31 March 2003. The chief accountant has prepared the following list of problems which will have to be resolved before the statements can be finalised.

(a) Events after the balance sheet date (IAS 10)

A fire broke out at the company's Westown factory on 4 April 2003. This has destroyed the factory's administration block. Many of the costs incurred as a result of this fire are uninsured.

A major customer went into liquidation on 27 April 2003. The customer's balance at 31 March 2003 remains unpaid. The receiver has intimated that unsecured payables will receive very little compensation, if any.

(6 marks)

(b) Possible development expenditure (IAS 38)

The company paid the engineering department at Northtown University a large sum of money to design a new pulping process which will enable the use of cheaper raw materials. This process has been successfully tested in the University's laboratories and is almost certain to be introduced at D's pulping plant within the next few months.

The company paid a substantial amount to the University's biology department to develop a new species of tree which could grow more quickly and therefore enable the company's forests to generate more wood for paper manufacturing. The project met with some success in that a new tree was developed. Unfortunately, it was prone to disease and the cost of the chemical sprays needed to keep the wood healthy rendered the tree uneconomic.

(7 marks)

(c) Possible contingent liabilities (IAS 37)

One of the company's employees was injured during the year. He had been operating a piece of machinery which had been known to have a faulty guard. The company's lawyers have advised that the employee has a very strong case, but will be unable to estimate likely financial damages until further medical evidence becomes available.

One of the company's customers is claiming compensation for losses sustained as a result of a delayed delivery. The customer had ordered a batch of cut sheets with the intention of producing leaflets to promote a special offer. There was a delay in supplying the paper and the leaflets could not be prepared in time. The company's lawyers have advised that there was no specific agreement to supply the goods in time for this promotion and, furthermore, that it would be almost impossible to attribute the failure of the special offer to the delay in the supply of the paper.

(7 marks)

Requirement

Explain how each of these matters should be dealt with in the published accounts for the year ended 31 March 2003 in the light of the accounting standards referred to above. You should assume that the amounts involved are material in every case.

(Total = 20 marks)

17.3 MAY 2003

BY prepares its financial statements to 31 March each year. The following information relates to the year ended 31 March 2003; the financial statements for the year to 31 March 2003 have not yet been completed. There are some transactions regarding non-current assets that need to be clarified.

(a) Some of the cars used by BY's sales force needed replacing. Three new cars were acquired on 1 October 2002. The cars were leased from CarLease on the following terms:

- a non-cancellable 5-year lease;
- a total of 10 payments, made every six months in arrears;
- each installment to be $7,200 ($2,400 per car);
- the interest rate implicit in the lease was 3.5% per six-month period;
- the fair value of each car was $20,000. The present value of these payments equals the fair value of the cars at the inception of the lease;
- the residual value of each car at the end of the lease is assumed to be zero;
- BY will pay for all insurance, repairs and maintenance costs.

Requirements

(i) Explain the meaning of 'finance lease', using the above to illustrate your answer. Identify whether the lease on BY's cars should be treated as an operating lease or a finance lease.

(8 marks)

(ii) Assuming that the lease is to be treated as a finance lease, calculate the figures that will appear in respect of the lease in BY's income statement for the year ended 31 March 2003 and its balance sheet at that date.

(7 marks)

(b) A new type of delivery vehicle, when purchased on 1 April 2000 for $20,000, was expected to have a useful economic life of 4 years. It now appears that the original estimate of the useful economic life was too short, and the vehicle is now expected to have a useful economic life of 6 years, from the date of purchase.

All delivery vehicles are depreciated using the straight-line method and are assumed to have zero residual value.

Requirement

State how BY should record the delivery vehicle in the income statement for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate International Accounting Standards.

(5 marks)

(c) A new machine was purchased from a German enterprise during the year to 31 March 2003. The purchase contract provided for payment to be made in dollars. The following payments were detailed in the contract:

	$
Basic cost of the machine	110,000
Upgrades and specific modifications to BY specifications	22,000
Shipping and transport charges payable in Europe ($ equivalent)	3,200
Total invoiced cost	135,200
Delivery, handling and installation charges	900
Total purchase price	136,100

The contract provided for 10% of the invoiced cost to be paid when the contract was signed, 40% when the machine was despatched, and the balance one month after installation. The delivery, handling and installation charges were paid by 31 March 2003.

The contract was signed on 1 January 2003 and the machine was despatched on 1 February 2003. BY made both payments on the due date. Delivery was made and installation completed on 25 March 2003.

Requirement

State how BY should record the purchase of the machine in its income statement for the year ended 31 March 2003 and the balance sheet at that date. Justify your treatment by reference to appropriate International Accounting Standards.

(5 marks)
(Total = 25 marks)

17.4

Which of the following are examples of adjusting events as per IAS 10?

(i) Receivables
(ii) Reconstruction
(iii) Losses on inventories
(iv) Taxation
(v) Obligations
(vi) Discoveries of errors

A (i), (ii), (iv) and (v)
B (i), (ii), (iii) and (iv)
C (ii), (iii), (iv) and (v)
D (iii), (iv) and (v) only

(2 marks)

17.5

Give 4 examples of adjusting events and 4 examples of non-adjusting events.

(4 marks)

17.6

Which of the following is correct about IAS 24?

A Looks at intangible assets
B Relates to pensions
C Relates to government grants
D Relates to related parties

(2 marks)

17.7

Which of the following is not deemed to be related party?

A Customers
B Government departments
C Public utilities
D Close family members

(2 marks)

17.8

IAS 37 Provisions, Contingent Liabilities and Contingent Assets require contingencies to be classified as remote, possible, probable and virtually certain. Each of these categories should then be treated differently, depending on whether it is an asset or a liability.

Requirements

(i) Explain why IAS 37 classifies contingencies in this manner.

(5 marks)

The Chief Accountant of Z, a construction enterprise, is finalising the work on the financial statements for the year ended 31 October 2002. She has prepared a list of all of the matters that might require some adjustment or disclosure under the requirements of IAS 37.

(a) A customer has lodged a claim against Z for repairs to an office block built by the enterprise. The roof leaks and it appears that this is due to negligence in construction. Z is negotiating with the customer and will probably have to pay for repairs that will cost approximately $100,000.
(b) The roof in (a) above was installed by a subcontractor employed by Z. Z's lawyers are confident that the enterprise would have a strong claim to recover the whole of any costs from the subcontractor. The Chief Accountant has obtained the subcontractor's latest financial statements. The subcontractor appears to be almost insolvent with few assets.
(c) Whenever Z finishes a project, it gives customers a period of three months to notify any construction defects. These are repaired immediately. The balance sheet at 31 October 2001 carried a provision of $80,000 for future repairs. The estimated cost of repairs to completed contracts as at 31 October 2002 is $120,000.
(d) During the year ended 31 October 2002, Z lodged a claim against a large firm of electrical engineers which had delayed the completion of a contract. The engineering enterprise's Directors have agreed in principle to pay Z $30,000 compensation. Z's Chief Accountant is confident that this amount will be received before the end of December 2002.

(e) An architect has lodged a claim against Z for the loss of a laptop computer during a site visit. He alleges that the enterprise did not take sufficient care to secure the site office and that this led to the computer being stolen while he inspected the project. He is claiming for consequential losses of $90,000 for the value of the vital files that were on the computer. Z's lawyers have indicated that the enterprise might have to pay a trivial sum in compensation for the computer hardware. There is almost no likelihood that the courts would award damages for the lost files because the architect should have copied them.

Requirement

(ii) Explain how each of the contingencies (a) to (e) above should be accounted for. Assume that all amounts stated are material.

(3 marks for each of (a) to (e) = 15 marks)

(Total = 20 marks)

✓ Answers

17.1 (i)

(a) Under the rules of IAS 37, this will give rise to a contingent liability.

The lawyers indicate that there is a legal obligation as a result of past events.

As it has been proved impossible to determine the likely level of claims, the only appropriate treatment is therefore to make a detail note in the balance sheet as to the nature of the contingent provision.

(b) The company has present obligation (unless proved fraudulent) as a result of past event (sale of Lotto card).

In this situation the amount of liability is known at $200,000 which will be charged in the income statement and recognised under current liabilities in the balance sheet.

(c) The company has no obligation due to the fraudulent nature of the claim. The likelihood of the claim being successful are remote and hence under IAS 37 it is appropriate not to disclose and therefore the claim will not be rejected in the financial statements.

(d) The 'bogus' nature of the cards implies that the company has no legal obligation to pay.

However, under IAS 37 an enterprise has present obligation as a result of past event if a constructive obligation derives from and enterprise's actions which in our case is clearly suggested as the company has announced it will make a 'goodwill' payment.

Since it is yet to be made, IAS 10 comes into effect 'post balance sheet event' likely to be non-adjusting as no evidence of a condition existing at balance sheet date is given.

(ii)

(a) As contingent liabilities are disclosed by way of notes to the accounts, users occasionally may not have access to such information.

Most users of financial statements pay particular attention to the actual accounts than to the additional notes.

(b) IAS 37 looks into the concept of provision which are liabilities or uncertain timing and amounts.

Recognition in the financial statements depends on the enterprise's present obligation or it is probable that an outflow of resources will be required to settle an obligation as a result of past event.

Such material contingent liabilities will depend on the likelihood of occurrences.

- if remote then no disclosure
- if possible then disclose
- if probable then make a provision.

17.2 (a) IAS 10 – Events after balance sheet date – looks at both favourable and unfavourable events that occur between the balance sheet date and the date on which the financial statements are authorised for issue. There are two types of such events. 'Adjusting' events provide evidence of conditions that existed at balance sheet date and 'non-adjusting' conditions that occurred after balance sheet date and did not exist at balance sheet – such events need disclosure by way of notes in the financial statements.

The problem of fire broke out on 4 April after balance sheet date of 31 March – hence this is an example of non-adjusting event and therefore the details of the fire should be disclosed by way of notes to the accounts.

As the major customer went into liquidation after the balance sheet date 27 April, however he owed a material balance before the year end and as this balance is irrecoverable, it should be written-off as bad debts in the financial statements to 31 March 2003 as it is an adjusting event.

(b) IAS 38 Intangible assets looks at research and development expenditures and states that all research expenditure should be written-off as incurred, however development expenditure must be carried forward if it satisfies the following criteria:

(i) the project is technically feasible
(ii) there is intention to complete the project
(iii) there is ability to use or sell the item
(iv) there are adequate resources available, technical and financial, to complete the project
(v) there is ability to measure the expenditure reliably.

In our case the new pulping process does seem to satisfy all the above criteria and hence the costs to date must be carried forward in the balance sheet as an intangible asset.

The new species tree fails to satisfy the above criteria and it is not commercially viable and may not recover all costs and hence the costs of the project must be written-off as incurred.

(c) IAS 37 Provisions, Contingent assets and liabilities defines contingent liabilities as 'Possible obligation that arises from past events whose existence will be confirmed by the occurrence of one or more uncertain future events or a present obligation that arises from past events but is not recognised because it is not probable to transfer economic benefit or the obligation cannot be measured with sufficient reliability.'

IAS 37 sets the following accounting treatment

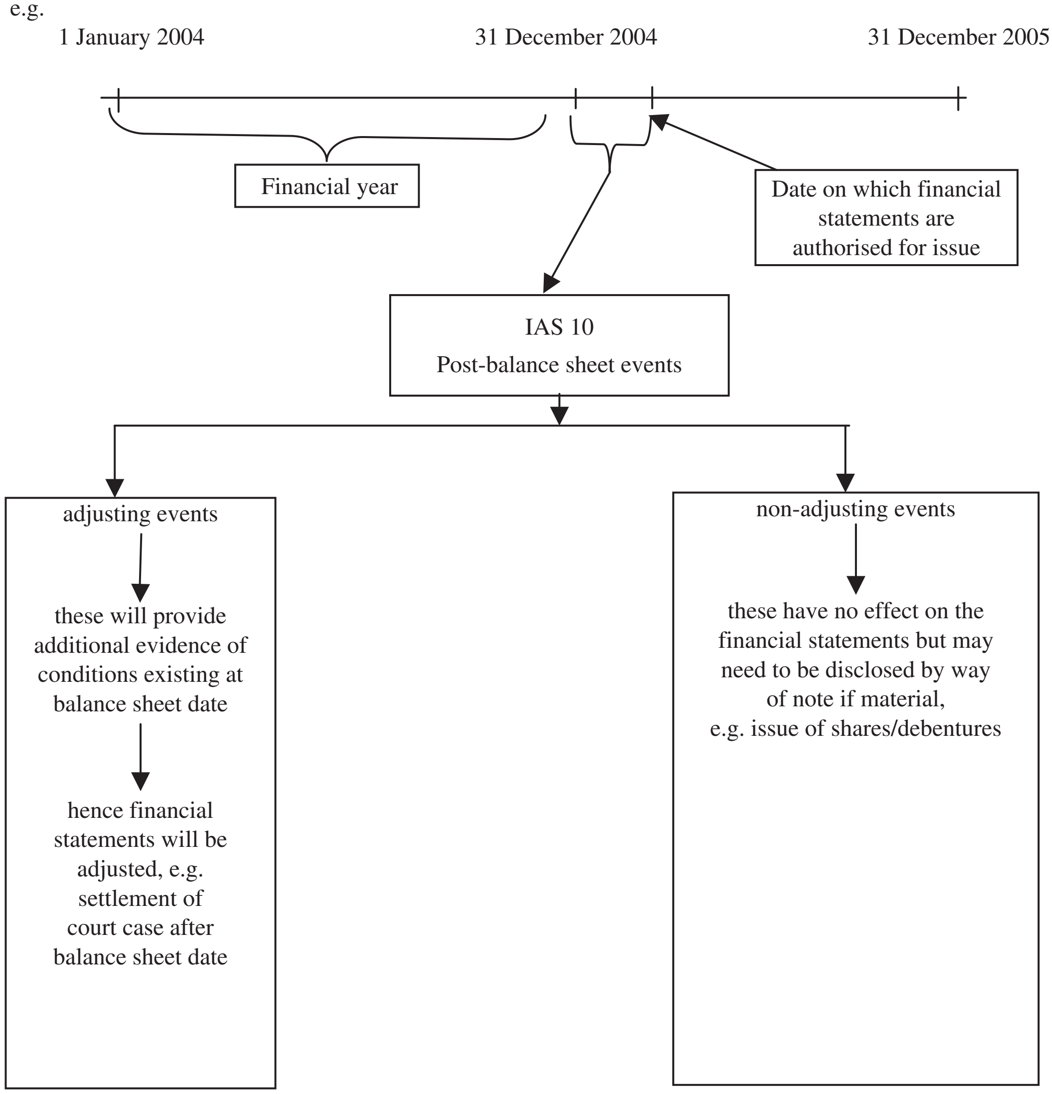
Likelihood of occurrence	*Material contingent liability*
Remote $<5\%$	No disclosure
Possible $5 \times 50\%$	Disclosure by way of note
Probable $50 \times 95\%$	Make provision
Certain $>95\%$	Make provision

The employee's injury is probable even though we are unable to estimate the likely financial damages.

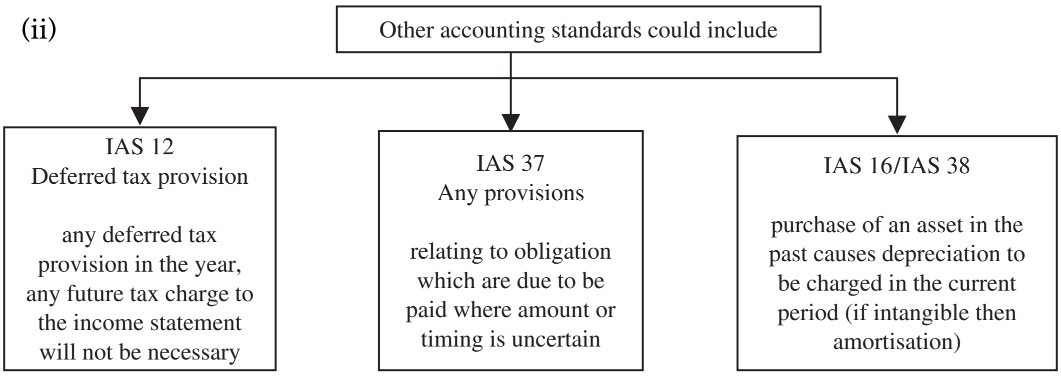
17.3 (a) (i)

May 2003
A transaction or event which occurs immediately after the year end and which effects the results for the previous year are known as post-balance sheet events and are covered by IAS 10.

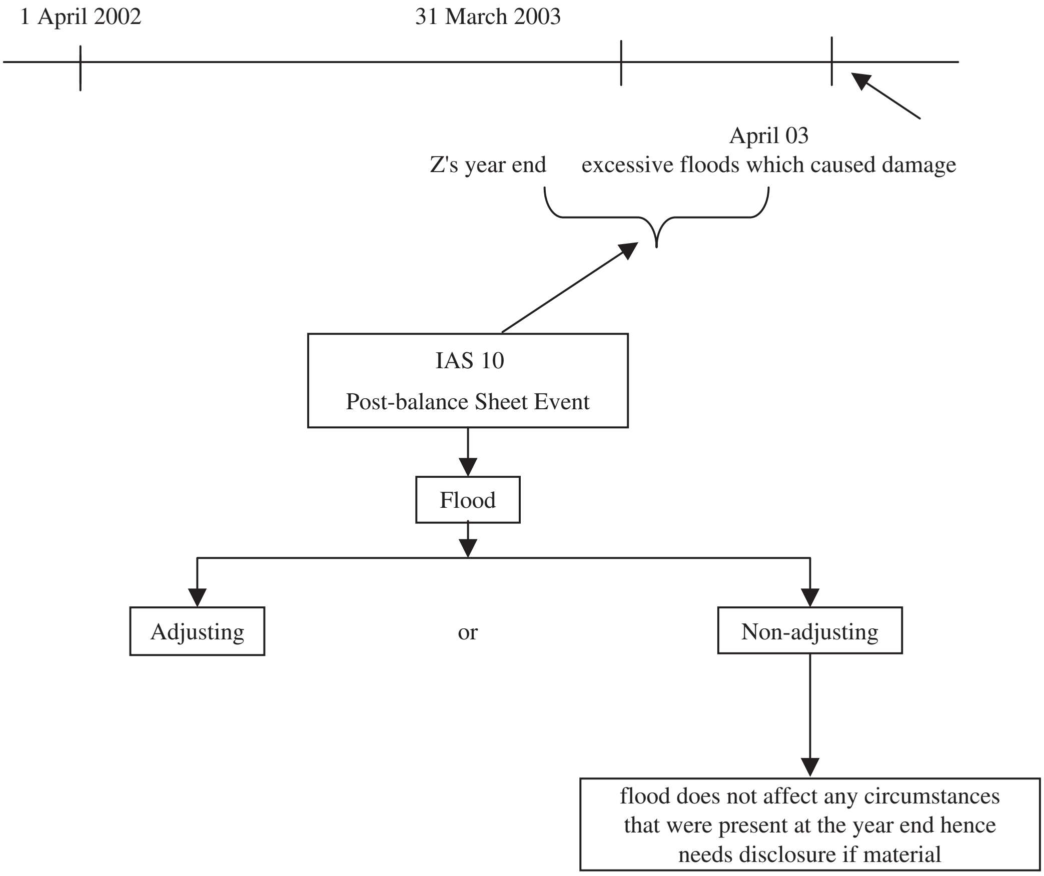
e.g.



(ii)



(b)

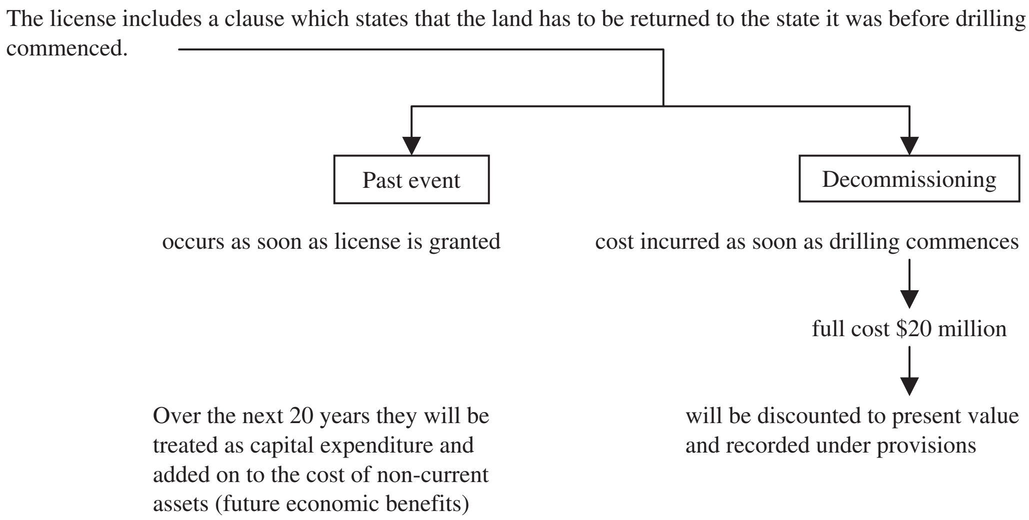


Z will not incur significant losses due to insurance cover.

However, the time lag to rectify the damage caused by the flood would mean that it will have a material impact on Z's future performance since it will purchase finished goods' inventories from outside suppliers.

(c)

IAS 37 relates to obligations which are due to be paid where the amount or timing is uncertain. In the case of N, these obligations will need to be recognised immediately.



Here there are two possible treatments – lawyers should be pressed for a reasonable estimate of the claim which should be provided in the accounts.

If lawyer fails to provide an estimate then it should not be accrued instead disclose the facts in the notes to the accounts.

The problem of delivery is much more straightforward in that the lawyers have advised there are no specific agreements to supply the paper on time for promotions and hence any possible liability will be remote and under IAS 37 this requires No disclosure in accounts.

17.3 (c)

(i) The valuers have valued the postage stamp at $ 1/2 million; it is not a 'possible asset' whose existence requires confirmation by the occurrence of an uncertain event and hence should be recognised as a current asset in the balance sheet at its valuation.

However if there were any doubt as to its authenticity, it would be disclosed as a contingent asset.

(ii) The probable claim for damages would result in it being accounted for as a provision.

The successful counter-claim is also considered as a contingent asset if the counter-claim was virtually certain and recognised as an asset in the balance sheet.

(iii) If it can be proved by legal and other advisors that the defeat was a result of manufacturer's fault, the claim by the players is so remote as to require no accountancy action.

17.4 **A**

All others are non-adjusting events.

17.5

Adjusting events:	Non-adjusting events:
• Receivables: amounts owing by customers or insolvencies • Inventories and work-in-progress: proceeds from sales after balance sheet date results in below cost • Property: valuation resulting in permanent diminution in value • Obligation: settlement of court case after balance sheet date • Non-current assets: Determination of purchase price or proceeds of sale of assets purchased or sold before the year end • Discoveries: of errors and found which were incorrect • Taxation: receipt of information regarding rates of taxation • Investments: receipt of information on unlisted company providing evidence of permanent diminution in value of investment	• Mergers and acquisitions • Reconstructions • Issues of shares/debentures • Purchase/sale of investment • Losses of inventories due to catastrophe – e.g. fire • Opening/closing of significant trading activities • Decline in investment if proved occurred after balance sheet date • Government action, e.g. nationalisation • Strikes or labour disputes • Documentation of pension benefits

17.6 **D**

17.7 **D**

17.8 (i)

IAS 37 has made an effort with reference to contingencies and their disclosure requirements have been designed to give maximum information to the users of financial statements. Contingencies are categorised as to their likelihood of occurrence or non-occurrence and hence a description is provided in the notes to the financial statements to leave it to the user of the financial statements to draw their own conclusion. Unlikely events are not disclosed at all.

(ii)

(a) In this scenario, liability is certain to arise and so the amount can be predicted very accurately and hence the amount needs to be stated in the income statement as well as a liability in the Balance Sheet.
(b) Although the fact under consideration is an asset but as the other party is not able to meet its obligations, it is not realistic. There is no need to mention the counter-claim in the financial statements.
(c) In this case, it is probable that the liability will arise and hence it needs to be recognised as a liability worth $120,000 as provision. Increase in provision of $40,000 is supposed to be moved to the income statement as cost of repairs.
(d) It is probable that the asset will be recovered even in the absence of the written agreement, however to be on the safe side, its disclosure in the notes to the financial statements is recommended.
(e) The purpose of financial statements is to give a true and fair view of the financial statements and in this case, the chances of material payments is remote and hence mentioning this may divert the view of the user hence it is recommended that no mention of this should be made in the notes to the financial statements.

Working Capital Ratios 18

Measures of short-term solvency

(a) $$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

It is an important part of the structure of a balance sheet. A current ratio of about 2 is generally considered to be about right. It implies that short-term obligations can be met approximately twice over by the existing short-term sources of funds.

(b) $$\text{Liquidity ratio} = \frac{\text{Liquid assets*}}{\text{Current assets}}$$

It is a more stringent test of short-run solvency and is generally regarded as satisfactory if it is equal to 1 or just above that figure.

* Current assets (excluding stock)

Also known as Acid test or Quick ratio.

Measures of performance of working capital management

(a) $$\text{Debtor's days ratio} = \frac{\text{Debtors}}{\text{Credit sales}} \times 365$$

This is a rough measure of the average length of time that the debtors take to settle their accounts.

Also known as debtor's payment period.

(b) $$\text{Creditor's payment period} = \frac{\text{Average trade creditors}}{\text{Purchases or Cost of sales}} \times 365 \text{ days}$$

An increase in creditor days is often a sign of long-term finance or poor management of current assets.

(c) $$\text{Stock turnover} = \frac{\text{Cost of sales}}{\text{Average stock}}$$

A very high level of stock turnover indicates a relatively low level of stock and vice versa.

Questions

18.1 Philips plc has a current ratio of 1.75. The management has decided that in future they will pay the trade creditors after 40 days, instead of 30 days as it has in the past. What will be the impact of this new policy on the company's current ratio and its cash operating cycle?

A It will increase both
B It will increase current ratio and decrease cash operating cycle
C It will decrease the current ratio and increase cash operating cycle
D It will decrease current ratio and decrease cash operating cycle

(2 marks)

18.2 Which of the following policies would very likely reduce working capital?

A Paying payables early
B Increasing the credit period credit granted to receivables
C Repaying an overdraft out of cash
D Offering a discount to a debtor for immediate cash settlement

(2 marks)

18.3 Atlantis plc has a current ratio of 1.5:1. The credit control department advises management to use surplus cash balances to settle 30% of its total current liabilities. The aftermath of such a decision on the current ratio will be:

A a decrease by more than 30%
B a decrease by less than 30%
C an increase by more than 30%
D an increase by less than 30%

(2 marks)

18.4 Incas plc purchases commodities on credit and has to sell them on credit for less than the purchase price. What is the consequence of these two transactions immediately after the sale has taken place?

A Inventory decreases and cash decreases
B Cash decreases and payables increase
C Inventory decreases and receivables increase
D Receivables increase and payables increase

(2 marks)

18.5 Working capital is most likely to increase when

A payments to creditors are postponed
B the credit period granted to debtors is reduced
C fixed assets are disposed of
D stock levels are increased

(2 marks)

18.6 The formula for calculating the rate of stock turnover is:

A average stock at cost divided by cost of goods sold
B sales divided by average stock at cost
C sales divided by average stock at selling price
D cost of goods sold divided by average stock at cost

(2 marks)

18.7 Colonel plc has the following particulars extracted from its balance sheet

	$'000
Stocks	1,900
Debtors	1,000
Bank overdraft	100
Creditors	1,000

Its liquidity position could be said to be:

A very well controlled, inasmuch as its current assets exceed its current liabilities by $1,800
B poorly controlled, because its current liabilities outweigh its current assets
C poorly controlled, because its current ratio is significantly higher than the industry norm of 1.8
D poorly controlled, because it has a bank overdraft

(2 marks)

18.8 Which ONE of the following transactions is most likely to affect the overall amount of working capital?

A Cash receipt from debtor
B Disposal of a fixed asset on credit at its net book value
C Payment of a creditor
D Purchase of raw material on credit

(2 marks)

18.9 If the current ratio for a business enterprise is equal to its acid test (that is, the quick ratio), then

A the current ratio must be greater than unity
B the company does not carry any stock
C debtors plus cash exceed than creditors minus stock
D working capital is positive

(2 marks)

18.10 Efficiency ratios are also known as:

A Use of assets ratio
B Working capital ratios
C Acid test ratios
D Performance ratios

(2 marks)

Answers

18.1 **D**

18.2 **D**

18.3 **D**

Current ratio at present = 1.5/1 = 1.5

The settlement brings the new current ratio to:

$(1.5 - 0.3)/(1 - 0.3) = 1.71$

Increase = $(1.71/1.5 - 1)100\% = 14\%$

18.4 **D**

18.5 **C**

18.6 **D**

18.7 **A**

The current ratio is 2.6:1 and is therefore high compared to the industry norm of 1.8.

18.8 **B**

18.9 **B**

18.10 **A**

Short-term Finance and Types of Investment 19

Questions

19.1 Overtrading occurs when a business expands too quickly. What is the symptom of overtrading?

A High ratio of current assets: proprietor's capital
B Low ratio of current assets: annual sales
C A high ratio of current assets: current liabilities
D Shorter credit period given by suppliers (creditors)

19.2 De Montfort Ltd sells goods and services to its customers on credit. The normal terms of payment is 30 days net. What would it cost to the company if it offers 2% discount for payment within 10 days of invoice date?

Assume a 365-day year.

A 64.5%
B 37.2%
C 24.4%
D 36.5%

19.3 The following is the trading account of Poltroon Ltd for the year ended 31.12.04

	$	$
Sales (all on credit)		45,000
Less:		
Cost of sales		
Opening stock	3,100	
Purchases (all on credit)	28,000	
	31,100	
Closing stock	(3,310)	
		27,790
Gross profit		17,210

Other information	*At 31.12.04*
Debtors	5,918
Creditors	4,600

On the basis of these figures, the length of the cash operating cycle is:

A 45
B 33
C 31
D 153

19.4 Companies with huge amount of surplus cash may decide to invest in short-term money market instruments. Of the following money market instruments which one would carry the lowest interest rate?

A Finance house deposits
B Local authority deposits
C Sterling certificates of deposit
D Treasury bills

19.5 Forfeiting is most appropriately described as:

A Sight bills for immediate payment to suppliers
B A medium-term source of export finance
C Term bills where the importer is allowed a credit period
D Confiscation of unpaid shares

19.6 A bill of exchange is best described as:

A A letter of credit
B An instrument of payment allowing a credit period for the importer and immediate payment for the exporter (if so desired)
C A bill of lading in triplicate
D A negotiable instrument devised by the central bank to promote foreign trade

19.7 What is a certificate of deposit?

A An evidence that an individual has a bank deposit account that is tax-exempt
B A proof of lodgements in a deposit account in a commercial bank
C A negotiable instrument issued by a bank which acknowledges a deposit lodged in that bank
D A legal certificate that an individual has an authorised bank deposit account

19.8 What are treasury bills?

A Bills issued by the treasury department of the government
B Finance bills
C Bill issued by central banks and guaranteed by the governments of the country of issue
D Negotiable instruments raised by the Chancellor to finance health and education

19.9 What is countertrade?

A Transactions carried out at a retail counter in retail trade
B A type of barter or reciprocal trade
C The action taken by a trading bloc to counter the entry of competitors in its market
D A form of competition and business process engineering developed by the Japanese

19.10 Which one of the following decisions would reduce the working capital of a firm?

A Allowing a settlement discount to a debtor for immediate cash payment
B Repaying a bank overdraft by cash
C Lengthening the period of credit given to receivables
D Early payments to payables

19.11 'Cash invested in working capital is idle, whereas cash invested in fixed assets is active. Working capital investment should therefore be kept at an absolute minimum'. Discuss.

(10 marks)

19.12 Marshall and Co. runs a retail shop selling on a cash only basis and earning an average gross profit of $33\frac{1}{3}\%$ on sales. The manager wishes to start offering monthly credit terms in order to boost sales and he estimates that turnover would soar by £50,000 per annum if this were done. All the new sales would be on credit and a further £50,000 of existing cash customers would probably take advantage of the credit facility. He is quite realistic about the risks involved in advancing credit in this trade and expects a bad debt rate of about 15% but still feels that the policy is worthwhile. He produces the figures given below:

	£
Extra sales generated by new policy	50,000
Less:	
Expected bad debts	(15,000)
Net extra sales	35,000
Less:	
Cost of extra sales	(33,333)
Net gain from policy	1,667

Criticise and correct these figures assuming any other quantities required.

(10 marks)

19.13 MP Ltd is a manufacturing company which trades with a large number of suppliers of raw materials, components, etc. The company's financial manager has asked you, her assistant, to review the terms of trade and their associated costs. As part of the exercise, you randomly choose three regular suppliers of one particular component. They have the following terms:

Supplier A charges a fixed penalty of 2% of invoice value for late payment.

Supplier B charges compound interest at 2% per 30-day period after the due date of payment.

Supplier C offers a 2% discount if payment is made within 10 days of invoice date but charges simple interest at 10% per annum on the invoice value if payment is after the due date.

Assume that the due date for payment in each case is 30 days but that MP Ltd's current credit control policy is to take an average of 90 days to pay these suppliers' invoices.

To simplify your calculations, assume also that MP Ltd purchases £1,000 worth of goods from each supplier every month.

Requirements

Write a report to the financial manager which includes:

1 a calculation of the annualised interest rate (i.e. percent per annum) for each of the three suppliers;

(8 marks)

2 a discussion of the arguments for and against using trade credit as a source of funds, in general and from MP Ltd's point of view, given their current credit policy;

(8 marks)

3 a discussion of the advantages and disadvantages to MP Ltd of introducing standard terms of trade with which all suppliers will have to conform.

(4 marks)
(Total = 20 marks)

19.14 XYZ plc is an unlisted company which has been trading for almost 10 years. The board of directors is concerned about the cost and level of the company's overdraft which have been increasing over the past two years. The company's financial manager estimates the deterioration will continue into 2005 and beyond, unless action is taken. The directors agree that the company should take action to improve its liquidity and debt collection procedures, and as a consequence, reduce the overdraft. The options available are:

(a) Offer a cash discount to all credit customers of 1.5% for payment within 10 days. The normal terms of trade allow for 60 days although many customers regularly exceed this limit. Approximately, 70% of sales are on credit and all credit customers trade regularly up to their maximum credit limit. If this scheme is introduced, approximately half of all credit customers are expected to take advantage. Bad debts are expected to fall by 50%.

(b) Employ a debt factoring company. The factor has agreed to accept 90% of XYZ plc's credit customers and will charge a commission of 2% of acceptable debtors' value. Finance charges will be 11%, which is 5% over base rate. XYZ plc will take the maximum finance available and use it to turn the overdraft into a cash balance. The use of a debt factor is expected to result in a saving of $65,000 on XYZ plc's in-company credit management costs.

(c) Raise $500,000 by taking out a 10-year mortgage secured on the company's premises and use the proceeds to reduce the overdraft. The interest rate on this debt will be 9%.

XYZ plc pays overdraft interest at 4% over base rate. Its opportunity cost of capital is 12%.

Summary financial information is as follows:

	2005 Forecast $'000
Turnover	4,850
Cost of sales	2,862
Bad debts	48
Profit after tax	325
Stock	455
Trade debtors	850
Total current assets	1,305
Trade creditors	550
Overdraft	565
Total current liabilities	1,115
Net current assets	190
Shareholders' funds	1,575
Director's loan (13% unsecured 2000)	450

Requirements

You are required to evaluate for each of the three options.

(i) the net financial benefit to the company;
(ii) the effect on current ratio and debtors' days.

(20 marks)

✓ Answers

19.1 **A**

Overtrading occurs when a business tries to support too large a volume of trade with the capital resources at its disposal.

19.2 **B**

De Montfort Ltd agrees to accept $98 in 10 days in lieu of $100 in 30 days. Therefore, the implied cost of capital is:

$2/98 \times 365/(30 - 10) \times 100\% = 37.2\%$

19.3 **B**

		Days
Average stockholding period (number of days)	3,205/26,000 × 365	45
Debtors credit period	5,918/45,000 × 365	48
Time taken to pay creditors	4,600/28,000 × 365	(60)
Cash operating cycle		33

19.4 **D**

Treasury bills carry a low rate of interest because they are risk free.

19.5 **B**

19.6 **B**

19.7 **C**

19.8 **C**

19.9 **B**

Exports to a country occur on the condition that the exporter will in turn import from the same country.

19.10 **A**

Less cash than expected is received. It reduces the cash fund.

19.11 Almost any investment in a productive fixed asset will entail a consequential investment in working capital. For instance, if the fixed asset is a machine which manufactures a saleable product, it will be necessary to acquire and maintain a stock of raw materials so that production may flow smoothly without interruption caused by waiting for supplies.

It will also be necessary to finance an appropriate level of debtors to facilitate sales of the product. Quite clearly, then, investment in working capital is not idle since without it, the projects that it supports would come to a halt. What may be true, however, is that it may be very difficult to identify and evaluate a rate of return on the investment in working capital. This difference, however, is more apparent than real because an investment in a fixed asset requires a corresponding investment in working capital. Conceptually, the investment is, in fact, the whole sum required including the working capital. The return can then be regarded as the cash flow from the total investment that can be appraised accordingly.

In a business that is a going concern the components of the working capital are not always identifiable with the fixed assets to which they relate. The financial manager's efforts must thus be directed at optimising the amount invested in working capital. Optimisation is different from minimisation. An optimum policy seeks to strike a balance between the costs of working capital and the costs of being without it. Stockholding, for example, incurs the cost of the capital tied up in it and the costs of storing and controlling it. An absence of stock incurs the costs of idle equipment and customer disappointment.

19.12 The manager of Marshall and Co. has ignored two main points:

1 the cost of financing the debtors and
2 the average debtor collection period.

For the purpose of illustration, we are assuming that 10% of credit sales will be outstanding as debtors at any one time and the cost of capital is 20% per annum.

	£	£
Extra sales (Proposed policy)		50,000
Gross profit @ $33\frac{1}{3}\%$		16,667
Less:		
Bad Debts (£100,000 × 15%)	15,000	
Add:		
Cost of finance (£10,000 × 20%)	2,000	17,000
Net cost of policy implementation		333

Note:

The average debtor collection period = 10,000/100,000 × 365 days = 36.5 days

19.13

REPORT

To: The Financial Manager

From: The Assistant Financial Manager

Date: 8 December 2004

Subject: MP's management policy for trade creditors

Introduction

Further to your request, I have reviewed the terms of trade with our suppliers and the associated costs in dealing with them. This report contains the findings of my review and my recommendations. It comprises of three sections, viz.

1 calculation of annualised interest rates relating to three of our suppliers' terms of trade;
2 arguments for and against using trade credit as a source of funds; and
3 the advantages and disadvantages of MP Ltd using standard terms of trade.

1 Annualised interest rates

For each supplier, I have assumed that the company purchases £1,000 of invoiced goods. The calculations are based on both simple and compound interest.

Supplier A

The supplier allows us a 30-day credit period and charges a fixed penalty of 2% of invoice value for late payment. Our current policy of paying on average after 90 days, means that we are paying an extra (2% × £1,000) = £20 for 60 days extra credit. This is an annual rate of:

- 365/60 × 2% = 6.08 × 2% = 12.17% p.a. (simple interest)
- $(1.02)^{6.08} - 1 = (1.1279 - 1) = 0.1279$, i.e. 12.79% p.a. (compound interest)

Supplier B

The supplier allows us a 30-day credit period but charges compound and cumulative interest at 2% per 30-day period after the due date. Working in terms of our current 30-day delay, this means B charges interest of:

(2% × £1,000) + (2% × £1,000) (1.02) = £20 + £20.40 = £40.40 over 60 days. This is an annual rate of:

- 365/60 × £40.40/£1,000 = 6.08 × 4.04% = 24.56% on the overdue amount (simple interest)
- $(1.0404)^{6.08} - 1 = (1.2723 - 1) = 0.2723$, i.e. 27.23% p.a. (compound interest)

Supplier C

The supplier grants a 2% discount for payment within 10 days of invoice, but applies simple interest at 10% for payments after the due date. Our policy involves costs of:

Lost discount = (2% × £1,000) = £20

This is the cost of securing extra financing of (98% × £1,000) for 20 days, i.e. £980. The cost of the lost discount corresponds to an annual cost of:

- £20/£980 × 365/20 = (2.04% × 18.25) = 37.23% p.a. (simple interest)
- $(1.0204)^{18.25} - 1 = (1.4456 - 1) = 0.4456$, i.e. 44.56% p.a. (compound interest)

Moreover, there is the cost of late payment of 10% p.a.

Conclusion

Given these terms and our policy, Supplier A clearly offers the most attractive terms.

2 Trade credit as a source of funds

Trade credit is a means of decreasing the length of the cash conversion cycle. By taking more trade credit we reduce our need to obtain finance from other sources, at least in the short term. But trade credit is not 'free' finance, inasmuch as there are obvious costs. Beware that the Late Payment of Commercial Debts (Interest) Act 1998 introduced the statutory right of suppliers to charge interest on overdue accounts. The three suppliers illustrated already take advantage of this right and my calculations definitely reveal that the financial cost of exploiting trade credit can be high.

Moreover, there are several 'concealed' costs of trade credit in the form of:

(i) Poorer terms regarding length of trade credit and amount of credit agreed.
(ii) Lower priority when suppliers are stretched to meet demand of credit-worthy customers.
(iii) Loss in overall credit rating which will restrict our ability to borrow and negotiate better terms of trade with other suppliers.
(iv) Rising administrative costs in terms of purchase ledger stewardship and dealing with the demand of irritated suppliers.

Conclusion

Our present policy drives considerable costs already. From my standpoint, a 90-day, settlement period is excessive, certainly above the average for our industry (68 days, according to Trade Indemnity).

19.14

(i) Cash discount option

Total credit sales $= 0.7 \times \$4.85\text{m} = \$3.395\text{m}$
Cost of discount $= 0.015 \times 0.50 \times £3.395\text{m}$
$= £25{,}000$ approx.
Benefit of discount = Reduction in overdraft interest + bad debts avoided

Debtor days are currently $\dfrac{\$850{,}000}{3.395\text{m}/365} = 91$ days approx.

Half the credit customers will pay at 10 days rather than 91 days, so the extra funds received will be

$0.5 \times 81 \text{ days} \times \dfrac{\$3.395\text{m}}{365} = \$377{,}000$ approx.

Therefore, reduction in overdraft interest $= 10\% \times \$377{,}000$
$= \$38{,}000$ approx.

Bad debts avoided $= 0.5 \times £48{,}000 = \$24{,}000$
Total benefit of discount $= \$62{,}000$
Net benefit $= \$37{,}000$

The overdraft at the end of 2005 should fall to:

	$'000
Original forecast	(565)
Funds received	377
Interest avoided	38
New forecast	(150)

(ii) Debt factoring option

Existing forecast current ratio $= \dfrac{1{,}305}{1{,}115} = 1.17$

New forecast current ratio $= \dfrac{1{,}305 - 377}{550 + 150} = 1.33$

New forecast debtor days $= \dfrac{850 - 377}{\$3{,}395\text{m}/365} = 51$ days

Cost of factoring = 2% commission + 11% finance charge
= (2% × 90% × \$3.395m) + (11% × 90% × \$850,000)
= 61,000 + 84,000 approx.
= \$145,000

Benefit of factoring = Reduction in O/D interest + Administration costs saved

Funds equal to 90% × \$850,000 = \$765,000 are released, converting the overdraft into a cash balance in hand. Assuming that positive balances earn interest at the 10% overdraft rate, the benefit will be 10% × \$765,000 = \$76,500.

Administrative costs saved are given as \$65,000.

New forecast current ratio $= \dfrac{455 + 85 + 196.5}{550} = 1.34$

New forecast debtor days $= \dfrac{\$850{,}000}{\$3.395\text{m}/365} = 9$ days

(iii) Secured mortgage option

Interest rate paid on the mortgage = 9%
Interest rate avoided on the overdraft = Base rate + 4%
= 10% currently.

As long as base rate remains at 6%, the net benefit of the mortgage is 1% × \$500,000 = \$5,000.

New forecast current ratio $= \dfrac{1{,}305}{550 + 65 - 5} = 2.14$

Forecast debtor days remains at 91 days.

Recommendation

The cash discount option has the highest net benefit of the three options, so all other things being equal, it is the option that should be chosen assuming that the directors' objectives are to reduce the overdraft and maximise the value of the company.

However sometimes all other things are not equal, e.g. no account has been taken of the effects of tax in the above analysis, or there may be a further fourth option which is better than any of the three so far considered.

Sometimes the values of accounting ratios are important directly, e.g. the director's loan agreement might state that the loan is repayable immediately if the current ratio falls below some stated figure, but no details have been given of such a possibility in this case.

Working Capital: Receivables and Payables

20

Questions

20.1 Recent research has shown that a large percentage of small company failures were due to poor financial management skills and poor credit management.

Requirements

(i) Explain the problems faced by small companies in respect of credit management, and discuss internal actions which they could take to minimise the effects of these problems.

(8 marks)

A medium-sized manufacturing company is suffering a fall in sales of many of its product lines. It is reviewing its business strategy and the heads of all departments have been asked to review their activities. The accounting department has been asked to review specifically the company's credit control policy. At present the company offers its goods to customers on 30 days credit (from date of invoice), subject to satisfactory trade references. It does not offer a discount for prompt payment.

(ii) Assume you are a management accountant working in the company's credit control department. Write a report to the Credit Manager which discusses the contribution that credit control policy can make to overall business strategy, assesses the advantages and disadvantages of introducing discounts for prompt payment. Include in your assessment a calculation and comment on the true cost of discounts. For the sake of your discussion you should assume a 1% discount for payment within 10 days if the normal credit period allowed continues for 30 days.

(12 marks)
(Total = 20 marks)

20.2 Barot plc has an annual average sales turnover of $2 million.

It has expanded over the years and its management policies have not kept pace with the growth. The credit control is very poor and it is more concerned with accurate record keeping rather than managing credit. Bad debts record has deteriorated and the average collection periodic at present amounts to 10% of all sales and the average debtor takes 60 days to pay. The managing director appointed Francis Gobind (a consultant) to examine the problem. He made the following recommendations:

(i) Set up a proper credit control department and run it as a cost centre by investing \$100,000 for office equipment and office space. This decision will incur an annual operating cost of \$30,000 for wages and other overheads.
(ii) Withdraw credit facilities from the least credit worthy customers. This decision will result in a loss of business estimated at \$200,000 per annum. However, the average bad debt record should decrease from 10 to 5% of all sales. The marginal contribution of sales is 15%.
(iii) Insist that the debtors pay within 30 days and chase late payers. This decision is expected to decrease the average period of collection to 30 days.

Requirement

Determine the net benefit to Barot plc of adopting the recommendations of the consultant. Its cost of capital is 18%.

(10 marks)

20.3 How Chin Wah Ltd makes annual credit sales of \$1,500,000. Though its credit terms are 30 days the average collection period has been 45 days with 0.5% of sales resulting in bad debts that are written off. The company decide to outsource debt collection to a factor who would take on the responsibility of debt administration and credit checking at an annual fee, which is 2.5% of credit sales. The company would save £30,000 a year in administration costs. The payment period would be 30 days.

The factor would also provide an advance of 80% of invoiced debts at an interest rate of 14% (3% over the current base rate). The company can obtain an overdraft facility to finance its debtors at a rate of 2.5% over base rate.

Requirements

(i) Should the factor's services be accepted (assume a constant monthly turnover)?

(7 marks)

(ii) What is the difference between the following two terms:
  (a) Non-recourse factoring
  (b) With recourse factoring?

(3 marks)
(Total = 10 marks)

20.4 Outline the main components of a firm's credit management policy.

(10 marks)

✓ Answers

20.1 (i) The problems faced by small companies in respect of credit management are as follows:

(a) Credit control personnel

Small companies cannot afford to employ full-time dedicated credit controllers. Part-time staff might write up the books but do not dedicate the time building up the necessary relationships with customers. The owner/director usually concentrates on making new sales rather than collecting the debts due from past sales.

(b) Formality in credit documentation

Invoices issued might not state the standard credit terms, and there are no in-house mechanisms to trigger further action if the standard credit period is exceeded.

(c) Lack of bargaining power

A small business might do a large proportion of its work for one or more larger businesses.

Consequently, it cannot coerce the debtors to be more punctual in payments if they are slow payers. It can only stop working for the larger business at its own risk.

(d) Under-capitalisation

Most small businesses are under-capitalised; they are financed by a small amount of owner's equity and a large bank overdraft. The owner has to spend time continually discussing the size of the overdraft with the bank. Long credit periods only worsen the liquidity situation and serve to increase the size of required overdraft.

The internal actions that small businesses could take to minimise the effects of these problems are as follows:

(a) Formalisation of credit management

If credit management is to be kept in-house, procedures should be formalised as far as possible. A credit limit should be set for each credit customer, and no more goods should be sent to a customer if the shipment would exceed the credit limit. Standard credit terms should be agreed with each customer, for example, payment within 30 days after delivery, and these terms should be stated on the invoice to avoid misunderstandings. Set procedures should be implemented if an account remains unpaid after the credit period, starting with telephone calls to the debtor to remind them of the payment due.

(b) Equity capital/Bank loans/Cash flow forecasts

The under-capitalisation problem could be solved by investing more equity into the business, or seeking bank loans to replace an overdraft. Regular cash flow forecasts should be prepared, for example, monthly for the six months ahead, to identify cash shortages before they arise so that the bank can be approached in good time if an increase in overdraft facilities is required.

(c) External specialist

If an effective credit management operation is not possible in-house, then responsibility could be handed over to an external specialist such as a factoring company, to run the sales ledger operation. Alternatively, some sort of strategic alliance might be possible where the small business teams up with a larger organisation with spare capacity in its credit management operations.

(ii) REPORT

To: The Credit Manager

From: The Management Accountant

Date: X-X-XX

Subject: Credit control policy

Introduction

The purpose of this report is to discuss the contribution that credit control policy can make to overall business strategy and assesses the advantages and disadvantages of introducing discounts for prompt payment.

Credit control policy

Credit control policy is an essential aspect of the overall business strategy. It is the counterpart of 'increasing turnover'. The role of credit control is to ensure that our customers will settle their bills on time. It is a screening exercise which reassures that increasing sales are matched by increasing good debtors.

Credit control officers must assess the state of current and potential customers. This implies much more than calculating liquidity ratios from published accounts where they are available. They must appraise the state of the business areas within which these customers trade; if prospects are good for the sector, there is less likely to be a problem with bad debts.

The debtors balance is part of the working capital requirement of a business, which has to be financed. All other things being equal a lower debtors figure will benefit a company in that a lower working capital total needs financing (at the average cost of capital, or perhaps at a particular interest rate such as an overdraft interest rate). By lowering the total debtors figure, a credit control department can therefore benefit the organisation.

Introducing discounts for prompt payment

If, for instance, a 1% discount is offered for payment at 10 days rather than 30 days, effectively 1% is being paid to bring forward the date of payment by 20 days. This is equivalent to a simple annual interest rate of 365/20 = over 18%. 18% is a high cost for us to pay to attract funds. From the debtor's standpoint, it is an attractive return; indeed it has to be attractive to convince the debtor to accept the discount terms. So the drawback for the supplier is the comparatively high cost, compared to other sources of funds like a bank loan or bank overdraft.

But there are advantages that the supplier will expect from offering a prompt payment discount:

(a) By convincing the debtor to pay earlier, the possibility of the debtor not paying at all is eliminated. In other words, there should be fewer bad debts if a discount for prompt payment is offered.
(b) Discounts often have to be offered to match the norm in a particular industry. Businesses that fail to offer discounts, that customers have become used to, face real problems in generating sales.
(c) Decreasing the total debtors figure means a lower total for working capital has to be financed.

Conclusion

Credit control has a fundamental role to play in an organisation's overall business strategy. Although prompt payment discounts have an equivalent annual cost which appears expensive, such discounts are expected to offer certain benefits.

I trust that the information contained in this report is useful and if you require further information about any matter discussed, please contact me.

20.2

Cost of setting up the department

Investment: $100,000 @ 18%	18,000
Running cost	30,000
	48,000
Loss of business: $200,000 × 15%	30,000
Total cost	78,000
Benefits	110,000
Reduction in bad debts	
(10% × $2m) − (5% × $1.8m)	
Financing of debtors	
($2m × 60/365) × 15% − ($1.8m × 30/365) × 15%	27,123
Total benefits	137,123
Net benefit (137,123 − 78,000)	59,123

20.3 (i) Current position

Credit sales $1,500,000 per annum

Average credit 45 days

Annual cost is:

	$
45/365 × $1.5m × 13.5%	24,966
Bad debts 0.5% × £1.5m	7,500
Total cost	32,466

Cost of the factor:

		$
Factors finance	30/365 × £1.2m × 14%	13,808
Overdraft	30/365 × £0.3m × 13.5%	3,329
Cost of factor's services	£1.5m × 2.5%	37,500
Savings in administration		(30,000)
Net cost of the factor		24,637

Conclusion

The factor is cheaper.

(ii) (a) 'Non-recourse factoring' means that the bad debts are the responsibility of the factor.
(b) 'With recourse factoring' means that bad debts remain the liability of the client company.

20.4 The principal components of a firm's credit management policy are as follows:

(i) Terms of sale – a company must decide on the credit terms to be offered to a customer and the cash discount, if any.
(ii) Credit analysis – a company should access all available information before deciding on the credit terms to be allowed to a customer. This information could include:
(a) *Trade references*. The potential customer is requested to provide the names of at least two existing suppliers who will testify to the firm's credit standing.
(b) *Bank opinion*. The customer's bank is approached to enquire about his credit worthiness. Note that banks are frequently unwilling to give bad references.
(c) *Specialist references or credit rating agencies*. These bodies provide independent assessments of credit worthiness for a fee.
(d) *Opinion of sales team*. The salesmen are in regular contact with current and potential customers and are, therefore, in a unique position to provide information on customer creditworthiness.
(d) *Published information* (e.g. company accounts). Recent accounts may be analysed to determine the customer's ability to pay.
(iii) Collection policy – a monthly aged analysis of debtors should be maintained to identify the average collection rate and to highlight any problematic or potential bad debts. A company needs then to consider the amount of its own resources it can afford to invest in pursuing debtors who are slow to pay (this can be an expensive process if internally administered). In cases where the credit control administration costs threaten to become particularly onerous, consideration might be given to engaging the services of a specialist factoring agency.

The collection policy should incorporate techniques for chasing overdue debts such as:

(a) *Reminder letters*. Customers generally ignore them.
(b) *Telephone calls*. These are very expensive and the benefits need to be weighed against the costs.
(c) *Withholding supplies*. Such action can encourage rapid settlement of debts.
(d) *Debt collection agencies and trade associations*. These organisations offer debt collection services for a fixed fee basis or on 'no collection no charge' terms.
(e) *Legal action*. This is the ultimate decision. The matter is handed over to the solicitor to commence legal action to recover the debt.

Working Capital: Inventory

21

Questions

21.1 Union Carbide plc uses two important materials in its productive process. A stock shortage of either of these materials will entail delays in production. Besides being expensive, these materials are corrosive and difficult to store.

Relevant information is:

	Material X	*Material Y*
Annual usage	24,000 litres	15,000 kg
Holding costs	5 cents per litre	10 cents per kg per annum
Buying costs	$100 per order	$80 per order
Delivery time	5 weeks	10 weeks

Determine the economic order quantity and the reorder level for each material. Assume a fifty-week working year.

(10 marks)

21.2 (i) Explain the rationale underlying the economic order quantity model using a diagram to illustrate your answer. (The mathematical derivation is not required.) State the formula used for calculating economic order quantity.

(7 marks)

(ii) Given the data below for material HC700, calculate:

(a) the economic order quantity;
(b) the number of orders needed per year; and
(c) the total cost of ordering and holding material HC700 for the year.

Annual requirements for material HC700: 14,400 units
Ordering cost: £12.50 per order
Holding cost per annum: 20% of purchase price
Purchase price per unit: £5.00
Safety stock requirements: None

(7 marks)

(iii) Although stocks of materials may be planned to maximize profitability when stock record cards are compared to actual physical stocks, differences arise. Discuss possible reasons for these differences.

(6 marks)
(Total = 20 marks)

✓ Answers

21.1

Economic order quantities and reorder levels

(i) For X

$$EOQx = \frac{\sqrt{2\ BN}}{C}$$

$$= \frac{\sqrt{2 \times \$100 \times 24{,}000}}{0.05}$$

$$= 9{,}798 \text{ litres}$$

$$\text{Reorder level} = \frac{DN}{W}$$

$$= \frac{5 \times 24{,}000}{50}$$

$$= 2{,}400 \text{ litres}$$

(ii) For Y

$$EOQy = \frac{\sqrt{2\ BN}}{C}$$

$$= \frac{\sqrt{2 \times \$80 \times 15{,}000}}{0.10}$$

$$= 4{,}899 \text{ kgs}$$

$$\text{Reorder level} = \frac{DN}{W}$$

$$= \frac{10 \times 15{,}000}{50}$$

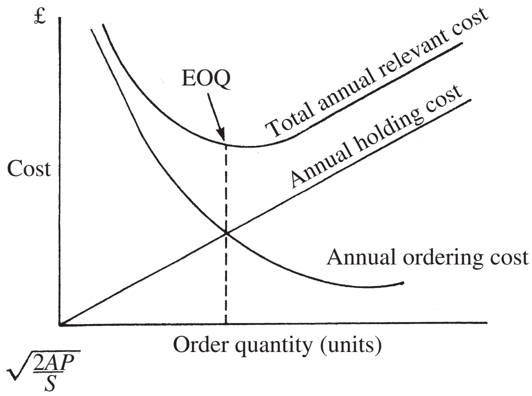
$$= 3{,}000 \text{ kgs}$$

It is essential that Union Carbide plc never finds itself out of stock. To avoid that possibility it might be advisable that the reorder levels be increased by, say, 50%. However, that decision would also rely on the probability that delivery times would be met.

21.2 (i) Relevant costs which are associated with stock control are
(a) ordering costs and
(b) holding costs.

Ordering costs usually comprise the clerical costs of preparing a purchase order as well as special processing and receiving costs relating to the number of orders processed. The holding costs usually comprise a desired rate of return on the investment in stock, costs of storage space, breakage, obsolescence deterioration, insurance.

Shown graphically:



Where:

EOQ = order size
A = annual quantity used, in units
P = cost of making an order
S = annual holding cost per unit.

(ii) (a) $\text{EOQ} = \dfrac{\sqrt{(4{,}400)(12.50)}}{1.00}$

$= \sqrt{360{,}000} = 600$

(b) $\text{Orders per year} = \dfrac{14{,}400}{600} = 24$ orders per year.

(c) Cost of ordering = 24 × £12.50 = £300.

Cost of holding = 600/2 × £1 = £300.

Thus, the total cost of ordering and holding = £600.

(iii) The recorded balances may differ from actual physical balances due to:

- clerical errors in the record card;
- storekeeper's errors, clerical and physical (e.g. over-issue);
- errors in procedure (e.g. failure to record returned material on a materials returned note);
- unrecorded losses due to evaporation or breaking;
- pilferage and falsification of documents.

Pilot Paper

MANAGERIAL LEVEL

FINANCIAL MANAGEMENT PILLAR

PAPER P7 – FINANCIAL ACCOUNTING AND TAX PRINCIPLES

This is a Pilot Paper and is intended only to be an indicative guide for tutors and students of the style and type of questions that are likely to appear in future examinations. It does not seek to cover the full range of the syllabus learning outcomes for this subject.

Financial Accounting and Tax Principles will be a three hour paper with two compulsory sections (50 marks and 30 marks, respectively) and one section with a choice of questions for 20 marks.

CONTENTS

SECTION A – 50 MARKS

ANSWER *ALL* 21 SUB-QUESTIONS

Requirements

On the indicative ANSWER SHEET, either write your answer in the space provided where the sub-question requires a written response, or place a circle 'O' around the letter that gives the correct answer to the sub-question where a list of distractors has been provided.

If you wish to change your mind about an answer to such a sub-question, block out your first answer completely and then circle another letter. You will not receive marks if more than one letter is circled.

Space has been provided on the four-page answer sheet for workings. If you require further space, please use the last page of your answer book and clearly indicate which question(s) these workings refer to.

You must detach the answer sheet from the question paper and attach it to the front cover of your answer book before you hand it to the invigilators at the end of the examination.

? Question One

1.1 Which ONE of the following transactions is most likely to affect the overall amount of working capital?

(A) Receipt of full amount of cash from a customer to settle their trade receivable account
(B) Payment of a trade payable account in full
(C) Sale of a non-current asset on credit at its net book value
(D) Purchase of inventory on credit **(2 marks)**

Financial Accounting and Tax Principles

INDICATIVE ANSWER SHEET FOR SECTION A

Write here your full examination number:				
Centre Code				
Hall Code				
Desk Number				

1.1	**A**	**B**	**C**	**D**
1.2	**A**	**B**	**C**	**D**
1.3	**A**	**B**	**C**	**D**
1.4	**No more than 15 additional words:** A direct tax is one that			
1.5	The optimal amount to the nearest $100 to be transferred is:			
1.6	*1*			
Maximum 5 words per item	*2*			
	3			
	4			
1.7	The annual rate of interest is: %			
1.8	**A**	**B**	**C**	**D**
1.9	The average working capital cycle is:			
1.10	**A**	**B**	**C**	**D**
1.11	**A**	**B**	**C**	**D**
1.12	**A**	**B**	**C**	**D**
1.13	Cash expected to be received is: $			
1.14	**A**	**B**	**C**	**D**
1.15	Tax due is: $			
1.16	**A**	**B**	**C**	**D**

THIS ANSWER SHEET CONTINUES ON PAGE 4

1.17	**In no more than 30 words:**			
1.18	**In no more than 30 words:**			
1.19	The value of goodwill to be included in the accounts is: $			
1.20	The optimal order size is:			
1.21	**A**	**B**	**C**	**D**

You must detach this Answer sheet from the question paper and attach it to the inside front cover of your answer book before you hand it in to the invigilators at the end of the examination.

Space for workings for Section A

Space for workings for Section A

1.2 B entered into a 3-year contract to build a leisure centre for an enterprise. The contract value was $6 million. B recognises profit on the basis of certified work completed.

At the end of the first year, the following figures were extracted from B's accounting records:

	$000
Certified value of work completed (progress payments billed)	2,000
Cost of work certified as complete	1,650
Cost of work-in-progress (not included in completed work)	550
Estimated cost of remaining work required to complete the contract	2,750
Progress payments received from enterprise	1,600
Cash paid to suppliers for work on the contract	1,300

What values should B record for this contract as 'gross amounts due from customers' and 'current liabilities – trade and other payables'?

	Gross amounts due from customers	*Current liabilities – trade and other payables*
(A)	$950,000	$350,000
(B)	$950,000	$900,000
(C)	$1,250,000	$600,000
(D)	$2,550,000	$900,000

(2 marks)

1.3 IAS 8 – *Net Profit or Loss for the Period, Fundamental Errors and Changes in accounting policies* specifies the definition and treatment of a number of different items.

Which of the following is NOT specified by IAS 8?

(A) The effect of a change in an accounting estimate
(B) Prior period adjustments
(C) Provisions
(D) Extraordinary items **(2 marks)**

1.4 In no more than 15 words, complete the following sentence:
'A direct tax is one that …'
(Write your answer in the space provided on the answer sheet.) **(2 marks)**

1.5 A company uses the Baumol cash management model. Cash disbursements are constant at $20,000 each month. Money on deposit earns 5% a year, while money in the current account earns a zero return. Switching costs (i.e., for each purchase or sale of securities) are $30 for each transaction.

What is the optimal amount (to the nearest $100) to be transferred in each transaction?
(Write your answer in the space provided on the answer sheet.) **(2 marks)**

1.6 List (using no more than five words per item) the four main sources of tax rules in a country.
(Write your answer in the space provided on the answer sheet.) **(4 marks)**

1.7 WM's major supplier, INT, supplies electrical tools and is one of the largest companies in the industry, with international operations. Deliveries from INT are currently made monthly, and are constant throughout the year. Delivery and invoicing both occur in the last week of each month.

Details of the credit terms offered by INT are as follows:

Normal credit period	*Cash discount*	*Average monthly purchases*
40 days	2% for settlement in 10 days	$100,000

WM always takes advantage of the cash discount from INT.

Calculate the annual rate of interest (to two decimal places) implied in the cash discount offered by INT. Assume a 365-day year.

(Write your answer in the space provided on the answer sheet.) **(3 marks)**

1.8 A company has a current ratio of 2 : 1. Due to having significant surplus cash balances, it has decided to pay its trade payable accounts after 30 days in future, rather than after 50 days, as it has in the past.

What will be the effect of this change on the company's current ratio and its cash operating cycle?

	Current ratio	*Cash operating cycle*
(A)	Increase	Increase
(B)	Increase	Decrease
(C)	Decrease	Increase
(D)	Decrease	Decrease

(2 marks)

1.9 The following balances were extracted from the books of A:

	Year ended 31 March 2003
	$000
Revenue	300
Cost of sales	200
Gross profit	100

	At 31 March 2003
	$000
Closing inventory	15
Trade receivables	36
Trade payables	28

Assume all revenue is credit sales and cost of sales equates to inventory purchases. What is A's average working capital cycle for the year ended 31 March 2003?

(Write your answer in the space provided on the answer sheet.) **(3 marks)**

1.10 Double tax relief is used to

(A) ensure that you do not pay tax twice on any of your income
(B) mitigate taxing overseas income twice
(C) avoid taxing dividends received from subsidiaries in the same country twice
(D) provide relief where a company pays tax at double the normal rate

(2 marks)

1.11 A withholding tax is:

(A) tax withheld from payment to the tax authorities
(B) tax paid less an amount withheld from payment

(C) tax deducted at source before payment of interest or dividends
(D) tax paid on increases in value of investment holdings **(2 marks)**

1.12 Tax on an enterprise's trading profits could be referred to as:

(i) Income tax
(ii) Profits tax
(iii) Indirect tax
(iv) Direct tax
(v) Earnings tax

Which TWO of the above would most accurately describe tax on an enterprise's trading profits:

(A) (i) and (iii)
(B) (i) and (iv)
(C) (ii) and (iii)
(D) (iv) and (v) **(2 marks)**

1.13 An enterprise commenced business on 1 April 2002. Revenue in April 2002 was \$20,000, but this is expected to increase at 2% a month. Credit sales amount to 60% of total sales. The credit period allowed is one month. Bad debts are expected to be 3% of credit sales, but other customers are expected to pay on time. Cash sales represent the other 40% of revenue.

How much cash is expected to be received in May 2002?
(Write your answer in the space provided on the answer sheet.) **(3 marks)**

1.14 Which of the following types of taxes is regarded as an indirect tax?

(A) Taxes on income
(B) Taxes on capital gains
(C) Taxes on inherited wealth
(D) Sales tax (Value added tax) **(2 marks)**

1.15 E has an accounting profit before tax of \$95,000. The tax rate on trading profits applicable to E for the year is 25%. The accounting profit included non-taxable income from government grants of \$15,000 and non-tax allowable expenditure of \$10,000 on entertaining expenses.

How much tax is E due to pay for the year?
(Write your answer in the space provided on the answer sheet.) **(2 marks)**

1.16 Which TWO of the following are underlying assumptions in the International Accounting Standards Board's Framework for the preparation and presentation of financial statements?

(i) Accruals
(ii) Relevance
(iii) Comparability
(iv) Going concern
(v) Reliability

(A) (i) and (v)
(B) (ii) and (v)

(C) (iii) and (iv)
(D) (i) and (iv) **(2 marks)**

1.17 The International Accounting Standards Board's Framework for the preparation and presentation of financial statements defines elements of financial statements. In no more than 30 words define an asset.
(Write your answer in the space provided on the answer sheet.) **(2 marks)**

The following data is to be used to answer Questions 1.18 and 1.19

X acquired the business and assets from the owners of an unincorporated business: the purchase price was satisfied by the issue of 10,000 equity shares with a nominal market value of $10 each and $20,000 cash. The market value of X shares at the date of acquisition was $20 each.

The assets acquired were:

- Net tangible non-current assets with a book value of $20,000 and current value of $25,000.
- Patents for a specialised process valued by a specialist valuer at $15,000.
- Brand name, valued by a specialist brand valuer on the basis of a multiple of earnings at $50,000.
- Publishing rights of the first text from an author that the management of X expects to become a best seller. The publishing rights were a gift from the author to the previous owners at no cost. The management of X has estimated the future value of the potential best seller at $100,000. However, there is no reliable evidence available to support the estimate of the management.

1.18 In no more than 30 words, explain the accounting treatment to be used for the publishing rights of the first text.
(Write your answer in the space provided on the answer sheet.) **(2 marks)**

1.19 Calculate the value of goodwill to be included in the accounts of X for this purchase. **(4 marks)**

1.20 SK sells bathroom fittings throughout the country in which it operates. In order to obtain the best price, it has decided to purchase all its annual demand of 10,000 shower units from a single supplier. RR has offered to provide the required number of showers each year under an exclusive long-term contract.

Demand for shower units is at a constant rate all year. The cost to SK of holding one shower unit in Inventory for one year is $4 plus 3% of the purchase price.

RR is located only a few miles from the SK main showroom. It has offered to supply each shower unit at $400 with a transport charge of $200 per delivery. It has guaranteed such a regular and prompt delivery service that SK believes it will not be necessary to hold any safety Inventory (that is buffer Inventory) if it uses RR as its supplier.

Using the economic order quantity model (EOQ model), calculate the optimal order size, assuming that RR is chosen as the sole supplier of shower units for SK.
(Write your answer in the space provided on the answer sheet) **(3 marks)**

1.21 Which of the following would be LEAST LIKELY to arise from the introduction of a Just-in-time stock ordering system?

(A) Lower stockholding costs
(B) Less risk of stock shortages
(C) More frequent deliveries
(D) Increased dependence on suppliers **(2 marks)**

(Section A = 50 marks)

SECTION B – 30 MARKS

ANSWER *ALL* SIX SHORT-ANSWER QUESTIONS

? Question Two

A new type of delivery vehicle, when purchased on 1 April 2000 for $20,000, was expected to have a useful economic life of 4 years. It now appears that the original estimate of the useful economic life was too short, and the vehicle is now expected to have a useful economic life of 6 years, from the date of purchase. All delivery vehicles are depreciated using the straight-line method and are assumed to have zero residual value.

Requirements

As the trainee management accountant, draft a memo to the transport manager explaining whether it is possible to change the useful economic life of the new delivery vehicle. Using appropriate International Accounting Standards, explain how the accounting transactions relating to the delivery vehicle should be recorded in the income statement for the year ended 31 March 2003 and the balance sheet at that date. **(5 marks)**

? Question Three

NDL drilled a new oil well, which started production on 1 March 2003. The licence granting permission to drill the new oil well included a clause that requires NDL to 'return the land to the state it was in before drilling commenced'.

NDL estimates that the oil well will have a 20-year production life. At the end of that time, the oil well will be de-commissioned and work carried out to reinstate the land. The cost of this de-commissioning work is estimated to be $20 million.

Requirements

As the trainee management accountant, draft a memo to the production manager explaining how NDL must treat the de-commissioning costs in its financial statements for the year to 31 March 2003. Your memo should refer to appropriate International Accounting Standards. **(5 marks)**

Question Four

HRD owns a number of small hotels. The room occupancy rate varies significantly from month to month. There are also high-fixed costs. As a result, the cash generated each month has been very difficult to estimate.

Christmas is normally a busy period and large cash surpluses are expected in December. There is, however, a possibility that a rival group of hotels will offer large discounts in December and this could damage December trade for HRD to a significant extent.

January is a poor period for the industry and therefore all the company's hotels will close for the month, resulting in a negative cash flow. The Finance Director has identified the following possible outcomes and their associated probabilities:

	$000	*Probability*
Expected cash balance at 30 November 2003	+175	1.0
Net operating cash flow in December 2003	+700	0.7
	−300	0.3
Net operating cash flow in January 2004	−900	1.0

Assume cash flows arise at month ends.

After January 2004, trade is expected to improve, but there is still a high degree of uncertainty in relation to the cash surpluses or deficits that will be generated in each month.

Requirements

Calculate the expected cash balance or overdraft of HRD at 31 January 2004.

Explain why your answer may not be useful for short-term cash planning and outline alternative approaches that could be used. **(5 marks)**

Question Five

On 1 January 2003, SPJ had an opening debit balance of $5,000 on its tax account, which represented the balance on the account after settling its tax liability for the previous year. SPJ had a credit balance on its deferred tax account of $1.6 million at the same date.

SPJ has been advised that it should expect to pay $1 million tax on its trading profits for the year ended 31 December 2003 and increase its deferred tax account balance by $150,000.

Requirement

Prepare extracts from the income statement for the year ended 31 December 2003, balance sheet at that date and notes to the accounts showing the tax entries required. **(5 marks)**

Question Six

IAS 37 defines the meaning of a provision and sets out when a provision should be recognised.

Requirements

Using the IAS 37 definition of a provision, explain how a provision meets the International Accounting Standards Board's Framework for the preparation and presentation of financial statements definition of a liability. **(5 marks)**

Question Seven

A lessee leases a non-current asset on a non-cancellable lease contract of 5 years, the details of which are:

- The asset has a useful economic life of 5 years.
- The rental is $21,000 per annum payable at the end of each year.
- The lessee also has to pay all insurance and maintenance costs.
- The fair value of the asset was $88,300.

The lessee uses the sum of digits method to calculate finance charges on the lease.

Requirement

Prepare income statement and balance sheet extracts for years one and two of the lease.

(5 marks)

(Section B = 30 marks)

SECTION C – 20 MARKS

ANSWER ONE QUESTION ONLY

Question Eight

AZ is a quoted manufacturing enterprise. Its finished products are stored in a nearby warehouse until ordered by customers. AZ has been re-organising the business to improve performance.

The trial balance for AZ at 31 March 2003 was as follows:

	$000	*$000*
7% Loan Notes (redeemable 2007)		18,250
Accumulated profits at 31 March 2002		14,677
Administrative expenses	16,020	
Bank & Cash	26,250	
Cost of goods manufactured in the year to 31 March 2003		
(excluding depreciation)	94,000	
Distribution costs	9,060	
Dividends paid	1,000	
Dividends received		1,200
Equity shares $1 each, fully paid		20,000
Interest paid	639	
Inventory at 31 March 2002	4,852	
Plant & Equipment	30,315	
Provision for Depreciation at 31 March 2002:		
Plant & Equipment		6,060
Vehicles		1,670
Provision for doubtful trade receivables		600
Restructuring costs	121	
Sales revenue		124,900
Share issue expenses	70	
Share premium		500
Trade payables		8,120
Trade receivables	9,930	
Vehicles	3,720	
	195,977	195,977

Additional information provided

(i) Non-current assets are being depreciated as follows:
Plant & Equipment 20% per annum straight line
Vehicles 25% per annum reducing balance
Depreciation of plant and equipment is considered to be part of cost of sales, while depreciation of vehicles should be included under distribution costs.
(ii) Tax due for the year to 31 March 2003 is estimated at $15,000.
(iii) The closing inventory at 31 March 2003 was $5,180,000.
(iv) A dividend of 5 cents per ordinary share was paid in February 2003.
(v) The 7% loan notes are 10-year loans due for repayment by 31 March 2007. AZ incurred no other interest charges in the year to 31 March 2003.
(vi) The restructuring costs in the trial balance represent the cost of the final phase of a major fundamental restructuring of the enterprise to improve competitiveness and future profitability.
(vii) At 31 March 2003, AZ was engaged in defending a legal action against the enterprise. Legal advisers have indicated that it is reasonably certain that the outcome of the case will be against the enterprise. The amount of compensation is currently estimated at $25,000 and has not been included in the trial balance.
(viii) On 1 October 2002, AZ issued 1,000,000 equity shares at $1.50 each. All money had been received and correctly accounted for by the year end.

Requirement

Prepare AZ's income statement for the year to 31 March 2003, a balance sheet at that date, and a statement of changes in equity for the year. These should be in a form suitable for presentation to the shareholders, in accordance with the requirements of International Accounting Standards.

Notes to the financial statements are NOT required, but all workings must be clearly shown. DO NOT prepare a statement of accouting policies or a statement of total recognised gains and losses.

(20 marks)

? Question Nine

The following information has been extracted from the draft financial statements of TEX, a manufacturing enterprise:

TEX – Income statement for the year ended 30 September 2003

	$000
Revenue	15,000
Cost of sales	(9,000)
Gross profit	6,000
Other operating expenses	(2,300)
	3,700
Finance cost	(124)
Profit before tax	3,576
Income tax expense	(1,040)
Dividends	(1,100)
	1,436

TEX – Balance sheets at 30 September

	2003		2002	
	$000	*$000*	*$000*	*$000*
Assets				
Non-current assets		18,160		14,500
Current assets				
Inventories	1,600		1,100	
Trade receivables	1,500		800	
Bank	150		1,200	
		3,250		3,100
Total assets		21,410		17,600
Equity and liabilities				
Capital and reserves				
Issued capital		10,834		7,815
Accumulated profits		5,836		4,400
		16,670		12,215
Non-current liabilities				
Interest-bearing borrowings	1,700		2,900	
Deferred tax	600		400	
		2,300		3,300
Current liabilities				
Trade payables	700		800	
Proposed dividend	700		600	
Tax	1,040		685	
		2,440		2,085
		21,410		17,600

Non-current assets

	Property	*Plant*	*Total*
	$000	*$000*	*$000*
At 30 September 2002			
Cost	8,400	10,800	19,200
Depreciation	1,300	3,400	4,700
Net book value	7,100	7,400	14,500
At 30 September 2003			
Cost	11,200	13,400	24,600
Depreciation	1,540	4,900	6,440
Net book value	9,660	8,500	18,160

(i) Plant disposed of during the year had an original cost of $2,600,000 and accumulated depreciation of $900,000; cash received on disposal was $730,000.

(ii) All additions to non-current assets were purchased for cash.

(iii) Dividends were declared before the balance sheet dates.

Requirement

Prepare TEX's cash flow statement and associated notes for the year ended 30 September 2003, in accordance with IAS 7 – *Cash Flow Statements*. **(20 marks)**

(Section C = 20 marks)

End of Question Paper

APPLICABLE MATHS TABLES AND FORMULAE

Present value table

Present value of £1, that is $(1 + r)^{-n}$ where r = interest rate; n = number of periods until payment or receipt.

Periods (n)	Interest rates (r)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods (n)	Interest rates (r)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Cumulative present value of £1 per annum

Receivable or Payable at the end of each year for n years $\frac{1-(1+r)^{-n}}{r}$

Periods (n)	Interest rates (r)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods (n)	Interest rates (r)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	7.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Formulae

Valuation models

(i) Future value of *S*, of a sum *X*, invested for *n* periods, compounded at *r*% interest:

$$S = X[1 + r]^n$$

(ii) Present value of £1 payable or receivable in *n* years, discounted at *r*% per annum:

$$PV = \frac{1}{[1 + r]^n}$$

(iii) Present value of an annuity of £1 per annum, receivable or payable for *n* years, commencing in 1 year, discounted at *r*% per annum:

$$PV = \frac{1}{r}\left[1 - \frac{1}{[1 + r]^n}\right]$$

(iv) Present value of £1 per annum, payable or receivable in perpetuity, commencing in 1 year, discounted at *r*% per annum:

$$PV = \frac{1}{r}$$

(v) Present value of £1 per annum, receivable or payable, commencing in 1 year, growing in perpetuity at a constant rate of *g*% per annum, discounted at *r*% per annum:

$$PV = \frac{1}{r - g}$$

Inventory management

(i) Economic order quantity

$$EOQ = \sqrt{\frac{2C_oD}{C_h}}$$

where: C_o = cost of placing an order
C_h = cost of holding one unit in Inventory for one year
D = annual demand

Cash management

(i) Optimal sale of securities, Baumol model:

$$\text{Optimal sale} = \sqrt{\frac{2 \times \text{Annual cash disbursements} \times \text{Cost per sale of securities}}{\text{interest rate}}}$$

(ii) Spread between upper and lower cash balance limits, Miller-Orr model:

$$\text{Spread} = 3\left[\frac{\frac{3}{4} \times \text{transaction cost} \times \text{variance of cash flows}}{\text{interest rate}}\right]^{\frac{1}{3}}$$

Solutions to Pilot Paper

SECTION A

✓ Solution One

1.1 The answer is (C).

1.2

Gross amounts due from customers are calculated as:	$
Certified value of work completed	2,000
Less cash received from enterprise	1,600
	400
Plus work in progress	550
	950
Current liabilities – trade and other payables are calculated as:	
Cost of work certified as complete	1,650
Cost of work in progress (not included in completed work)	550
	2,200
Less cash paid to creditors for work on the contract	1,300
	900

The answer is (B).

1.3 The answer is (C).

1.4 A direct tax is one that is levied directly on the person who is intended to pay the tax.

1.5 $\sqrt{[(2 \times 30 \times 240{,}000)/0.05]}$ = \$16,970 that is approximately **\$17,000**

1.6 (1) Domestic legislation and court rulings
(2) Practice of tax authority
(3) Supranational bodies
(4) International treaties

1.7 $(100/98)^{365/30} - 1 = 27.86\%$

1.8 The answer is (A).

1.9 Inventory turnover $(15/200) \times 365 = 27.4$ days
Receivables $(36/300) \times 365 = 43.8$ days
Payables $(28/200) \times 365 = 51.1$ days
Working capital cycle is therefore $= (27.4 + 43.8 - 51.1) = 20.1$ days

1.10 The answer is (B).

1.11 The answer is (C).

1.12 The answer is (D).

1.13 $(20{,}000 \times 1.02 \times 40\%) + (20{,}000 \times 60\% \times 0.97) = \$19{,}800$

1.14 The answer is (D).

1.15

Accounting profit	$95,000
Less non-taxable income	$15,000
	$80,000
Add non-tax allowable expenses	$10,000
Taxable profit	$90,000
Tax at 25%	$22,500

1.16 The answer is (D).

1.17 'An asset is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.'

1.18 The publishing rights had no cost as they were a gift, therefore they cannot be recognised. Expected future value cannot be recognised as the event has not yet occurred.

1.19

		$
Tangible non-current assets		25,000
Patents		15,000
Brand name		50,000
		90,000
Purchase consideration:	$	
Cash	20,000	
Shares	200,000	
		220,000
Goodwill		130,000

1.20 Holding cost $= \$4 + (3\% \times \$400) = \$16$

EOQ $= \sqrt{(2C_oD/C_h)}$

$= \sqrt{[(2 \times 10{,}000 \times \$200)/\$16]}$

Optimal order $= 500$ units

1.21 The answer is (B).

SECTION B

☑ Solution Two

Memo
To: Transport Manager
From: Trainee Management Accountant
Date: January 2004

International Accounting Standards (IAS) require the economic life of the vehicle to be changed.

IAS 16 requires the useful economic lives of non-current assets to be regularly reviewed and adjusted if they are found to be incorrect. IAS 16 also requires realistic economic lives to be used for non-current assets. A review of the delivery vehicle indicates that its useful economic life must be adjusted to a more realistic total of six years from date of purchase.

When economic lives are adjusted, IAS 16 requires the net book value to be recovered over the remaining useful economic life of the asset.

The delivery vehicle will have been depreciated for two years, 2000/2001 and 2001/2002.

	$000
Cost	20
Depreciation 2/4	10
Net book value at 31 March 2002	10

The useful economic life is adjusted to six years, two years having elapsed. The remaining useful life is now four years. The net book value, at 31 March 2002, of $10,000 will be depreciated over the remaining four years at $2,500 a year. The effect in the Income Statement for the year to 31 March 2003 will be to charge $2,500 depreciation.

The balance sheet will show cost $20,000, less accumulated depreciation of $10,000 plus $2,500, total $12,500. The net book value at 31 March is $7,500.

☑ Solution Three

Memo
To: Production Manager
From: Trainee Management Accountant
Date: January 2004

International Accounting Standard (IAS) 37 requires that any future obligations arising out of past events should be recognised immediately. The drilling licence includes a clause that requires the land to be returned to the state it was in before drilling commenced. The past event occurs as soon as the licence is granted and the de-commissioning costs are incurred as soon as the oil well has been drilled on the site.

The full obligation must be recognised in the accounts ending 31 March 2003. The full cost of the de-commissioning has been estimated ($20 million); this is then discounted to present value and recorded as a provision in the balance sheet at 31 March 2003

Where the expenditure gives access to future economic benefits such as access to oil reserves for the next 20 years, the de-commissioning costs are treated as capital expenditure and added on to the cost of the non-current asset. The new total cost of the oil well would then need to be reviewed to ensure that its book value was not greater than its recoverable amount.

The cost of the oil well (including the provision) should be depreciated each year and charged to the income statement. The provision will remain in the balance sheet until the oil well is de-commissioned in 20 years' time.

☑ Solution Four

	\$000	*\$000*
Opening balance (1 December 2003)		175
December		
+700 × 0.7	490	
−300 × 0.3	−90	
		400
January		−900
Closing balance (31 January 2004)		−325

The expected balance at 31 January is an overdraft of \$325,000.

The expected balance is based on probabilities and will not occur. It therefore provides a poor basis for short-term cash planning. Based on the probabilities provided, there will either be a cash inflow of \$700,000 in December or a cash outflow of \$300,000.

The mean expected value would only be relevant if the event could be repeated a significant number of times. The alternative approaches to planning should be to plan for each of the two possible outcomes, +\$700,000 or −\$300,000.

☑ Solution Five

Notes to the accounts

Note 1: Tax expense

	\$
Balance brought forward 1 January 2003	(5,000)
Tax for current year	1,000,000
Deferred tax increase	150,000
Income statement	1,145,000

Note 2: Deferred tax

Deferred tax – balance at 1 January 2003	1,600,000
Increase in year	150,000
Balance at 31 December 2003	1,750,000

Income Statement (extract) for the year ended 31 December 2003

Tax expense (note 1)	\$1,145,000

Balance Sheet at 31 December 2003 (extracts)

Current liabilities:	
Tax payable	\$1,000,000
Non-current liabilities	
Deferred tax (note 2)	\$1,750,000

☑ Solution Six

The International Accounting Standards Board's Framework for the preparation and presentation of financial statements (the Framework) defines a liability as:

a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources from the enterprise.

IAS 37 defines a provision as a liability of uncertain timing or amount. A provision is only recognised when:

- There is a present obligation (legal or constructive) arising as a result of a past event.
- It is probable (or more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation.
- A reliable estimate can be made of the amount of the obligation.

This definition is very similar to the one given in the IASB's Framework for a liability.

… a present obligation of the enterprise arising from past events.

A provision is a present obligation arising from a past event. The event must already have happened at the balance sheet date. If the event has not occurred, the entity may be able to avoid it, so a provision will not be made.

The obligation can arise from legal consequences or could be constructive. Constructive obligations arise out of past practice or as a result of promises previously made which have created the expectation that the organisation would honour its promise. Therefore a provision meets this part of the definition of a liability.

… the settlement of which is expected to result in an outflow of resources from the enterprise.

Settlement is probably going to result in an outflow of resources. If the outflow of resources is more likely than not to occur it can be expected to happen, thus meeting this part of the definition of a liability.

☑ Solution Seven

		$
Payments under the lease	5 × 21,000	105,000
Fair value		88,300
Finance charge		16,700

Finance charge spread using 5 years' sum of digits

		$
Yr 1	5/15 × 16,700 =	5,567
Yr 2	4/15 × 16,700 =	4,453
Yr 3	3/15 × 16,700 =	3,340
Yr 4	2/15 × 16,700 =	2,227
Yr 5	1/15 × 16,700 =	1,113

	Balance	*Finance charge*	*Repayment*	*Balance*
Yr 1	88,300	5,567	21,000	72,867
Yr 2	72,867	4,453	21,000	56,320
Yr 3	56,320	3,340	21,000	38,660
Yr 4	38,660	2,227	21,000	19,887
Yr 5	19,887	1,113	21,000	0

Income statement (extracts)

Year 1	*$*
Depreciation	17,660
Finance charge	5,567
Year 2	*$*
Depreciation	17,660
Finance charge	4,453

Balance sheet (extracts)

	$ Year 1	$ Year 2
Non-current assets at cost – leased	88,300	88,300
Provision for depreciation	17,660	35,320
Net book value	70,640	52,980
Liabilities – amounts due under leases		
Current liabilities	16,547	17,660
Non-current liabilities	56,320	38,660

SECTION C

Solution Eight

AZ – Income Statement for the year ended 31 March 2003

	$000	*$000*
Revenue		124,900
Cost of sales (W1)		(99,735)
Gross profit		25,165
Distribution costs (W4)	(9,573)	
Administration expenses (W3)	(16,045)	
Other operating expenses	(121)	(25,739)
Loss from operations		(574)
Finance cost (W7)	(1,278)	
Income from other fixed asset investments	1,200	(78)
Loss before tax		(652)
Income tax expense		(15)
Net loss for the period		(667)

Earnings per share	*Earnings*	*No. of Shares*	*Per Share*
	(667)	19,500	−3.4 cents per share

AZ – Statement of Changes in Equity for the year ended 31 March 2003

	Share capital	*Share premium*	*Accumulated profits*	*Total equity*
Balance at 31 March 2002	19,000	0	14,677	33,677
Issue of shares	1,000	500		1,500
Share issue costs		(70)		(70)
Net loss for the period			(667)	(667)
Dividends (W6)			(1,000)	(1,000)
Balance at 31 March 2003	20,000	430	13,010	33,440

AZ – Balance Sheet at 31 March 2003

	$000	$000	$000
Non-current Assets	*Cost*	*Depreciation*	*Net book value*
Property, plant and equipment (W9)	34,035	14,306	19,729
Current Assets			
Inventory		5,180	
Trade receivables (W8)		9,330	
Cash at bank & in hand		26,250	
			40,760
			60,489
Capital and Reserves			
Called up share capital		20,000	
Share premium account		430	
Accumulated profits		13,010	
			33,440
Non-current liabilities			
7% Loan notes (redeemable 2007)		18,250	
Other provisions		25	
			18,275
			51,715
Current liabilities			
Trade payables		8,120	
Tax		15	
Accruals (W7)		639	8,774
			60,489

Workings

W1 Cost of sales

Opening inventory	4,852	
Cost of goods manufactured in year	94,000	
	98,852	
Less closing inventory	(5,180)	
	93,672	
Add depreciation – plant and equipment (W2)	6,063	
	99,735	

W2 Depreciation

Plant and equipment, cost	30,315	
Depreciation for year @ 20%	6,063	(IS)
Depreciation b/f	6,060	
Depreciation c/f	12,123	(BS)

W3 Administration expenses

Per trial balance	16,020	
Provision for legal claim	25	
	16,045	

W4 Distribution expenses

Per trial balance	9,060	
Depreciation vehicles (W5)	513	
	9,573	

W5 Depreciation

Vehicles, cost	3,720	
Depreciation b/f	1,670	
	2,050	
Depreciation for year @ 25%	513	(IS)
Depreciation b/f	1,670	
Depreciation c/f	2,183	(B/S)

W6 Dividends

Dividends paid		
Ordinary dividend 0.05 × 20 million shares =	1,000	(SCE)

W7 Finance cost

7% interest on Loan notes	1,278	(IS)
Paid	639	
Accrued interest	639	(B/S)

W8 Trade receivables

	9,930
Provision for doubtful trade receivables	600
Trade receivables – Balance sheet	9,330

W9 Non-current assets

	Cost		*Depreciation*	
	Plant	*Vehicles*	*Plant (W2)*	*Vehicles (W5)*
Balance b/f	30,315	3,720	6,060	1,670
Depreciation			6,063	513
Balance c/f	30,315	3,720	12,123	2,183
Totals	34,035		14,306	

W10 EPS $-667/[19{,}000 + (1{,}000 \times 6/12)] = -667/19{,}500 = -3.4$ cents per share

Solution Nine

TEX – Cash Flow Statement for the year ended 30 September 2003

	$000	*$000*
Cash inflow from operating activities		
Cash receipts from customers (W1)	14,300	
Cash paid to suppliers and employees (W2)	(8,290)	
Cash generated from operations	6,010	
Interest paid	(124)	
Income taxes paid (W4)	(485)	
Net cash from operating activities		5,401
Cash flows from investing activities		
Purchase of property, plant and equipment (W6)	(8,000)	
Proceeds from sale of equipment	730	
Net cash used in investing activities		(7,270)
Cash flows from financing activities		
Proceeds from issue of share capital (W5)	3,019	
Repayment of long term borrowings	(1,200)	
Dividends paid (W3)	(1,000)	
Net cash from financing activities		819
Net decrease in cash and cash equivalents		(1,050)
Cash and cash equivalents at 30 September 2002		1,200
Cash and cash equivalents at 30 September 2003		150

Notes

(1) During the period the company acquired property, plant and equipment with an aggregate cost of $8 million. These were paid for by cash.

(2) Cash and cash equivalents consist of cash on hand and balances with banks. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts:

	2002	*2003*
	$000	*$000*
Cash on hand and balances with banks	1,200	150

Workings

	$000
W1 Cash receipts from customers	
Trade Receivables	
Balance at 30 September 2002	800
Revenue from Income statement	15,000
	15,800
Balance at 30 September 2003	1,500
Receipts	14,300
W2 Cash paid to suppliers and employees	
Cost of Sales	
Income Statement	9,000
Less depreciation (W6)	(2,640)
Less loss on disposal	(970)
Income Statement cost of sales	5,390
Less inventory at 30 September 2002	(1,100)
	4,290
Add inventory at 30 September 2003	1,600
Purchases	5,890
Trade Payables	
Balance at 30 September 2002	800
Purchases	5,890
	6,690
Less balance at 30 September 2003	(700)
Payments to suppliers	5,990
Total payments to suppliers and employees	
Payments to suppliers	5,990
Other expenses from Income Statement	2,300
Total	8,290
W3 Dividends	
Balance at 30 September 2002	600
Income statement	1,100
	1,700
Less balance at 30 September 2003	(700)
Paid	1,000
W4 Income Taxes	
Balance at 30 September 2002	
Taxes	685
Deferred tax	400
	1,085
Income Statement	1,040
	2,125
Less balance at 30 September 2003	
Taxes	(1,040)
Deferred tax	(600)
	485
W5 – Share capital	
Balance at 30 September 2002	7,815
Balance at 30 September 2003	10,834
Cash issue	3,019

W6 – Tangible non-current assets

Property	*Cost*	*Depreciation*
	$000	*$000*
Balance at 30 September 2002	8,400	1,300
Balance at 30 September 2003	11,200	1,540
Purchased	2,800	
Depreciation in year		240

Plant	*Cost*	*Depreciation*
	$000	*$000*
Balance at 30 September 2002	10,800	3,400
Less disposal	2,600	900
	8,200	2,500
Balance at 30 September 2003	13,400	4,900
Purchased	5,200	
Depreciation in year		2,400

Total purchases	*$000*
Property	2,800
Plant	5,200
	8,000

Total depreciation	
Property	240
Plant	2,400
	2,640