



ICPAR
Unlimited possibilities



CPA
RWANDA

Operational Level Financial Reporting (FR2.4) Workbook

Institute of Certified Public Accountants of Rwanda

January 2026

© ICPAR, 2026. All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means; electronic, mechanical, photocopying, recording, or otherwise; without the prior written permission of the Institute of Certified Public Accountants of Rwanda (ICPAR).

Published January 2026



Operational Level Financial Reporting (FR2.4) Workbook

Institute of Certified Public Accountants of Rwanda
January 2026

Acknowledgement.

We wish to formally acknowledge and appreciate all parties who contributed to the review and update of the revamped syllabus. Our sincere thanks go to the tutors and lecturers from various training institutions, our partners, and the Ministry of Finance and Economic Planning (MINECOFIN) for their valuable input, collaboration, and continued support.

Contents

Overview of the Module.....	1
Introduction to the Module.....	2
Unit A: Regulatory frameworks for financial reporting	4
Unit B: Development and presentation of financial and non-financial information for a single entity.....	37
Unit C: Financial reporting standards	78
Unit D: Preparation of the financial statements of group entities.....	176
Unit E: Analysis and interpretation of financial reports	206
Unit F: Developments in financial reporting regulations and practices.....	238
Unit G: Use of digital technologies.....	245



Overview of the Module

CPA level	Operational level
Title	Financial Reporting
Guided learning hours	120
Exam length	3 hrs

Introduction to the Module

The Operational Level Financial Reporting syllabus develops and builds upon knowledge and skills acquired in Financial Accounting from the Technical Level (or completed during CAT). The syllabus aim is for the candidate to be able to prepare and present financial reports for a single entity and groups in the private or public sector, and analyse and interpret financial reports, in the context of regulatory frameworks and continuing developments and advances in reporting.

The Financial Reporting syllabus is divided into seven parts.

The first part deals with the regulatory frameworks applicable to financial reporting in both the private and public sectors, with reference to legal requirements as well as accounting standards. The adoption of International Financial Reporting Standards is considered, as is the development of these standards. This first part of the syllabus also explores the need for a conceptual framework for financial reporting, and includes the qualitative characteristics of financial information and the fundamental bases of accounting applicable to both private and public sectors.

The syllabus then moves on to cover the development and presentation of financial and non-financial information. This section includes the main presentation and disclosure requirements applicable to single entities in accordance with International Financial Reporting Standards (IFRS Standards) and International Public Sector Accounting Standards (IPSAS Standards). It also introduces narrative reports including management commentary and sustainability reports.

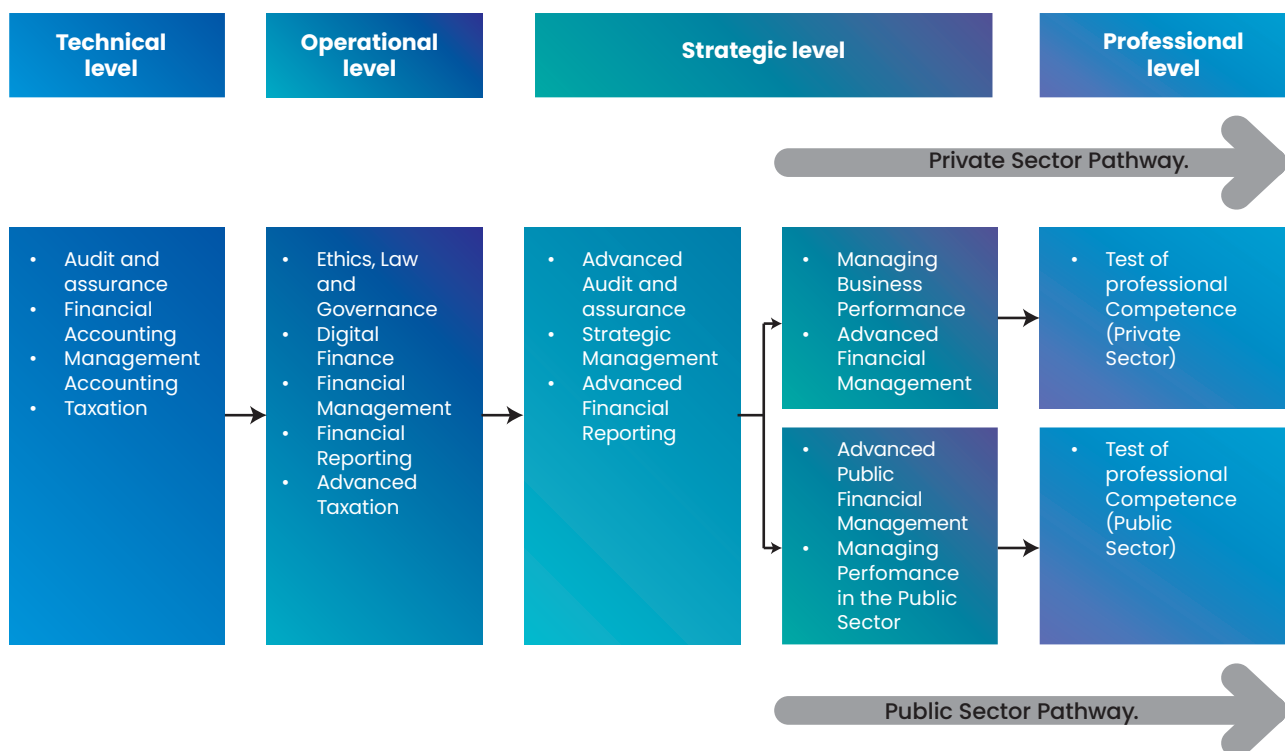
The third section of the syllabus covers the reporting requirements applicable to specific types of transactions, in accordance with IFRS Standards and IPSAS Standards. Here the emphasis is on IFRS Standards, with consideration of how IPSAS Standards differ.

The fourth part of the syllabus deals with group accounting and the preparation of the consolidated statement of profit or loss and consolidated statement of financial position for groups that include one subsidiary and may also include one associate.

The next part of the syllabus deals with analysis and interpretation of financial statements of a single entity and/or groups of entities with a focus on meeting the needs of different stakeholder groups and making appropriate recommendations to them.

The final two sections of the syllabus consider developments in financial reporting. The first of these refers to developments in the content of financial reports, including improvements to accounting standards; the second refers to developments in methods of reporting and analysing financial information, and specifically the use of digital technologies in order to process financial information more efficiently and effectively for the benefit of stakeholders.

This module is one of five completed at the operational level of the CPA.



Key competencies

- Discuss and evaluate developments in the regulatory frameworks for financial reporting in the private and public sectors.
- Develop and present financial and non-financial information in order to provide a holistic view of an organisation's performance for relevant stakeholders.
- Apply professional judgement to complex financial reporting issues for corporate entities and public sector organisations.
- Prepare the financial statements of groups of entities.
- Analyse and interpret financial reports, applying professional scepticism, communicate the implications effectively to different stakeholders and recommend suitable decisions.
- Monitor developments in financial reporting standards, regulation and business practices, assess the implications for the financial reporting function and recommend necessary changes to processes as appropriate.
- Discuss the application of digital technologies in accessing and analysing organisational reporting information, and in presenting this information as effectively as possible to stakeholders.

Unit A: Regulatory frameworks for financial reporting

Learning outcomes

- A1. Financial reporting framework in the private sector
- A2. Financial reporting framework in the public sector
- A3. The need for a conceptual framework

Introduction to Unit A

In this module we will be looking at the preparation and presentation of financial statements for companies and other organizations, including the way that standards and regulations are applied in that process. In order to properly understand the role of standards and regulations, it is important to first consider the overall regulatory framework, the constituent elements of the framework, how this interact, and how they develop over time.

In this unit, we will focus on the regulatory framework and discuss how it impacts on the preparation and presentation of financial statements in Rwanda. In doing so, we will, consider both the international and national contexts.

The regulatory framework

In simple terms, some regulation of the process of preparing financial statements is needed in order to provide a level of consistency in the way that different individuals and organisations approach this activity.

The framework does not provide complete uniformity, as pronouncements such as accounting standards usually allow some flexibility and some areas of subjective interpretation. But there would be much more variation in approach if the standards did not exist.

Another key reason why the framework is essential, is to provide greater levels of assurance to users of financial statements. The fact that, for example, the financial statements of a limited company must comply with International Financial Reporting Standards (IFRS), and the applicable company legislation, means that any user of these statements can assume that they follow the requirements set out in these documents.

The key users of the financial statements of limited company, the shareholders, can expect the financial statements of a company to be prepared and presented with the shareholders' interests in mind. IFRSs are written in a way that aims to provide relevant information to users, particularly to shareholders, and the Conceptual Framework (which

is discussed later in this unit) specifies a number of essential characteristics that the information provided in the statements needs to reflect.

Adoption of IFRS in Rwanda.

The term 'GAAP' refers to Generally Accepted Accounting Practice (or 'Principles'), which is a set of detailed accounting guidelines, standards, etc that together present the requirements that an entity is required to comply with in the preparation of their financial statements.

In Rwanda, the current arrangement is that the accounting standards issued by the International Accounting Standards Board (IASB) are at the centre of the financial reporting framework. Rwanda has made a commitment in support of moving towards a single set of high-quality global accounting standards (ie IFRS).

This commitment is reflected in national legislation. This is seen in the Rwanda Law Relating to Companies of 2009 (Companies Act), especially in Article 254 (which requires that all companies use International Accounting Standards), and the Law number 11/2008 of 06/05/2008 establishing the Institute of Certified Public Accountants of Rwanda (the ICPAR Law), which was published in the official Gazette of the Republic of Rwanda on 1 August 2008. The Rwanda Companies Act 2021 is the relevant law currently in place in Rwanda, and continues the requirements on accounting standards set out in the 2009 law.

Rwanda has adopted IFRS Standards and the IFRS for Small and Medium-sized Enterprises (SMEs) Standard as issued by the Board.

From 2008 the ICPAR Law made it explicit that, for public sector entities, the accounting standards shall be consistent with International Public Sector Accounting Standards (IPSAS), while in the private sector they shall be consistent with IFRS Standards.

The Law also requires that auditing standards are consistent with the International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC). Similar requirements were included in the Companies Act of Rwanda of 2021.

Under the law, if an SME is a company, then it is required to use the IFRS for SMEs Standard. SMEs that are not companies (such as proprietorships and partnerships) are permitted to use the IFRS for SMEs Standard.

The IFRSs in use in Rwanda are these as issued by the IASB in English – ie they are not modified or translated for application in Rwanda.

The ICPAR is the official accounting standards-setting body in Rwanda. The policy of the ICPAR is to adopt IFRS exactly as issued by the IASB rather than set national accounting standards.

IFRS Foundation and the International Accounting Standards Board

IASB members are responsible for the development and publication of IFRS Accounting Standards, including the IFRS for SMEs Accounting Standard. The IASB is also responsible for approving Interpretations of IFRS Accounting Standards as developed by the IFRS Interpretations Committee (formerly IFRIC).

Members are appointed by the Trustees of the IFRS Foundation through an open process, and there as a requirement for this to include a broad geographical diversity as well as the appropriate mix of practical experience in standards, accounting, auditing, accounting

education, etc.

Responding to the need for consistent and comparable sustainability information to inform economic and investment decisions, in 2021 the IFRS Foundation created the International Sustainability Standards Board (ISSB) which operates alongside the IASB. The ISSB develops IFRS Sustainability Disclosure Standards, designed to deliver a truly global baseline of sustainability disclosures to inform capital markets.

The IFRS Interpretations Committee (Committee) works with the IASB in maintaining and supporting the consistent application of IFRS Accounting Standards. The Committee responds to questions about the application of the Accounting Standards and does other work at the request of the IASB. The Committee comprises 14 voting members, appointed by the Trustees of the IFRS Foundation. The members provide the best available technical expertise and diversity of international business and market experience relating to the application of IFRS Accounting Standards.

The main activity of the IFRS Interpretations Committee (Interpretations Committee) is to discuss application questions from stakeholders and decide how to respond to those questions. Often the Interpretations Committee responds to a stakeholder's question by publishing an agenda decision with explanatory material. In such cases, the Interpretations Committee concludes that the principles and requirements in IFRS® Accounting Standards provide an adequate basis for companies to determine their accounting, so standard-setting is not needed. In other cases, the Interpretations Committee concludes that responding to a question requires adding to or changing IFRS Accounting Standards, by means of an IFRIC Interpretation or a narrow-scope amendment.

IFRS process

The IFRS Foundation has a highly regarded, inclusive and transparent due process for developing IFRS Standards. The IFRS Foundation's due process is outlined in its Constitution and in further detail in the Due Process Handbook.

The due process enables stakeholders all over the world to contribute to and scrutinise the standard-setting, helping us ensure the best thinking worldwide informs the development of the requirements.

The due process is essential both for developing high-quality IFRS Standards and for ensuring that stakeholders can be confident that all relevant views have been considered when the Standards are developed. The process builds trust, legitimacy and global acceptance of the Standards.

Three underlying principles make the due process robust:

- Transparency
- Full and fair consultation
- Accountability.

The Trustees, who are responsible for the governance of the IFRS Foundation, are also responsible for ensuring that the International Accounting Standards Board, the IFRS Interpretations Committee and the International Sustainability Standards Board follow the due process. The Trustees carry out this responsibility via their Due Process Oversight Committee (DPOC).

The elements of the IASB's standard-setting programme are outlined in the following table.

Agenda consultation	<p>Every five years, the IASB conducts a comprehensive review and consultation to define international standard-setting priorities and develop its project work plan.</p> <p>The IASB can also add topics to its work plan if necessary between agenda consultations. This can include topics following post-implementation reviews of Standards; the IFRS Interpretations Committee may also request the IASB review an issue.</p>
Research programme	<p>Most projects begin with exploring the issues, identifying possible solutions and deciding whether standard-setting is required. This may involve public consultation.</p> <p>If there is sufficient evidence that an accounting problem exists, the problem is sufficiently important to warrant changing an Accounting Standard or issuing a new one, and a practical solution can be found, the standard-setting process can begin.</p> <p>After a new Accounting Standard has been in use for a few years, the IASB carries out research through a post-implementation review to assess whether the Standard is achieving its objective and, if not, whether any amendments should be considered. As a result of the post-implementation review, the IASB may start a new research project.</p>
Standard-setting programme	<p>If the IASB decides to amend an Accounting Standard or issue a new one, they review the research, including comments on the discussion paper, and propose amendments or Accounting Standards to resolve issues that have been identified.</p> <p>Proposals for a new Accounting Standard or an amendment to an Accounting Standard are published in an exposure draft for public consultation. To gather additional evidence, members of the IASB and IFRS Foundation technical staff consult with a range of stakeholders from all over the world.</p> <p>The IASB analyses feedback and refines proposals before the new Accounting Standard, or an amendment to an Accounting Standard, is issued.</p>

Maintenance programme	<p>The IASB also supports consistent application of the Accounting Standards and maintenance of the Accounting Standards themselves.</p> <p>This process includes consulting on the implementation of a new or amended Accounting Standard to identify any implementation or application problems that may need to be addressed.</p> <p>If issues arise, the IFRS Interpretations Committee may decide to create an IFRIC Interpretation of the Accounting Standard or recommend a narrow-scope amendment. Such amendments follow the IASB's normal due process.</p>
-----------------------	--

The structure of the IASB has the following main features:

- The IFRS Foundation is an independent corporation having two main bodies – the Trustees and the IASB.
- The IFRS Foundation Trustees appoint the IASB members, exercise oversight and raise the funds needed. IASB members are appointed by the Trustees through an open and rigorous process that includes advertising vacancies and consulting relevant organisations. The main qualification for membership is professional competence and practical international business and market experience.
- The IASB has sole responsibility for setting accounting standards.
- There are also two further bodies, the IFRS Advisory Council and the IFRS Interpretations Committee, which support the IASB in its functions.

The Trustees comprise a group of 22 individuals, with diverse geographic and functional backgrounds. To ensure a broad international diversity, the constitution requires four members from the Asian/Oceania region, four from Europe; four from the Americas; one from Africa and one appointed from any area, subject to maintaining overall geographical balance. The Trustees' responsibilities include, but are not limited to:

- appointing members of the IASB, the IFRS Interpretations Committee and the IFRS Advisory Council;
- establishing and amending the operating procedures, consultative arrangements and due process for the IASB, the Interpretations Committee and the Advisory Council;
- reviewing annually the strategy of the IASB and assessing its effectiveness;
- ensuring the financing of the IFRS Foundation and approving its annual budget.

Six of the Trustees must be selected from the Asia/Oceania region, six from Europe, six from North America, one from Africa, one from South America and two from the rest of the world.

IFRS Advisory Council

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

of the Advisory Council are appointed by the Trustees.

IFRS Interpretations Committee (IFRIC)

The IFRS Interpretations Committee is the interpretative body of the IFRS Foundation.

The Committee is required to review on a timely basis any widespread accounting issues that have arisen within the context of current International Financial Reporting Standards (IFRSs). The work of the Committee is aimed at reaching consensus on the appropriate accounting treatment and providing authoritative guidance on those issues. This guidance takes the form of IFRIC interpretations.

The interpretations cover both:

- newly identified financial reporting issues not specifically dealt with in IFRSs; and
- issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance.

IFRIC interpretations are subject to IASB approval and have the same authority as a standard issued by the IASB.

The overall agenda of the IASB will be set initially by discussion with the IFRS Advisory Council. The process for developing an individual standard would involve the following steps:

Steps in the standard-setting process

In the table above, one of the elements of the IASB's programme is focused on setting new standards (or making amendments to existing standards). Looking at this part of its activities in more detail, we can identify six steps in the process from identifying an area that needs attention (eg a new standard) to issuing a final document, as described in the table below.

Step 1	IASB staff are asked to identify and review all the issues associated with the relevant topic and to consider the application of the Conceptual Framework. They may also study national accounting standards, as well as discuss the topic with national standards-setters.
Step 2	The Trustees and IFRS Advisory Council will be consulted about adding the topic to the IASB's agenda.
Step 3	The IASB may establish an Advisory Committee to give advice on issues arising in the project. Consultation with the Advisory Committee and the IFRS Advisory Council occurs throughout the project.
Step 4	A discussion document may be published for public comment.

Step 5	<p>An exposure draft (ED) is published for public comment.</p> <p>An ED is a draft version of the intended standard and must be approved by at least nine members.</p> <p>A basis for conclusions and any alternative views of any IASB members are also published.</p>
Step 6	<p>All comments received within the comment period are considered.</p> <p>An IFRS is then published. A basis for conclusions is also published, which includes any dissenting views of IASB members, public comments and the steps taken in the due process.</p>

Scope of IFRS

IFRSs apply to all general-purpose financial statements. General purpose financial statements aim to meet the needs of all financial statement users, for example, shareholders, lenders, employees and the public. A company's financial statements will be used by many different parties to help them make economic decisions, and for this reason, the IASB must ensure they always consider common information needs.

Although IFRSs are not designed with non-profit activities in mind, entities that engage in these activities (whether in the private or public sector) often find their application appropriate. IFRSs often form the basis of financial reporting in the public sector. For example, the International Public Sector Accounting Standards Board (IPSASB) prepares accounting standards for governments and other public sector entities, and these standards are based on IFRSs.

Compliance with IFRS

Financial statements should present fairly the financial position, financial performance and cash flows of an entity. In virtually all circumstances to achieve this fair presentation the entity must comply with all applicable IFRSs.

IFRSs set out the recognition (when items are included in the statements), measurement (how those items are valued), presentation (where and how should they be included in the statements) and disclosure requirements (are additional notes needed?) of transactions and events.

When an entity complies with all requirements of the applicable IFRSs, they must disclose this compliance in an 'explicit and unreserved' statement in the notes to the financial statements.

There are standards that allow more than one treatment for certain transactions or events. For example, the options of the cost and revaluation models in IAS 16 Property, Plant and Equipment, or the cost and fair value models in IAS 40 Investment Properties. The IASB aims to achieve consistency across different reporting entities and periods.

As set out in IAS 1, the overall requirements for the presentation of financial statements, in the rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework (see below) the entity should disclose:

- that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;
- that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;
- the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and
- for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

International harmonisation of standards

One of the IASB's objectives is to achieve harmonisation of accounting standards across the world. There is an assumption behind that objective, that there are benefits arising from IFRS standards that are not available through application of national standards.

One of the obvious benefits of adoption of IFRS across different countries is that there is then a level of consistency. A user can compare the financial statements of two companies from different countries and make meaningful comparisons, as they are both based on the same set of standards.

Another benefit is that expertise is pooled globally, so that IFRSs are developed through tapping into the expertise of accountants, auditors, accounting educators, etc from across the world, whereas national standards will tend to rely on the more limited expertise of local accountants.

Also, there is a benefit of greater independence. As IFRSs are controlled and developed through the IASB and its related bodies, it is less subject to the influence of the national politics or local self-interests that can affect national standards.

The following table summarises some key advantages of consistency, or global harmonisation, arising from the adoption and application of IFRSs. Note that similar conclusions can be made in respect of IPSAS in the public sector.

Advantages of harmonisation:	
Investors	Investors, both individual and corporate, would like to be able to compare the financial results of different companies internationally as well as nationally in making investment decisions.
Multinational companies	<p>Multinational companies would benefit from harmonisation for many reasons including the following:</p> <ul style="list-style-type: none"> • Better access would be gained to foreign investor funds; • Management control would be improved, because harmonisation would aid internal communication of financial information; • Appraisal of foreign entities for takeovers and mergers would be more straightforward; • It would be easier to comply with the reporting requirements of overseas stock exchanges; • Preparation of group accounts would be easier; • A reduction in audit costs might be achieved; and • Transfer of accounting staff across national borders would be easier.
Governments of developing countries	Governments of developing countries would save time and money if they could adopt international standards and, if these were used internally, governments of developing countries could attempt to control the activities of foreign multinational companies in their own country by requiring them to apply international accounting standards. These companies could not 'hide' behind foreign accounting practices which are difficult to understand.
Tax authorities	It will be easier to calculate the tax liability of investors, including multinationals which receive income from overseas sources, if the same accounting standards are used throughout the whole world.
Regional economic groups	Regional economic groups usually promote trade within a specific geographical region. This would be aided by common accounting practices within the region.
Large international accounting firms	Large international accounting firms would benefit as accounting and auditing would be much easier if similar accounting practices existed throughout the world

We should not ignore the fact that there are some potential downsides to the application of a single set of global standards:

Potential disadvantages of harmonisation:

- Different purposes of financial reporting, different legal systems and different user groups.
- Needs of developing countries, most of which are obviously behind in the standard-setting process. They need to develop basic standards and principles already in place in most developed countries.
- Nationalism is demonstrated in an unwillingness to accept another country's standards.
- Cultural differences result in objectives for accounting systems differing from country to country.
- Some countries may experience unusual circumstances affecting aspects of everyday life, impinging on the ability of companies to produce usual reports, for example hyperinflation, civil war, currency restrictions etc.
- Lack of strong accountancy bodies. Many countries do not have independent professional bodies that would enforce standards and harmonisation.

Public sector framework

As mentioned earlier in this unit, from 2008 the ICPAR Law made it explicit that, for public sector entities, the accounting standards shall be consistent with International Public Sector Accounting Standards (IPSAS), while in the private sector they shall be consistent with IFRS Standards.

The adoption of IPSAS in a country's public sector organisations is usually both a move from national regulations or standards to the use of international standards, and also a move from a cash basis of accounting to an accruals basis.

IPSAS standards consist of a full set of accruals-based accounting standards, similar in overall scope to IFRS (but with some important differences). The IPSAS Board (IPSASB) have also issued a separate standard for public sector entities that continue to prepare financial statements using the cash basis of accounting.

Although IPSASB include the Cash Basis IPSAS – Financial Reporting Under the Cash Basis of Accounting in their published documents, their stated preference is for organisations to move from cash accounting to the use of accruals accounting as the basis for their financial statements.

IPSAS

IPSAS are issued by the International Public Sector Accounting Standards Board. IPSASB focuses on the accounting and financial reporting needs of national, regional and local governments, related governmental agencies, and the constituencies they serve. IPSAS are generally based on International Financial Reporting Standards as adapted to the situation of the public sector.

IFRSs have been written with the needs of private sector companies in mind. Public and private sector organisations can have vastly different objectives, and so accounting

standards aimed at companies, with their focus on generating profits and returns for shareholders, may be inappropriate for the public sector. The underlying fundamental concepts are the same across all sectors, but the detailed requirements may need to be adapted for the public sector.

IPSAS are therefore written either where the equivalent IFRS/IAS does not deal comprehensively or appropriately with a financial reporting issue or for which there is no related IFRS. For example, there is no IFRS dealing with revenue from non-exchange transactions as private sector organisations rarely deal in non-exchange transactions, hence the rationale for issuing IPSAS 23 Revenue from Non-Exchange Transactions. Non-exchange transactions are where resources (eg cash) are received by the reporting entity without a directly related provision of goods or services of a similar value – eg tax revenue, fines, donations.

IPSASs are designed to apply to the general-purpose financial reports (GPFRs) of all public sector entities that meet the following criteria:

- Are responsible for the delivery of services to benefit the public and / or to redistribute income and wealth;
- Mainly finance their activities, directly or indirectly, by means of taxes and / or transfers from other levels of government, social contributions, debt or fees; and
- Do not have a primary objective to make profits.

GPFRs are financial reports intended to meet the information needs of users who are unable to require the preparation of financial reports tailored to meet their specific information needs.

International Public Sector Accounting Standards Board (IPSASB)

The governance arrangements for IPSASB are designed to demonstrate the legitimacy of a standard-setting organisation, including the independence of its members and the adequacy of technical expertise.

The governance of the IPSASB is overseen by its parent body the International Federation of Accountants (IFAC). IFAC is the global organisation for the accountancy profession. It works with its 175 members and associates in 130 countries and jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants. IFAC members and associates are primarily national professional accountancy bodies.

The IPSASB functions as an independent standard-setting body under the auspices of IFAC. It achieves its objectives by:

- Issuing International Public Sector Accounting Standards (IPSASs);
- Promoting their acceptance and the international convergence to these standards; and
- Publishing other documents which provide guidance on issues and experiences in financial reporting in the public sector.

The members of the IPSASB are appointed by the Board of IFAC. The IPSASB comprises 18 volunteer members, 15 of whom are nominated by the member bodies of IFAC and three of whom are appointed as public members. Each member has one vote.

The IFAC Nominating Committee seeks to ensure that IPSASB members possess appropriate technical expertise, knowledge of institutional arrangements encompassed

by its constituency, technical proficiencies of users, preparers and auditors, and a broad geographical spread. There are 10 international organizations with formal observer status including the International Monetary Fund (IMF), World Bank, and European Union (EU). Approximately 50% of the IPSASB's funding comes from IFAC, with the remaining 50% from various voluntary contributions from governments and observers.

IPSAS standard-setting process

The Preface to the International Public Sector Accounting Standards (IPSASs) sets out the objectives of the IPSASB and explains the scope and authority of the IPSASs. The IPSASB are responsible for producing IPSASs and have a structured process to follow when doing so. The principal consideration that the IPSASB must take when producing standards is to ask whether the equivalent IFRS is suitable for their needs or requires modification to be applicable in the public sector. Key elements of the IPSASB's development process are set out in its Terms of Reference and in Guidelines or "rules of the road" for modifying IFRSs for application by public sector entities.

In particular, the Terms of Reference sets out the following parts of the process:

- The IPSASB supports the convergence of international and national public sector accounting standards and the convergence of accounting and statistical bases of financial reporting where appropriate.
- The IPSASB follows due process in the development of all IPSASs through Exposure drafts and Consultation papers.
- Comments received as a result of the exposure process are considered by the IPSASB and the exposure draft is revised as appropriate.
- Approval of exposure drafts, re-exposure drafts and IPSASs is made by the affirmative vote of at least two-thirds of the members.

The guidelines provide more detail on current approaches, explaining that the IPSASB develops International Public Sector Accounting Standards (IPSASs) to address public sector financial reporting issues in two different ways:

1. By addressing public sector financial reporting issues:
 - That have not been comprehensively or appropriately dealt with in existing International Financial Reporting Standards (IFRSs), or
 - For which there is no related IFRS.
2. By developing IPSASs that are converged with IFRSs by adapting them to the public sector context, in line with a 4-step process as follows:
 - Step 1: Are there public sector issues that warrant departure?
 - Step 2: Should a separate public sector project be initiated?
 - Step 3: Modify IASB documents
 - Step 4: Make IPSASB style and terminology changes to IASB documents.

The need for public sector standards

Government bodies across the world prepare financial statements with very similar objectives in mind. However, the 'user manual' in each national jurisdiction may vary to take account of the local environment in which entities operate. Consequently, the same transaction may be accounted for in a number of different ways depending on which version of the 'user manual' is used: for example, the one for the UK, for the US, for Australia or for Japan. Such significant differences reduce the comparability and usefulness of financial statements. While national variations in accounting practices have endured for many years, more recently there has been pressure to harmonise financial reporting practice and regulation on a global basis in order to reduce inconsistencies.

Cash and accruals accounting

As mentioned above, there are two types of IPSAS: cash basis and accruals basis. The standard, Financial Reporting under the Cash Basis of Accounting was revised and re-issued in 2017. It comprises two Parts:

- Part 1 of the standard is mandatory for all public sectors preparing financial statements under the cash basis
- Part 2 is not mandatory, but identifies additional accounting policies and disclosures that organisations are encouraged to adopt in order to enhance the usefulness of financial statements.

The standard includes guidance on the transition process from cash to accruals basis.

Whilst the IPSASB hopes that all government entities will eventually be able to adopt an accruals-based accounting system, following the requirements of the cash basis IPSAS will nevertheless enhance transparent and comprehensive financial reporting. The accruals-based IPSASs focus on revenue, cost, assets, liability and equity, rather than only reporting cash transactions.

The basis of accounting that will be required for most financial statements that are covered in this module is the accruals basis. This basis relies on use of the accruals and matching concepts, recognising income when it is earned and expenditure when it is incurred regardless of cash the timing of cash transactions. The accruals concept gives rise to the concept of surpluses and deficits (as shown in the IPSAS statement of financial performance or the IFRS statement of profit or loss), as well as various balances existing at the year-end (as shown in the statement of financial position).

An alternative approach is the use of the cash basis of accounting. Cash accounting involves recording receipts and payments only, which show the value of money received and paid. Cash accounting is a lot simpler to apply and understand, but gives us information that is far less useful and less reliable and is more prone to manipulation. This is because it is easier to manipulate the timing of cash transactions in order to record receipts and payments in a particular accounting period. The table below summarises the main advantages and disadvantages of each approach:

Accruals basis	Cash basis
Advantages	
The recognition of assets and liabilities improves the management of those elements	Simple and objective
Provides information on the full cost of services which aids government policy and decision making and may assist improved economic performance	Useful for assessing compliance with cash budgets
Focuses on retaining and upgrading assets, as well as spending, so examines a broader range of options for managing assets	Useful for monitoring and estimating a government's cash resources
Assets may be revalued and are reviewed for impairments so that the quality of information is improved when making asset assessments	
Revenues and expenses are recognised making performance measurement more reliable	
Gives useful information about an entity's level of liabilities	
Disadvantages	
Technically complex and contains elements of subjectivity	Fails to show a full picture of financial position and performance
Costly to implement – adequate accounting systems, training	Prevents decision makers from making future predictions
	Does not provide full total cost of services
	Focuses on spending on new assets rather than retaining or upgrading
	Users are unaware of true level of liabilities.

Conceptual Framework

Both the IASB and IPSASB have developed and published a Conceptual Framework that applies to their standard setting activities.

The conceptual framework is a body of interrelated objectives and fundamentals. The objectives identify the goals and purposes of financial reporting, and the fundamentals

are the underlying concepts that help achieve those objectives.

The key aim of the Conceptual Framework is to provide a set of accepted accounting principles that can be used by standard setters. The Framework then enables a consistent approach to this development of new standards.

The purposes of the IASB Conceptual Framework are as follows:

1. To assist the IASB in the development of IFRSs that are based on consistent concepts.
2. To assist preparers of financial statements develop consistent accounting policies when no Standard exists or when a Standard allows an accounting policy choice.
3. To assist all parties to understand and interpret the Standards.

The Conceptual Framework is not an accounting standard and so does not overrule any individual Standard. When developing or amending Standards, the Board may have to depart from the Conceptual Framework. In this case the departure will be explained in that Standard.

The IASB Conceptual Framework consists of eight chapters:

1. The objective of general-purpose financial reporting
2. Qualitative characteristics of useful financial information
3. Financial statements and the reporting entity
4. The elements of financial statements
5. Recognition and derecognition
6. Measurement
7. Presentation and disclosure
8. Concepts of capital and capital maintenance

Qualitative characteristics

This chapter sets out the characteristics that information in financial statements should have to make them useful and help with decision making.

The chapter identifies two fundamental characteristics and four enhancing characteristics.

Fundamental characteristics	
Relevance	<p>Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.</p> <p>The relevance of information is also impacted by the size of the item, and this is known as materiality.</p> <p>Information is material if omitting it or misstating it could reasonably be expected to influence decisions that the primary users of general purpose make on the basis of those reports</p>

Faithful representation	<p>To be a faithful representation, information must be complete, neutral, and free from error.</p> <p>Complete means to include all information necessary for a user to understand the phenomenon being depicted, including necessary descriptions and explanations.</p> <p>Neutral means without bias in the selection or presentation of financial information.</p> <p>Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced.</p>
Enhancing characteristics	
Comparability	<p>Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items.</p> <p>Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or date. The disclosure of accounting policies will improve comparability</p>
Verifiability	<p>Verifiability means that different knowledgeable and independent observers could reach consensus although not necessarily complete agreement, that a particular depiction is a faithful representation.</p> <p>Consistency means using the same methods for the same items and this will enable the goal of comparability to be met. For example, the cash balance on the Statement of financial position can be reconciled to the bank statement, therefore it faithfully represents the entity's cash figure.</p>
Timeliness	<p>Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is.</p> <p>For example publication of financial statements twelve months after the year end would not be useful as it is so out of date.</p>
Understandability	<p>Classifying, characterising and presenting information clearly and concisely makes it understandable.</p> <p>The Framework states that financial reports are prepared for users who have a reasonable knowledge of business and therefore does mean that everybody should understand them. Areas of complexity should not be excluded on the basis that the majority of users would not understand them. The users may need to consult an expert for explanation.</p>

Going concern assumption

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future.

The elements of financial statements

Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

The elements relating to financial position are listed and defined in the following table:

Asset	<p>A present economic resource controlled by an entity as a result of past events.</p> <p>An economic resource is a right that has the potential to produce economic benefits.</p> <p>The Conceptual Framework explains that the right to produce an economic benefit can arise from the obligation of another party or the right over physical objects. For example, a trade receivables arises from the obligation of the other party to pay cash.</p> <p>The potential to produce economic benefit does not need to be certain or likely it just needs to exist. However, if there is a low probability this will impact on the measurement and recognition of the asset.</p> <p>Control links an economic resource to an entity and control arises from the entities present ability to direct the use of an asset. Control can arise even if the entity does not have legal ownership such as when a right-to-use asset is recognised.</p>
Liability	<p>A present obligation of the entity to transfer an economic resource as a result of the past events</p> <p>An obligation is a duty or responsibility that the entity has no practical ability to avoid</p>
Equity	<p>The residual interest in the assets of the entity after deducting all its liabilities.</p>
Income	<p>Increases in assets, or decreases in liabilities, that results in increase in equity, other than those relating to contributions from equity holders.</p>
Expenses	<p>Decreases in assets, or increases in liabilities, other than those relating to distributions to equity holders</p>

Recognition of the elements of financial statements

Recognition is the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements.

The recognition criteria in the Conceptual Framework are:

- It meets the definition of an element, and
- It provides users with information that is relevant and a faithful representation of the item.

The relevance of an item may be affected by the low probability of economic benefits and uncertainty over its existence. The faithful representation of an item may be affected if there is a high degree of uncertainty.

For example, Company A acquired a licence for Rwf 10 million, which gives the right to broadcast on a satellite television for five years. This is an intangible asset as there is an economic resource that Company A controls as a result of a past event.

Measurement

When an element is recognised in the financial statements, it needs to be quantified at a monetary amount. The two measurement bases referred to in the Conceptual Framework are historical cost and current value.

- Historical cost means that transactions are recorded at the original price of that transaction. For example, the historic cost of an asset would be the original purchase price paid on acquisition or the price when the asset was created for example manufactured . The historical asset will be updated as the asset is consumed via depreciation or if it is impaired in value.
- Current value means that the transactions are measured by reference to up-to-date information at the measurement. The table below summarises different approaches to determining the current value of an item.

Current value measurement basis	Definition
Fair value	Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.
Value in use or fulfilment value	<p>Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal.</p> <p>Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability.</p>

Current value measurement basis	Definition
Current cost	<p>Current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date</p> <p>Current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date.</p>

The factors that should be considered in selecting a measurement basis are the fundamental characteristics of relevance and faithful representation.

Relevance will consider the characteristics of the asset or liability and the contribution to future cash flows.

Examples of when assets and liabilities are valued at each of the measurement bases are presented below.

Measurement basis	Examples
Historical cost	<ul style="list-style-type: none"> Tangible non-current assets such as computers, vehicles and machinery which are recognised initially at cost and not revalued (IAS 16). Intangible non-current assets such as development costs which are not revalued (IAS 38). Trade payables.
Fair value	<ul style="list-style-type: none"> Land and buildings held at current cost as permitted by IAS 16. Investment properties held at fair value as permitted by IAS 40.
Value in use	<ul style="list-style-type: none"> Impairment – write-down of non-current asset to fair value less costs to sell.
Fulfilment value	<ul style="list-style-type: none"> Lease liabilities (IFRS 16). Long term provisions discounted to today's value (IAS 37).

Presentation and disclosure

Chapter 7 of the Conceptual Framework states that the primary source of information about performance of an entity should be in the statement of profit or loss, and in principle all income and expenses should be included in the profit or loss.

The Board concluded that in exceptional circumstances they might exclude items from the statement of profit or loss and include them in 'other comprehensive income'. The decision to include items in other comprehensive income will be based on this, providing a more relevant and faithful representation.

IPSASB Conceptual Framework

As mentioned, the IPSASB's Conceptual Framework is similar in format and content to the IASB version summarised above, but there are some important additional features that reflect key differences in the accounting requirements in the public sector.

Non-exchange transactions

One of the main characteristics of public sector entities as a whole is that a major part of their revenue is received as taxation or other mandatory payments by citizens or companies, rather than being paid in exchange for good and services. Many public sector bodies also receive donations or grants. A major part of their expenditure involves making payments or providing services for no fee, a nominal amount, or an amount which will not recover costs. These may include payments to relieve poverty, debt forgiveness, and other social expenditures.

These 'non-exchange transactions', in which the parties do not make exchanges of approximately equal value, are a characteristic feature of public sector financial reporting. Non-exchange transactions arise rarely if at all in the private sector, and consequently there is no IFRS covering non-exchange transactions. After considering such transactions, the IPSAS Board developed a standard to prescribe the financial reporting requirements of revenue arising from non-exchange transactions.

In a non-exchange transaction, an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without receiving approximately equal value in exchange.

The objective of IPSAS 23 Revenue From Non-Exchange Transactions (Taxes And Transfers) is to set out requirements for the financial reporting of non-exchange revenue. IPSAS 23 applies to revenues from the following transactions and events:

- Taxes, from whatever source.
- Other non-exchange revenue (called 'transfers' in the standard), such as grants, fines, bequests, gifts, donations, and services-in-kind.

IPSAS 23 does not apply to:

- Revenue from exchange transactions
- Public sector combinations
- Changes in fair value of financial instruments and other assets
- Agriculture assets

The same principles apply to the recognition of revenue from non-exchange transactions as for other revenue. Revenue collected on behalf of third parties (including other government organisations) is not counted as part of the entity's revenue. Revenue is recognised when:

- It is probable that future economic benefits or service potential will flow to the entity.
- The amount of revenue can be measured reliably.

Approved budgets

IPSAS 24 Presentation of Budget Information in Financial Statements requires a comparison of budget amounts and the actual amounts to be included in the financial statements of entities that are required to, or elect to, make publicly available their approved budget(s) and for which they are, therefore, held publicly accountable. IPSAS 24 also requires disclosure of an explanation of the reasons for material differences between the budget and actual amounts.

IPSAS 24 aims to ensure that public sector entities demonstrate accountability and enhance the transparency of their financial statements by showing how they have complied with the approved budget(s) for which they are held publicly accountable.

The approved budget is the expenditure authority derived from laws, appropriation bills, government ordinances and other decisions related to the anticipated revenue or receipts for the budgetary period.

Longevity of the public sector

The Preface to the IPSASB Conceptual Framework refers to 'the nature of public sector programmes and the longevity of the public sector.

This refers to the fact that many public sector programmes are long-term, and the ability to meet commitments depends on future taxation and contributions. Many commitments arising from such programmes and the powers to levy future taxation do not meet the definition of a liability or an asset, and therefore are not reflected in the financial statements.

It follows that financial statements can not provide all the information that users need in relation to long-term programmes, particularly those delivering social benefits.

An interesting example of the approach of IPSASB to this issue is in the measurement of expenses and liabilities in IPSAS 42 Social Benefits. IPSAS 42 defines social benefits as cash transfers paid to specific individuals and/or households to mitigate the effect of social risk. Examples provided in the standard include state retirement benefits, disability benefits, income support and unemployment benefits.

The standard requires an entity to recognize an expense and a liability for the next social benefit payment. This will usually be a short-term liability, as only the next payment of social benefit expenditure needs to be accounted for. This means that, although a government may have an obligation to pay state retirement benefits for several year, the liability in the financial statements will only show the amount related to the next payment (eg for one month).

Assets and liabilities in the public sector

Some differences between standards under IFRS and IPSAS arise from the fact that assets in the public sector may be held for their service potential rather than their ability to generate cash flows; eg a school or a hospital. Many public sector assets are also specialised, with no discernible market associated with them (eg military assets, infrastructure assets).

For example, these differences are reflected in the following areas:

- Impairment. Under IPSAS, there are two separate standards for impairment: IPSAS 26 focusing on cash-generating assets (and using a similar approach to IAS 36), and

IPSAS 21 dealing with non-cash-generating assets. The calculation of 'value in use' is the main difference, as the future cash flows are not a relevant basis for valuing non-cash-generating assets.

- Property, plant and equipment. IPSAS 17 includes content on valuation of specialised assets, heritage assets (ie assets held for their historical or cultural value, such as a palace or parliament building, rather than their functional use), infrastructure assets (roads, sewerage systems, etc).

Regulatory role of public sector entities

One of the roles of government is to regulate entities that operate in specific sectors of the economy, in order to safeguard the public interest (eg to control pollution, or to ensure safety of the public). Judgement is required to determine whether such regulatory activities create rights or obligations and therefore lead to recognition of assets and liabilities.

Statistical reporting

As well as presenting financial statements, governments may also provide Government Financial Statistics (GFS) on the General Government Sector (GGS) for the purposes of macroeconomic analysis and decision making.

There is some overlap between IPSAS and GFS. Both are concerned with financial, accruals-based information, and include content on assets, liabilities, revenue, expenses, and cash flows. However, the objectives of financial reporting by public sector entities are to provide information about the reporting entity that is useful to users for accountability and decision making. GFS, on the other hand, is more concerned with evaluating the impact of the GGS and broader public sector on the economy, within the complete macroeconomic statistics framework.

The different objectives and focus on different reporting entities lead to different treatment of some transactions and events. The IPSASB has a policy of reducing unnecessary differences between IPSAS and GFS reporting guidelines, where appropriate. The IPSASB decided that the objectives of financial reporting are better served by developing characteristics that are based on IPSASB's current and developing literature over which it has control rather than relying on third-party guidelines.

Reporting entity

Whether dealing with public sector or private sector, it is essential to clarify what the reporting entity is, otherwise financial statements are of limited use to users.

In some situations in the public sector, there may be some difficulty in determining the boundaries of a reporting entity, and this can lead to potential confusion. For example, a central government ministry may have policy responsibilities that include the work of agencies and other bodies, and the financial statements of the ministry must clarify whether the figures include the other bodies or not.

Where issues of control or significant influence are relevant, the requirements of the IPSAS dealing with consolidated financial statements, associates, joint ventures, and business combinations will need to be applied.

The Conceptual Framework identifies two key characteristics of a public sector reporting entity:

- It is an entity that raises resources from, or on behalf of, constituents and/or uses resources to undertake activities for the benefit of, or on behalf of those constituents, and
- There are service recipients or resource providers dependent on financial reports of the entity for information for accountability or decision-making purposes.

General Purpose Financial Reports (GPFRs) are prepared to report information that is useful to users for accountability and decision-making purposes. Service users are identified as the primary users of GPFRs. This means that a key characteristic of a reporting entity is the existence of service recipients or resource providers who are dependent on GPFRs.

Elements of public sector financial statements

The elements identified in the IPSASB Conceptual Framework are very similar to those in the IFRS document, but there is some difference in terminology:

Asset	<p>A resource presently controlled by the entity as a result of past events.</p> <p>A resource is an item with service potential or the ability to generate economic benefits.</p> <p>Some resources embody an entity's rights to a variety of benefits, including the right to provide services, to convert the resource into cash through its disposal, to benefit from the resource's appreciation in value, etc.</p> <p>Service potential is the capacity to provide services that contribute to achieving the entity's objectives, not necessarily through generating cash flows.</p> <p>Economic benefits are cash inflows or reduction in cash outflows.</p>
Liability	<p>A present obligation of the entity for an outflow of resources as a result of the past events</p> <p>A present obligation is a legally binding obligation, or a non-legally binding obligation that an entity has little or no realistic alternative to avoid.</p> <p>Non-legally binding obligations that give rise to obligations have the following attributes:</p> <ul style="list-style-type: none"> • The entity has indicated to other parties that it will accept certain responsibilities. • The entity has created a valid expectation that it will discharge these responsibilities. • The entity has little or no realistic alternative to avoid settling the obligation.

Ownership contributions and ownership distributions	<p>Ownership contributions are inflows of resources to an entity, contributed by external parties in their capacity as owners, which establish or increase an interest in the net financial position of an entity.</p> <p>Ownership distributions are outflows of resources to an entity, distributed to external parties in their capacity as owners, which return or reduce an interest in the net financial position of an entity.</p>
Revenue	Increases in the net financial position of the entity, other than increases arising from ownership contributions
Expenses	Decreases in the net financial position of the entity, other than increases arising from ownership contributions

Recognition

Chapter 6 of the IPSASB Conceptual Framework states that the recognition criteria are that:

- An item satisfies the definition of an element, and
- Can be measured in a way that achieves the qualitative characteristics, and takes account of constraints on information in GPFRs.

All items that satisfy the recognition criteria are recognised in the financial statements.

Recognition involves an assessment of uncertainty related to the existence and measurement of the element.

Derecognition is the process of evaluating whether changes have occurred since the previous reporting date that warrant removing an element from the financial statements, and removing the item if appropriate.

Measurement

The objective of measurement, according to Chapter 7 of the IPSASB Conceptual Framework, is to select those measurement bases that most fairly reflect the cost of services, operational capacity, and financial capacity of the entity in a manner that is useful in holding the entity to account, and for decision making.

The choice of measurement basis for assets and liabilities affects how a user assesses the cost of services provided, the operational capacity of the entity, and capacity to fund its activities.

The following table summarises the measurement bases for assets. Note that some bases are more related to the purchase of an item, whereas others are related to its sale. Also, some amounts are specific to the entity, whereas others are more likely to be related to various entities within a market.

Measurement basis	Entry (purchase) or exit (sale)	Observable in a market or not	Entity specific or not
Historical cost	Entry	Generally observable	Entity-specific
Market value in active market	Both	Observable	Not
Market value in inactive market	Exit	Depends on valuation technique	Depends on valuation technique
Replacement cost	Entry	Observable	Entity-specific
Net selling price	Exit	Observable	Entity-specific
Value in use	Exit	Unobservable	Entity-specific

Notes:

- Historical cost is the consideration given to acquire or develop an asset at the time of acquisition or development
- Market value is the amount for which an asset can be exchanged between knowledgeable, willing parties in an arm's length transaction
- Replacement cost is the most economic cost required for the entity to replace the service potential of an asset
- Net selling price is the amount that the entity can obtain from the sale of the asset, after deducting the costs of sale
- Value in use is the present value to the entity of the asset's remaining service potential or ability to generate economic benefits

The following table summarises the measurement bases for assets

Measurement basis	Entry or exit	Observable in a market or not	Entity specific or not
Historical cost	Entry	Generally observable	Entity-specific
Cost of fulfilment	Exit	Not	Entity-specific
Market value in active market	Both	Observable	Not
Market value in inactive market	Exit	Depends on valuation technique	Depends on valuation technique

Measurement basis	Entry or exit	Observable in a market or not	Entity specific or not
Cost of release	Exit	Observable	Entity-specific
Assumption price	Entry	Observable	Entity-specific

Notes:

- Historical cost is the consideration received to assume an obligation, or the value of the other consideration received at the time the liability is incurred
- Cost of fulfilment is the costs that the entity will incur in fulfilling the obligations represented by the liability
- Market value is the amount for which the liability can be settled between knowledgeable, willing parties in an arm's length transaction
- Replacement cost is the most economic cost required for the entity to replace the service potential of an asset
- Cost of release is the amount of an immediate exit from the obligation (eg repaying a loan early)
- Assumption price is the term used in the context of liabilities to refer to the same concept as replacement cost for assets; ie the amount the entity would be willing to accept in exchange for assuming the existing liability

Summary of Unit A and key learning outcomes

Unit A deals with the key competency 'Discuss and evaluate developments in the regulatory frameworks for financial reporting in the private and public sectors'. In this unit, we looked at the following learning outcomes:

Learning outcome	
Financial reporting framework in the private sector	You should now be able to describe the financial reporting framework of the private sector, including the impact of legislation and IFRS, and the role of the IASB and related bodies.
Financial reporting framework in the public sector	You should now be able to describe the financial reporting framework of the public sector, including the impact of legislation and IPSAS, and the role of the IPSASB and related bodies.
The need for a conceptual framework	You should now be able to summarise the key content of the Conceptual Frameworks of both IASB and IPSASB in relation to elements of financial statements, qualitative characteristics of information, recognition, measurement, and presentation.

Quiz questions

1	Learning Outcome: A1
Which of the following sets out the requirement for all companies in Rwanda to prepare financial statements in compliance with IFRS?	
A	ICPAR Law 2008
B	IASB Conceptual Framework
C	Rwanda Companies Act 2021
D	International Accounting Standard (IAS) 1, Presentation of Financial Statements

1	Feedback
A	Incorrect Rwanda Companies Act 2021
B	Incorrect Rwanda Companies Act 2021
C	Correct
D	Incorrect Rwanda Companies Act 2021

2	Learning Outcome: A1
Which of the following areas of IASB activity includes consulting on the implementation of a new or amended standard to identify any implementation or application problems?	
A	Agenda consultation
B	Maintenance programme
C	Research programme
D	Standard-setting programme

2	Feedback
A	Incorrect Maintenance programme
B	Correct
C	Incorrect Maintenance programme
D	Incorrect Maintenance programme

3	Learning Outcome: A1
Which of the following has responsibility for reviewing any widespread accounting issues arising in the context of IFRS?	
A	IFRS Interpretations Committee (IFRIC)
C	IFRS Advisory Council
B	IASB
D	IPSASB

3	Feedback
A	Correct
B	Incorrect IFRS Interpretations Committee (IFRIC)
C	Incorrect IFRS Interpretations Committee (IFRIC)
D	Incorrect IFRS Interpretations Committee (IFRIC)

4	Learning Outcome: A1
If the management of a company conclude that compliance with the requirements of an IFRS would be misleading, which of the following actions should be taken?	

A	They should disclose that the entity has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation
B	They should disclose that the financial statements have been modified
C	They should disclose that the financial statements do not comply with IFRS
D	They should add a note to show the effects of non compliance on relevant items in the financial statements

	Feedback
A	Correct
B	Incorrect They should disclose that the entity has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation
C	Incorrect They should disclose that the entity has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation
D	Incorrect They should disclose that the entity has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation

5	Learning Outcome: A1
Which of the following statements is true?	
A	One of the IASB's roles is to impose the use of IFRS in all public sector entities across the world
B	One disadvantage of international harmonisation of accounting standards is that appraisal of foreign entities for takeovers and mergers would be more difficult
C	One of the IASB's objectives is to achieve harmonisation of accounting standards across the world

D	One of the advantages of the international harmonisation of accounting standards is that it overcomes problems of hyperinflation
---	--

5	Feedback
A	Incorrect One of the IASB's objectives is to achieve harmonisation of accounting standards across the world
B	Incorrect One of the IASB's objectives is to achieve harmonisation of accounting standards across the world
C	Correct
D	Incorrect One of the IASB's objectives is to achieve harmonisation of accounting standards across the world

6	Learning Outcome: A2
Which of the following statements is true?	
A	IPSAS standards all use the cash basis of accounting
B	Each IPSAS standard includes guidance on both accruals and cash basis accounting treatments
C	The early IPSAS standards were designed for use in cash basis accounting, and more recent IPSAS standards reflect accruals basis accounting
D	IPSAS standards consist of a full set of accruals-basis standards and one separate cash-basis standard

6	Feedback
A	Incorrect IPSAS standards consist of a full set of accruals-basis standards and one separate cash-basis standard
B	Incorrect IPSAS standards consist of a full set of accruals-basis standards and one separate cash-basis standard

C	Incorrect IPSAS standards consist of a full set of accruals-basis standards and one separate cash-basis standard
D	Correct

7	Learning Outcome: A2
Which of the following is an advantage of financial statements that are prepared using the cash basis of accounting?	
A	They provide information on an entity's liabilities
B	They provide information on the full cost of services
C	They are simple to prepare and do not rely on subjective judgement
D	They include disclosure of increases in the value of assets in the period

7	Feedback
A	Incorrect They are simple to prepare and do not rely on subjective judgement
B	Incorrect They are simple to prepare and do not rely on subjective judgement
C	Correct
D	Incorrect They are simple to prepare and do not rely on subjective judgement

8	Learning Outcome: A3
Which of the following does the IASB Conceptual Framework describe as information that is complete, neutral, and free from error?	
A	Relevance
B	Understandability
C	Reliability

D	Faithful representation
---	-------------------------

8	Feedback
A	Incorrect Faithful representation
B	Incorrect Faithful representation
C	Incorrect Faithful representation
D	Correct

9	Learning Outcome: A3
Which of the following terms is required to complete the IASB Conceptual Framework's definition of fulfilment value: 'Fulfilment value is the _____ of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability'?	
A	Present value
B	Current cost
C	Historical cost
D	Real cost

9	Feedback
A	Correct 'Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability'
B	Incorrect 'Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability'
C	Incorrect 'Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability'

D	Incorrect 'Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability'
---	--

10	Learning Outcome: A3 Which of the following does the IPSASB Conceptual Framework define as 'inflows of resources to an entity, contributed by external parties in their capacity as owners, which establish or increase an interest in the net financial position of an entity'?
A	Ownership distributions
B	Ownership contributions
C	Present obligations
D	Revenue

10	Feedback
A	Incorrect Ownership contributions
B	Correct
C	Incorrect Ownership contributions
D	Incorrect Ownership contributions

Unit B: Development and presentation of financial and non-financial information for a single entity

Learning outcomes

- B1. Preparation of financial statements
- B2. Financial statement disclosure requirements
- B3. Non-financial reporting

Introduction to Unit B

In Unit B we will look at the development and presentation of both financial and non-financial information in the financial statements of a company.

As part of this unit, we will consider some specific technical aspects of financial reporting, including the way in which changes in accounting policies and estimates are accounted for, issues of foreign currency transactions, discontinued operations, and earnings per share reporting. Further technical issues are followed up in Unit C.

B1. Preparation of financial statements

Preparation of private sector financial statements - IFRS

As mentioned in the introduction, much of the technical accounting issues for this module are the focus of Unit C, for single entities, and in Unit D for consolidated financial statements, and in Unit B we will limit our attention initially to the overall requirements of the main financial statements.

Components of financial statements

Financial statements comprise:

- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changes in equity
- Statement of cash flows

- Accounting policies and notes to the accounts
- Comparative information for the previous period

Each of the statements should be presented with equal prominence.

IAS 1 Presentation of Financial Statements also requires disclosure of the following information in a prominent position:

- Name of the reporting enterprise
- Whether the accounts cover the single enterprise only or a group of enterprises
- The reporting date or the period covered by the financial statements as appropriate
- The reporting currency
- The level of precision used in presenting the figures in the financial statements (for example, Rwf '000 or Rwf million).

Note that other reports prepared by an enterprise and included in its annual report are not part of the financial statements, for example, a management review of performance, environmental reports and value-added reports.

Statement of financial position

The statement of financial position is a financial statement that shows a company's assets, liabilities and equity of a company, at a point in time.

The statement of financial position is often referred to as a balance sheet. IAS 1 does not prescribe a format for the statement of financial position (SFP). Therefore it would be acceptable to present the statement of financial position as

'assets – liabilities = equity' or

'total assets = total equity + total liabilities'.

The example given in IAS 1 follows the approach of 'total assets = total equity + total liabilities'.

The following is an example of a statement of financial position for a single entity, a limited company

Statement of financial position as at 31 March 20X5

Assets	Rwf million	Rwf million
Non-current assets		
Property, plant and equipment	7,083	
Total non-current assets		7,083
Current assets		
Inventories	171	
Trade receivables	627	

Assets	Rwf million	Rwf million
Investments	4,050	
Cash and cash equivalents	18	
Total current assets		4,866
Total assets		11,949
Equity and liabilities		
Share capital	2,250	
Share premium account	1,200	
Retained earnings	6,495	
Total equity		9,945
Non-current liabilities		
Long term borrowings	1,800	
Total non-current liabilities		1,800
Current liabilities		
Trade and other payables	204	
Total current liabilities		204
Total equity and liabilities		11,949

You should be familiar with the elements of the statement, and the distinction between current and non-current items:

Non-Current Assets	<p>An asset that is not a current asset. IAS 1 does not define a non-current asset – it simply defines current assets (see below) and states that all other assets that don't meet the 'current' definition are non-current by default.</p> <p>Examples of non-current assets include property, plant and equipment and intangible assets.</p>
--------------------	--

Current Assets	<p>An asset should be classified as current when it is:</p> <ul style="list-style-type: none"> • expected to be realised in, or is held for sale or consumption in the normal course of the entity's operating cycle; or • held primarily for trading purposes or for the short term and expected to be realised within 12 months of the reporting date; or • cash or cash equivalent asset which is not restricted in its use. Examples of current assets include inventories, trade receivables and marketable securities that are expected to be realised within 12 months.
Current Liabilities	<p>A liability should be classified as current when it is:</p> <ul style="list-style-type: none"> • expected to be settled in the normal course of the entity's operating cycle; or • due to be settled within 12 months of the reporting date; or • the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date. <p>Examples of current liabilities include trade payables, bank overdrafts and accruals.</p>
Non-Current Liabilities	<p>Any liabilities that are not current should be classified as non-current. This means that they are not due for settlement within 12 months.</p> <p>Examples of non-current liabilities include bank loans, debenture (a type of loan, often used by companies to raise money, that is paid back over a long period of time and at a fixed rate of interest) and redeemable preference shares.</p>
Share Capital and Reserves	<p>Regarding issued share capital and reserves, the following disclosures are required:</p> <ul style="list-style-type: none"> • number of shares authorised, issued and fully paid, and issued but not fully paid • par value • reconciliation of shares outstanding at the beginning and end of the period • descriptions of rights, preferences and restrictions • shares in the entity held by the entity, including shares held by subsidiaries and associates • shares reserved for issuance under options and contracts • a description of the nature and purpose of each reserve within equity

Statement of profit or loss and other comprehensive income

Prior to the amendment to IAS 1 in June 2011, the title used to be 'Statement of comprehensive income'. IAS 1 still permits entities to use this or other suitable titles.

IAS 1 lists the following as the minimum to be disclosed on the face of the statement of profit or loss and other comprehensive income:

- Revenue
- Finance costs
- Share of the profit or loss of associates and joint ventures accounted for using the equity method
- Tax expense
- A single amount for the total of discontinued operations
- Profit or loss
- Each component of other comprehensive income classified by nature
- Share of the other comprehensive income of associates and joint ventures accounted for using the equity method
- Total comprehensive income.

Expenses

An analysis of expenses must be shown either on the face of the statement of comprehensive income or by note. Expenses may be classified according to the nature of the expenses or by their function.

The nature method groups expenses according to the type of expense. For example, depreciation, purchases of materials, employee benefits, transport costs.

The function method groups expenses according to their purpose. For example, cost of sales, distribution costs, and administrative expenses.

An illustrative example of the statement of profit or loss and other comprehensive income suitable for publication is shown below.

Statement profit or loss and other comprehensive income for the year ended 31 December 20X0

	Part I – Profit or Loss	Rwf million
(i)	Revenue	1,148
(ii)	Cost of sales	(647)
	Gross profit	501
	Other operating income	0
(iii)	Distribution costs	(129)
(iv)	Administrative expenses	(120)
(v)	Other operating income	10
(vi)	Other operating expenses	(5)
	Profit from operating activities	257

	Part I – Profit or Loss	Rwf million
(vii)	Investment income	8
(viii)	Finance cost	(2)
	Profit before tax	263
(ix)	Income tax expense	(72)
	Profit/(Loss) for the year from continuing operations	191
(x)	Profit/(Loss) for the year from discontinued operations	20
	Profit/(loss) for the year	211
	Part II Other Comprehensive income	
	Items that will not be reclassified to profit or loss	
(v)	Gains/(loss) on property revaluation	25
	Total other comprehensive income	25
	Total comprehensive income for the year	236

Profit/(loss) for the year, together with the other comprehensive income, gives us the total comprehensive income for the year.

Part I

The first part, taking in lines (i) to (x) in the example above, is known as the 'Profit or loss'. Previously this was known as, and is still permitted to be called the 'Income Statement'. Profit or loss is the total of income less expenses, excluding items shown in 'Other comprehensive income'.

Each line in the statement is explained below:

Category	Explanation	Examples
(i) Revenue	Revenue is income arising in the ordinary course of an entity's business	Sales
(ii) Cost of sales	Refers to the direct costs attributable to the production of the goods or services sold by a company	Inventory Purchases Production costs Overheads Depreciation

Category	Explanation	Examples
(iii) Distribution costs	These are costs incurred after the production of the finished goods and up to and including transfer of the goods to the customers	Transport costs Selling and advertising costs Warehousing costs Depreciation
(iv) Administrative expenses	These are operating costs that have not been classified as either cost of sales or distribution costs	Bad debts Head office expenses Depreciation Changes in allowances for trade receivables
(v) Other operating income	These are items within the ordinary activities of the entity which are of such size, nature or incidence that their separate disclosure is required in the financial statements	Amortisation of government grants Revaluation surplus of investment properties
(vi) Other operating expenses	These are items within the ordinary activities of the entity which are of such size, nature or incidence that their separate disclosure is required in the financial statements	Write-down of assets (impairment loss) Revaluation deficits of investment properties
(vii) Investment income	Income from current and noncurrent asset investments	Bank interest receivable Dividends received
(viii) Finance costs	Costs incurred in financing the entity	Interest payable Debenture interest payable Finance charges on leases Dividends on redeemable preference shares
(ix) Tax expense	This will be the tax payable on the profit for the period Accounting for tax is covered in Unit C	Current tax payable

Category	Explanation	Examples
(x) Profit/(loss) for the year from discontinued operations	Discontinued operations are covered later in this unit	

Different entities may classify costs differently and the choice of classification will affect gross profit. This can make inter-firm comparisons difficult. Entities must be consistent year on year in the way that similar transactions are categorised and presented.

Part 2

The second part is known as other comprehensive income. This statement shows the income and expenses that are not recognised in profit or loss as required by other IFRSs. For example, a revaluation gain is recognised in other comprehensive income as IAS 16 requires that the gain is not recognised in profit or loss.

Information on other comprehensive income is useful because stopping at profit for the year will not provide the full picture of the company's performance during the year. The two statements together (profit or loss account and other comprehensive income) show all gains and losses for the period.

Other comprehensive income is split between 'items that will not be reclassified to profit or loss' and 'items that may be reclassified subsequently to profit or loss'. The former means that on disposal the revaluation reserve is directly transferred to retained earnings and does not impact the profit or loss account.

Note that companies have the choice of whether to present the two parts (profit or loss account and other comprehensive income) as two separate statements or as one continuous one.

Statement of changes in equity

The statement of changes in equity collects in one statement all the recognised changes in equity over the year. These include issues of share capital, profit for the year, other comprehensive income for the year and dividends paid.

The following example explains the components of statement of changes in equity.

Statement of changes in equity for the year ended 31 December 20X5					
Rwf million	Share capital	Share premium	Retained earnings	Revaluation reserve	Total equity
(i) Balance at beginning of year	100	250	1,250	480	2,080
(ii) Retrospective adjustment					
Restated balance	100	250	1,250	480	2,080

(iii) Share issues					0
(iv) Dividends payable				(50)	(50)
(v) Total comprehensive income for the year			211	25	236
Balance at end of year (= restated balance + iii + iv + v)	100	250	1,411	505	2,266

Category	Explanation
(i) Balance at the beginning of the year	The balances at the beginning of the year are the balances shown in previous year's statement of financial position.
(ii) Retrospective adjustment	Arises when there has been a prior period error reported and/ or when there has been a change in accounting policy. This is covered by IAS 8, and is discussed later in this unit.
(iii) Share issue	The issue of shares will impact the share capital account and possibly the share premium account.
(iv) Dividends payable	Dividends payable include ordinary and irredeemable preference dividends paid and payable if declared before the year end. Dividends can only be taken from retained earnings.
(v) Total comprehensive income for the year	These figures come directly from statement of profit or loss and other comprehensive income Retained earnings is adjusted for the profit or loss for the year Revaluation surplus is adjusted for other comprehensive income for the year

The following exercise will help to familiarise you with the statement of profit or loss, statement of financial position and statement of changes in equity.

Exercise B1

The following balances were extracted from the ledger of Govaig Company in respect of the year ended 31 December 20X5.

	Rwf million	Rwf million
--	-------------	-------------

Sales revenue		5,300
Cost of sales	1,350	
Dividends received		210
Administrative expenses	490	
Distribution costs	370	
Interest payable	190	
Dividends paid	390	
Property, plant and equipment	4,250	
Current investments	2,700	
Inventory	114	
Trade receivables	418	
Bank	12	
Trade payables		136
Long term loans (repayable 20X7)		1,200
Share capital		1,500
Share premium		800
Retained earnings		1,138
	10,284	10,284

Prepare a statement of profit or loss and a statement of changes in equity for the year ended 31 December 20X5, and a statement of financial position at that date for Govaig Company. These should be in a form suitable for publication.

Exercise B1 solution Rwf million	
Govaig Company Statement of profit or loss for the year ended 31 December 20X5	
Revenue	5,300
Cost of sales	(1,350)
Gross profit	3,950
Distribution costs	(370)

Administrative expenses	(490)
Profit from operating activities	3,090
Investment income	210
Finance costs	(190)
Profit before tax	3,110
Income tax expense	0
Profit for the year	3,110

Govaig Company Statement of changes in equity for the year ended 31 December 20X5

				Rwf million
	Ordinary share capital	Share premium	Retained earnings	Total equity
Balance at beginning of year	1,500	800	1,138	3,438
Retrospective adjustments				
Restated balance	1,500	800	1,138	3,438
Share issues				
Dividends payable			(390)	(390)
Profit for the year			3,110	3,110
Balance at the end of year	1,500	800	3,858	6,158

Govaig Company Statement of financial position as at 31 December 20X5 Rwf million

Assets		
Non-current assets		
Property, plant and equipment	4,250	
Total non-current assets		4,250
Current assets		
Inventories	114	
Trade receivables	418	

Investments	2,700	
Cash and cash equivalents	12	
Total current assets		3,244
Total assets		7,494
Equity and liabilities		
Share capital	1,500	
Share premium account	800	
Retained earnings	3,858	
Total equity		6,158
Non-current liabilities		
Long term borrowings	1,200	
Total non-current liabilities		1,200
Current liabilities		
Trade and other payables	136	
Total current liabilities		136
Total equity and liabilities		7,494

Statement of cash flows

A company's performance and future prospects depend not just on profits but also on its liquidity or cash position. A company may show a high profit but this does not necessarily mean that it has a strong cash position. The high profit may be due to the inclusion of revenue from credit sales but if the cash for those sales is not collected the company may not have enough cash to pay its suppliers and may not be a going concern. A company would struggle to survive in the long term without a positive cash flow position.

The profit or loss for the year is based on the accruals concept; i.e. it contains transactions which have no cash flow associated with them. For example, a company with a December year end makes a sale on credit on 31 December; the sale is recorded in the statement of profit or loss, but no cash has been received by the business at the reporting date.

Also, the profit figure is often subjective; for example, the amount of a depreciation charge, which is based on the estimated useful life of the asset. It may be argued therefore that profit or loss in itself does not give a complete picture of the company's performance.

A company's statement of financial position shows assets, liabilities, and equity, but only at a point in time. It is useful for users to know how this position has changed in cash terms during the accounting period.

Benefits of statement of cash flows

- Provides information in addition to that provided by the other financial statements
- Indicates the inflows and outflows of cash that have occurred during an accounting period
- The profit or loss account includes judgements, for example, the appropriate depreciation rate for depreciation.
- Enhances comparability of different companies because it eliminates the effects of using different accounting treatments/policies.

The format of the statement of cash flows as prescribed by IAS 7 is as follows:

Statement of cash flows for the year ended...	Rwf
Cash flows from operating activities	x/(x)
Cash flows from investing activities	x/(x)
Cash flows from financing activities	x/(x)
Net increase/(decrease) in cash and cash equivalents	x/(x)
Cash and cash equivalents at beginning of period	x/(x)
Cash and cash equivalents at end of period	x/(x)

The net increase / decrease in cash and cash equivalents is equal to the movement between the opening and closing balances for cash and cash equivalents.

IAS 7 gives the following definitions

Cash flows	Inflows and outflows of cash and cash equivalents
Cash	Cash comprises cash on hand and demand deposit (includes overdrafts).
Cash equivalents	Short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value.
Operating activities	Principal revenue producing activities and other activities of the entity that are not investing or financing activities
Investing activities	The acquisition and disposal of long-term assets and other investments not included in cash equivalents
Financing activities	Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity

The reporting of cash flows from operating activities can be either of the following methods:

- The direct method: major classes of gross cash receipts and gross cash payments and cash receipts from customers, and cash payments to suppliers are disclosed.
- The indirect method: profit or loss is adjusted for the effects of transactions of a noncash nature and the accrual or deferral of past or future operating cash receipts or payments e.g. profit adjusted for depreciation and any increase in trade payables and accruals.

Exercise B2

The following financial information relates to Renig Company for the year ended 31 December 20X7

		Rwf million
Revenue		222
Operating expenses		(165)
Operating profit		57
Finance costs		(9)
Profit before tax		48
Income tax		(21)
Profit		27
The following operating expenses were incurred in the year:		
Wages		36
Auditor’s remuneration		6
Depreciation		42
Cost of materials used		111
Gain on sale of non-current assets		(30)
Total		165
Other information:	31/12/x7	31/12/x6
Inventories	21	12
Trade receivables	24	21

Trade payables	(15)	(9)
Current tax liability	(16)	(20)
Calculate the cash flow from operating activities using the direct method		

Exercise B2 solution	
Renig Company – Cash flows from operating activities for year ended 31 December 20X7	
	Rwf million
Cash receipts from customers (W1)	219
Cash payments to suppliers and employees (W2)	(156)
Cash generated from operations	63
Interest paid	(9)
Tax paid (W3)	(25)
Net cash flows from operating activities	29
Workings:	
W1 Sales revenue	222
Plus: opening receivables (would pay in year)	21
Less: closing receivables	(24)
Cash receipts from customers	219
W2 Cost of materials used	111
Plus: closing inventories	21
Less: opening inventories	(12)
Materials purchased in year	120
Plus: opening payables	9
Less: closing payables	(15)
Payments made to suppliers in year	114

Auditors' remuneration	6
Payments to employees	36
Cash payments to suppliers and employees	156
W3 Tax expense for the year	21
Add: opening liability	20
Less: closing liability	(16)
Tax paid	25

Exercise B3

The following information has been extracted from the accounts of the Fleshrin Company.

Statement of financial positions as at 31 December:	20X3 Rwf million	20X4 Rwf million
Non-current assets		
Property, plant and equipment	1,585	1,407
Current assets		
Inventories	365	332
Trade receivables	153	320
Investments	<u>24</u>	<u>35</u>
Total assets	<u>2,127</u>	<u>2,094</u>
Equity and liabilities		
Share capital	1,030	1,000
Share premium	65	65
Revaluation reserve	60	90
Retained earnings	499	263
Non-current liabilities		

Long-term borrowings	157	129
Current liabilities		
Trade payables	159	237
Tax payable	30	41
Interest payable	7	4
Dividends (ordinary)	5	15
Bank overdraft	<u>115</u>	<u>230</u>
Total equity and liabilities	<u>2,127</u>	<u>2,094</u>
Statement of profit or loss for year ended 31 December 20X3 Rwf million		
Revenue		2,625
Cost of sales		(1,721)
Gross profit		904
Distribution costs		(260)
Administrative expenses		(175)
Operating profit		469
Interest receivable		17
Finance costs		(35)
Profit before tax		451
Income tax		(172)
Profit after tax		279

- (a) Dividends declared for year ended 31 December 20X3 total Rwf 63 million .
- (b) Depreciation charged in the year ended 31 December 20X3 was Rwf 27 million .
- (c) Some tangible non-current assets were revalued during the year ended 31 December 20X3.
- (d) Assets with a book value of Rwf 100 million were disposed of during the year, and receipts from their sales amounted to Rwf 125 million .
- (e) Trade receivables includes interest receivable, as follows:
 31 December 20X2 Rwf 4 million
 31 December 20X3 Rwf 3 million
- (f) Administrative costs include Rwf 150 million salaries and wages. There are no accruals relating to these.

Prepare the statement of cash flow for Fleshrin Company for the year ended 31 December 20X3 using the indirect method.

Exercise B3 solution

Statement of cash flows for year ended 31 December 20X3	Rwf million
Cash flows from operating activities	
Profit before tax	451
Adjustment for non-cash items:	
Depreciation	27
Profit on disposal (125 – 100)	(25)
Adjustment for items not related to operating activities:	
Investment income	(17)
Interest payable	35
Adjustment for movements in working capital	
Increase in inventory	(33)
Decrease in receivables	166
Decrease in payables	(78)
Cash generated from operations	526
Interest paid (35 + 4 – 7)	(32)
Tax paid (172 + 41 – 30)	(183)

Net cash flows from operations	311
Cash flows from investing activities	
Purchase of non-current assets (W1)	(335)
Proceeds from sale of non-current assets	125
Interest received (17 + 4 – 3)	18
Dividends received	0
Net cash flows from investing activities	(192)
Cash flows from financing activities	
Proceeds from issuing shares (1,030 – 1,000)	30
Payments to redeem shares	0
Proceeds from issuing debentures and loans (157 – 129)	28
Payments to redeem debentures and loans	0
Payment of lease principal	0
Dividends paid (63 + 15 – 5)	(73)
Net cash flow from financing activities	(15)
Net increase/(decrease) in cash and cash equivalents	104
Cash and cash equivalents at beginning of period (35 – 230)	(195)
Cash and cash equivalents at end of period (24 – 115)	(91)
Workings:	
W1 PPE Opening balance	1,407
Depreciation	(27)
Disposal	(100)
Revaluation decrease	(30)
Closing balance	<u>(1,585)</u>
Additions (bank)	<u>335</u>

Public sector financial statements – IPSAS

IPSAS 1 Presentation of financial statements is based on IAS 1 and therefore has many similarities. The financial statements required by a public sector entity that is preparing its statements in compliance with IPSAS are:

- Statement of financial performance
- Statement of financial position]
- Statement of cash flows
- Statement of changes in net assets/equity
- Notes to the financial statements

Statement of financial performance

The statement of financial performance sets out the revenues (ie income) and expenses of the entity to determine whether a surplus or deficit (rather than 'profit or loss') has been made in the period. As illustrated below, expenditure can be classified according to its nature or its function.

Public Sector Entity – Statement of financial performance for the year ended 31 December 20X2 (by <u>nature</u> of expenses)		
	20X2	20X1
Revenue		
Taxes	X	X
Fees, fines, penalties, and licences	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other revenue	X	X
Total revenue	X	X
Expenses		
Wages, salaries and employee benefits	(X)	(X)
Grants and other transfer payments	(X)	(X)
Supplies and consumables used	(X)	(X)
Finance costs	(X)	(X)
Depreciation and amortisation expense	(X)	(X)

Other expense	(X)	(X)
Total expense	(X)	(X)
Surplus/(deficit) for the period	(X)	X

Note – revenue is shown as a positive figure 'X', and the brackets show that expenses are negative figures '(X)'. The net figure may be positive or negative, and a surplus is shown as positive and a deficit as negative.

Public Sector Entity – Statement of financial performance for the year ended 31 December 20X2 (by <u>function</u> of expenses)		
	20X2	20X1
Revenue		
Taxes	X	X
Fees, fines, penalties, and licences	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other revenue	X	X
Total revenue	X	X
Expenses		
General public services	(X)	(X)
Defence	(X)	(X)
Public order and safety	(X)	(X)
Education	(X)	(X)
Health	(X)	(X)
Social benefits	(X)	(X)
Economic affairs	(X)	(X)
Other expenses ¹	(X)	(X)

¹ Other expenses will be those that can not be attributed to a programme or function.

Finance costs ²	(x)	(x)
Total expense	(x)	(x)
Surplus/(deficit) for the period	(x)	x

In the second example, expenses are categorised according to their function (i.e. according to the programme or purpose for which they were incurred) rather than by the nature of the expense. IPSAS 1 requires entities classifying expenses by function to disclose additional information on the nature of expenses, including depreciation expense, social benefits expenses, and employee benefits expense.

The following records have been taken from the trial balance of Capital Museum for the year ended 31 December 20X0.

The following information has been taken from the trial balance of Cross Museum for the year ended 31 December 20X0		
	Rwf million	Rwf million
Buildings	6,342	
Buildings accumulated depreciation		2,162
Inventories as at 31 December 20X0	1,223	
Receivables	100	
Short term investments	90	
Cash	420	
Payables		369
Long term loans		400
Accumulated surpluses		840
Staff costs	1,250	
Electricity	30	
Office stationery	15	
Insurance	345	
Bank interest charges	5	

² Finance costs may appear to be an example of expense by nature. But it needs to be shown separately, whichever presentation is used, because IPSAS 1 requires it to be identified separately on the face of the statement. It is also the case that finance costs are often difficult to attribute to a programme or function as they are often incurred for the organisation as a whole.

Investment income		20
Reserves		142
Revenue from admission charges		376
Grant for staff training		40
Donations		25
Other revenue		46
Government grant for operating expenses		1,400
Capital contributed by government		4,000
	9,820	9,820

Further information:

- Depreciation has still to be accounted for. The museum depreciates its assets over 40 years using the straight-line basis. Exhibits are not included in the trial balance as the museum has not been able to determine a realistic value for the majority of the items.
- On 1 October 20X0 the museum was given permission to take on a long-term loan of Rwf 400 million in order to acquire some artefacts of national significance. The loan interest is payable when the loan itself is to be repaid at the end of ten years and the interest rate to be applied is 8%. The artefacts have not yet been purchased.
- The insurance expenditure included in the trial balance has been paid for the period from 1 January 20X0 to 28 February 20X1.
- A pay increase was announced in December 20X0 and is to be applied from 1 November 20X0. The cost of the increase for 20X0 is Rwf 60 million, but this was not paid to employees until January 20X1.

Prepare the statement of financial performance and the statement of financial position for Cross Museum for the year ended 31 December 20X0

Statement of financial performance for Cross Museum for the year ended 31 December 20X0

	Rwf million
Revenue	
Admissions revenue	376
Grants	1,440

Donations	25
Investment income	20
Other revenue	46
Total revenue	1,907
Expenses	
Wages, salaries and employee benefits (1 250 + 60)	1,310
Depreciation (6 342/40)	159
Other expenses (15+ 345 – 50 [note workings below] + 30)	340
Financing transactions (5 + 8 (see workings))	13
Total expenses	1,822
Surplus/(deficit) for the year	85

Workings:

- Insurance – Rwf 345 million is for 14 months therefore charge is (approximately) Rwf 25 million per month. Two months' charge should be carried forward to next year this year's charge should be reduced by Rwf 50 million.
- Financing transactions – accrue three months interest on loan $(400 * 8\%) / 4 = \text{Rwf } 8 \text{ million}$.

Statement of financial position for Capital Museum as at 31 December 20X0

		Rwf million
Non-current assets		
Land and buildings (6 342 – 2 162 – 159)	4,021	
Total non-current assets		4,021
Current assets		
Inventories	1,223	
Receivables	100	
Short term investments	90	

Prepayments	50	
Cash	420	
Total current assets		1,883
Total assets		5,904
Capital and liabilities		
Capital contributed by government	4,000	
Designated reserves	142	
Accumulated surpluses (840 + 85)	925	
Total capital and reserves		5,067
Current liabilities		
Payables	369	
Accrued expenses	68	
Total current liabilities		437
Non-current liabilities		
Long term borrowings	400	
Total non-current liabilities		400
Total capital and liabilities		5,904

Workings:

Prepayment is the Rwf 50 million for two months' insurance payments that relate to January and February 20X6.

Buildings are shown net of accumulated depreciation including this year's depreciation charge of Rwf 159 million.

Accrued expenses consist of:

Interest	8
Pay increase	60
Total	68

Long term borrowing: Loan Rwf 400 million is reduced by the Rwf 10 million repayment of principal accrued this year.

Accumulated surpluses: The trial balance figure is increased by the net surplus for the year as shown in the statement of financial performance.

Accounting for changes in accounting policies and estimates

This topic is covered by the following standards in the private and public sectors respectively:

- IAS 8 Accounting Policies, Changes in Accounting Estimates, and Errors
- IPSAS 3 Accounting Policies, Changes in Accounting Estimates, and Errors

The two standards have identical titles, and the IPSAS standard is based on IAS 8. The IPSAS standard summarises the differences between it and IAS 8, as follows:

- IPSAS 3 uses different terminology (eg 'accumulated surplus or deficit' instead of 'retained earnings', and 'revenue' rather than 'income')
- IPSAS 3 has different set of definitions (reflecting the terminology differences)
- IPSAS 3 does not require disclosures about earnings per share.

In terms of the main financial reporting requirements, the two standards are very similar. The following summary of IAS 8 requirements is broadly the same as the IPSAS 3 requirements.

Accounting for changes in accounting policies

Accounting policies must be applied consistently from period to period and an entity is permitted to change an accounting policy only if the change:

- is required by a standard or interpretation; or
- results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance, or cash flows.

For example, a company used to treat borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as an expense, but now the company is required to capitalise such costs due to the requirements of a new accounting standard. This is an example of a change in accounting policy.

If a change in accounting policy occurs, it must be applied retrospectively (i.e. as though new accounting policy has always been in use). Retrospective application means adjusting the opening balance of each affected component of equity and the other comparative amounts disclosed as if the new accounting policy had been applied. Most typically the 'component of equity' impacted will be retained earnings. So we must:

- adjust opening balance of retained earnings;
- restate comparatives; and
- outline reasons for the change in a note to the accounts.

Example

Company C has previously used the first in first out method of inventory valuation. They have decided that the weighted average cost method is more appropriate as that is the standard for the industry which they operate in.

The opening balance for retained earnings for the year was Rwf 5,000 million.

The retained profit for the year following the new accounting policy was Rwf 1,500 million.

If the weighted average cost method had always been used retained earnings would have been Rwf 450 million higher at the start of the year.

The disclosure required within Statement of changes in equity for the year is as follows:

	Retained earnings Rwf million
Balance at beginning of year	5,000
Retrospective adjustment	450
Restated balance	5,450
Profit for the year	1,500
Balance at end of year	6,950

Certain disclosures are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods.

IAS 8 requires that companies disclose:

- the title of the standard or interpretation causing the change (or other reasons for change)
- the nature of the change in accounting policy
- for the current period and each prior period presented, to the extent practicable, the amount of the adjustment for each financial statement line item affected
- the amount of the adjustment relating to periods before those presented
- if retrospective application is impracticable, an explanation and description of how the change in accounting policy was applied.

An entity should also disclose information relevant to assessing the impact of new IFRS on the financial statements where these have not yet come into force.

Accounting for changes in accounting estimates

Accounting estimates are figures based on calculations which require judgement and approximation.

Examples include:

- A company increases its allowance for receivables from 5% to 10% due to its industry environment being hit hard by the recession.
- The allowance for inventory obsolescence needs to be increased due to unexpected technological advances made by a company's competitors.
- The provision for warranty obligation needs to be increased due to faults found in certain components of products.
- The useful life of a company's lorry fleet has to be shortened due to higher than expected annual mileage.

There is no need to re-state opening balances or apply the change retrospectively. The change is simply applied in the year in which it is determined, and in subsequent periods. This is called a prospective adjustment.

IAS 8 requires that companies disclose:

- the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods
- if the amount of the effect in future periods is not disclosed because estimating it is impracticable, the entity should disclose that fact.

Correction of prior period errors

IAS 8 deals with errors discovered in the current period that relate to a prior period. These include:

- Mathematical mistakes
- Mistakes in application of accounting policies
- Oversights
- Fraud

Errors are corrected retrospectively by re-stating the opening balances of assets, liabilities, equity and re-stating the prior year comparatives. This is the same approach taken when a change of accounting policy occurs. The following worked example illustrates the process of making a retrospective restatement for an error.

Example

Shortly after its 31 December 20X5 year end, the Lock company discovered fundamental errors in its 20X4 accounts which meant that operating expenses of Rwf 1 328 million had been completely omitted from the prior year accounts owing to a mistake by the new senior accountant. The 20X5 profit after tax was Rwf 11 008 million and retained earnings as at 31 December 20X4 as in the published 20X4 accounts were Rwf 3 763 million. As a result of this discovery, the directors feel that no dividend should be paid to shareholders in 20X5.

The error needs to be adjusted retrospectively in accordance with IAS 8, i.e. adjusted in the opening retained earnings brought forward as at 1 January 20X5.

The statement of changes in equity would include the following entries:

	Retained earnings Rwf million
Balance at beginning of year	3,763
Retrospective adjustments	(1,328)
Restated balance	2,435
Dividends paid	0
Total comprehensive income for the year	11,008
Balance at the end of the year	13,443

IAS 21 and IPSAS 4 – The Effects of Changes in Foreign Exchange Rates

The objective of the public and sector standards on foreign exchange rates is to prescribe how an entity includes foreign currency transactions in their financial statements, and how to translate financial statements into the presentation currency.

The functional currency is the currency of the primary economic environment in which the entity operates.

For most organisations that operate in Rwanda, the functional currency is the Rwanda Franc (Rwf). The entity will pay its employees and most suppliers in Rwf, and will receive income from customers in the same currency. There will, of course, be instances where a company is involved in transactions with foreign entities, and will receive funds or make payments in US dollars, Euros, or other currencies.

Two accounting concepts are relevant when dealing with currencies:

- Money measurement – ie financial information only takes into account those items that can be stated in monetary terms. By using a standard monetary measurement, the financial statements of different organisations can be compared.
- Stable monetary unit – ie it is assumed that the value of the currency unit (ie the Rwf, US dollar, or other currency being used) is stable.

When a user looks at a set of financial statements, they need to know what the figures represent; so the currency being applied needs to be made clear, otherwise the figures are meaningless. The currency used in the financial statements is referred to as the presentation currency.

The presentation currency will usually be the same as the functional currency. However, there may be instances, for example in the case of an entity that operates across international borders, where a currency other than the functional currency is used for presentation of consolidated financial statements.

As it would be impossible to make sense of financial statements if more than one currency was used, any transactions during the period that were made in a different currency (eg receipt of a grant from an international organisation in US dollars) will need to be translated into the functional currency.

A foreign currency transaction should be recorded initially at the rate of exchange at the date of the transaction.

At each subsequent reporting date, the foreign currency monetary amounts (eg cash held in a foreign currency account, or a receivable that will be in a foreign currency) should be reported using the exchange rate at the date of the transaction.

Example

KML Company uses Rwf as their functional and presentation currency. The company made sales in October 20X5 of £5,000. Other sales in the year to 31 December 20X5 were Rwf 525 million.

On 31 December 20X5, KML also had a US dollar bank account with a balance of \$25,000 and Rwf bank accounts totalling Rwf 140 million.

Exchange rates:		
31 October 20X5	£1 = Rwf 1,740	\$1 = Rwf 1,480
31 December 20X5	£1 = Rwf 1,700	\$1 = Rwf 1,500
How should these be shown in the financial statements to 31 December 20X5?		
Solution		
Sales = 525 million + (5,000 x 1,740) =		Rwf 533.7 million
Bank = 140 million + (25,000 x 1,500) =		Rwf 177.5 million

Discontinued operations

A discontinued operation according to IFRS 5 is a component of an entity that either has been disposed of or is classified as held for sale and:

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

The standard specifies presentation and disclosures that are aimed at helping users of the statements understand the financial effects of the entity discontinuing certain operations or disposing of non-current assets (or disposal groups).

The entity should disclose:

- (a) A single amount in the statement of profit or loss comprising the sum of:
 - i. The post-tax profit or loss on the discontinued operations; and
 - ii. The post-tax gain or loss arising from the sale of the operation or from changing its carrying value to fair value less costs to sell.

- (b) An analysis of this single amount into revenue, expenses, pre-tax profits or losses, the related tax expense (as per IAS 12), and the gain or loss arising from (a) (ii) above.
- (c) The net cash flows attributable to the operating, investing and financing activities of discontinued operations.

Example

On 20 October 20X8 the directors of a Digby Company made a public announcement of plans to close a steel works. The closure means that the company will no longer carry out this type of operation, which until recently has represented about 10% of its total revenue.

The works will be gradually shut down over a period of several months, with complete closure expected in July 20X9. At 31 December 20X8 output had been significantly reduced and some redundancies had already taken place.

The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the company's other operations.

Explain, based on the information available, how this transaction should be reflected in the financial statements of Digby for the year ended 31 December 20X8.

Solution

Because the steel works is being closed rather than sold, it is not a single co-ordinated plan, and therefore it cannot be classified as 'held for sale'. In addition, the steel works is not a discontinued operation.

Although at 31 December 20X8 the group was firmly committed to the closure, this has not yet taken place and therefore the steel works must be included in continuing operations. Information about the planned closure could be disclosed in the notes to the financial statements.

Earnings per share (EPS)

We need to distinguish between basic earnings per share and diluted earnings per share. We will consider basic earnings per share first.

Basic earnings per share

To calculate basic EPS the following three step approach is recommended.

Step 1: Calculate the basic earnings figure

Step 2: Calculate the basic weighted average number of shares (WANS)

Step 3: Calculate basic EPS

The issue of bonus shares, and the issue of shares at less than full market price will require the EPS figure for the previous year to be restated to ensure the results are comparable as 'free' shares have no earning potential.

Basic EPS example – Issue of shares at full market price

On 1 January 20X7, the issued share capital of the Atkinson company consisted of 1 000 000 ordinary shares with a nominal value of Rwf 300 each, and 300 000 10% preference shares with a nominal value of Rwf 1,000 each. On 1 July 20X7, Atkinson issued 200 000 ordinary shares at full market price.

The profit after tax for the year ended 31 December 20X7 is Rwf 670 million.

Solution

Using the first three steps of the approach outlined above we can calculate basic EPS as follows:

Step 1: Calculate the earnings figure

Profit after tax	670 million
Preference dividends	(30 million)
Earnings (profit attributable to ordinary shareholders)	640 million

Step 2: Calculate the WANS

When calculating the WANS, we must take into account the date on which any new shares are issued. In this example the 200 000 shares are issued on 1 July 20X7 which means that the funds raised from their issue will only contribute towards generating profit from that date. Therefore, we will only include the new issue of shares in our WANS calculation from 1 July – 31 December 20X7 (6 months).

Number of ordinary shares in issue at 1 Jan 20X7	1,000,000
Shares issued at full market price on 1 July (200 000 × 6/12)	100,000
WANS	1,100,000

Step 3 : Calculate EPS

Based on steps 1 and 2 we can now calculate basic EPS as follows:

$$= \text{Earnings} / \text{WANS} = 640\,000 / 1\,100\,000 = \text{Rwf } 582$$

During the year ending 31 December 20X7 each ordinary share in issue generated a profit of Rwf 582.

Fully diluted earnings per share

Basic EPS indicates the profit attributable to each ordinary share currently in issue; however, this does not take into consideration the impact of 'dilutive potential ordinary shares'. These are ordinary shares that might be issued at some future date, but which do not involve the funds available to the organisation increasing by a corresponding amount. This will lead to a reduction in EPS and the shareholders need to be informed.

IAS 33 Earnings Per Share requires that both the basic and diluted (if applicable) EPS must be disclosed.

The formula for calculating diluted earnings per share is:

Diluted EPS = diluted earnings/diluted weighted average number of shares in issue

Key definitions	
Deferred ordinary shares	Ordinary shares, which are entitled to a dividend only after a certain date or only if profits rise above a certain amount.
Convertible preference shares	Shares which can be converted into ordinary shares at the option of the holder
Convertible debentures / loan stock	A debt instrument which can be converted into ordinary shares at the option of the holder
Share options and warrants	These give the holder the option to buy a pre-determined number of ordinary shares at an agreed price in the future.
Contingently issuable shares	These shares are issued after certain conditions have been fulfilled

To calculate diluted earnings per share the following six step approach is recommended. You may note that the first three steps are the same as for basic earnings per share.

- STEP 1:** Calculate the basic earnings figure
- Step 2:** Calculate the weighted average number of shares
- Step 3:** Calculate the basic EPS
- Step 4:** Recalculate the earnings figure taking into account any future events that will potentially decrease earnings
- Step 5:** Recalculate the weighted average number of shares taking into account any future events that will increase shares without any earning potential
- Step 6:** Calculate diluted EPS

Example – Deferred ordinary shares

Company A has 10 million ordinary shares in issue and 3 million deferred ordinary shares (not currently ranked for dividend). In the year ended 31 December 20X8, Company A made a profit for the year after tax amounting to Rwf 540 million. Preference dividends payable are Rwf 20 million.

Calculate:

- (a) Basic EPS for the year ended 31 December 20X8.
- (b) Fully diluted EPS for the year ended 31 December 20X8.

Solution

- (a) Basic EPS

Step 1: Calculate the basic earnings figure

Profit after tax	540,000,000
Less: preference dividends	(20,000,000)
Earnings	520,000,000

Step 2: Calculate the WANS

Given in question = 10 000 000

Step 3: Calculate EPS

= Earnings / WANS = 520,000,000/10,000,000

= Rwf 52

- (b) Fully diluted EPS

Step 4: Recalculate the earnings figure

Earnings as per basic EPS: 520 million

The deferred ordinary shares have no impact on our earnings figure which is therefore the same as that used in our basic EPS calculation.

Step 5: Recalculate the WANS

WANS per basic EPS calculation	10 000 000
Deferred ordinary shares	3 000 000
Adjusted WANS	13 000 000

Step 6: Calculate diluted EPS

= Earnings / WANS = 520,000,000/13 000 000

= Rwf 40

We can see from the above example that in the year ended 31 December 20X8 each ordinary share issued by Company A earned a profit of Rwf 52. However, when we take into account the potential impact of the deferred ordinary shares, users of the accounts can clearly see that EPS falls to Rwf 40.

Non-financial reporting

Financial review by management

In addition to the financial statements discussed above, management may present a financial review outside of the financial statements. The financial review explains the main features of the company's financial performance and financial position as well as the main areas of uncertainty. This financial review typically includes the following:

- An outline of the main factors affecting performance including changes in the business environment in which the company operates, how the company has reacted to the changes, and the effect.
- The company's policy for investment and its dividend policy.
- How the entity is financed.
- Any resources that the entity uses that are not disclosed on the statement of financial position in accordance with IFRS.

Environmental reporting

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

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

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

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

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

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

- Set targets (publishing objectives can act as a motivator towards achieving those targets)
- Ensuring that reports are well prepared in the event that environmental reports become mandatory
- Improving access to lists of preferred suppliers
- Managing corporate risk – (if the company is clearly aware of the environmental risks it faces, it is more likely to have effective procedures in place to prevent disasters, thereby reducing the risk)
- Increasing profitability if revenues grow as a result of an improvement in customer perceptions
- Attracting and retaining high quality staff – (employees may be more likely to want to work for an environmentally friendly company).

Possible disadvantages of environmental reporting include the following:

- Additional costs in terms of labour hours and printing costs
- If the reports are voluntary, they are likely to focus on positive aspects and ignore any negatives
- If reports are not audited, the lack of regulation allows each company to provide the information in whatever format it wishes, making it more difficult for users to compare performance across companies.

The Global Reporting Initiative

The Global Reporting Initiative (GRI) is an organisation established in 1997 to develop a sustainability reporting framework for businesses. To this end, a number of versions of sustainability reporting standards have been issued. The GRI standards give guidance to companies on how to measure and report on management's approach to the economic, environmental and social aspects that impact on their businesses.

There are three types of GRI standards:

- Universal standards – these apply to all organisations
- Sector standards – enable more consistent reporting on sector-specific issues
- Topic standards – list disclosures relevant to a particular topic

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

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

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

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

Summary of Unit B and key learning outcomes

Unit B deals with the key competency 'Development and presentation of financial and non-financial information for a single entity'. In this unit, we looked at the following learning outcomes:

Learning outcome	
Preparation of financial statements	You should now be able to describe the format and content of the main financial statements as required by IAS 1 Presentation of Financial Statements
Financial statement disclosure requirements	You should now be able to discuss and apply the requirements of standards in respect of discontinued operations and earnings per share.
Non-financial reporting	You should now be able discuss the role of management commentary in financial reporting and the growing requirements for sustainability and environmental reports.

Quiz questions

1	Learning Outcome: BI
IAS 1 includes a list of the items that are the minimum to be disclosed on the face of the statement of profit or loss and other comprehensive income. Which of the following comprises items that are included in the list of minimum disclosure?	
A	Total of continued operations; Tax expense; Total comprehensive income
B	Finance costs; Sales income; Total comprehensive income
C	Depreciation costs; Tax expense; Total continued operations
D	Finance costs; Tax expense; Total comprehensive income

1	Feedback
A	Incorrect Total of continued operations is not included in the IAS 1 list of minimum disclosure Correct answer is Finance costs; Tax expense; Total comprehensive income
B	Incorrect Sales income is not included in the IAS 1 list of minimum disclosure Correct answer is Finance costs; Tax expense; Total comprehensive income
C	Incorrect Depreciation costs and Total of continued operations are not included in the IAS 1 list of minimum disclosure Correct answer is Finance costs; Tax expense; Total comprehensive income
D	Correct

2	Learning Outcome: BI
Which of the following is not a benefit of a Statement of Cash Flow?	
A	It provides information in addition to that provided by the other financial statements

2	Learning Outcome: BI
B	It is only relevant for private sector companies
C	It enhances comparability of different companies because it eliminates the effects of using different accounting treatments
D	It indicates the inflows and outflows of cash that have occurred during an accounting period

2	Feedback
A	Incorrect 'It is only relevant for private sector companies' is not a true statement, as the statement is also required under IPSAS for public sector organisations
B	Correct
C	Incorrect 'It is only relevant for private sector companies' is not a true statement, as the statement is also required under IPSAS for public sector organisations
D	Incorrect 'It is only relevant for private sector companies' is not a true statement, as the statement is also required under IPSAS for public sector organisations

3	Learning Outcome: BI
<p>Company FK has a fleet of lorries that it has been depreciating over a useful economic life of 10 years. This year it has decided that the life of lorries is only 8 years. Which of the following statements is correct?</p>	
A	This is a change in accounting estimate, and Company FK should apply the change in this year and in future years
B	This is a change in accounting policy, and Company FK should restate comparative information
C	This is a change in accounting estimate, and Company FK should apply the change retrospectively and revise opening balances for accumulated depreciation
D	This is a correction of a prior accounting error, and Company FK should make a retrospective adjustment

3	Feedback
A	Correct
B	Incorrect This is a change in accounting estimate, and Company FK should apply the change in this year and in future years
C	Incorrect This is a change in accounting estimate, and Company FK should apply the change in this year and in future years
D	Incorrect This is a change in accounting estimate, and Company FK should apply the change in this year and in future years

4	Learning Outcome: B2
Which of the following, according to IFRS 5, is a component of an entity that either has been disposed of or is classified as held for sale?	
A	Continuing operation
B	Going concern
C	Discontinued operation
D	Subsidiary

4	Feedback
A	Incorrect Discontinued operation
B	Incorrect Discontinued operation
C	Correct
D	Incorrect Discontinued operation

5	Learning Outcome: B2
<p>Company XD has issued share capital of 2 million shares with a nominal value of Rwf 1,200 each. On 1 April 20X5, XD issued 500,000 ordinary shares at full market price. The profit after tax for the year to 31 December 20X5 was Rwf 400 million.</p> <p>What is the basic EPS in 20X5?</p>	
A	Rwf 188
B	Rwf 200
C	Rwf 160
D	Rwf 157

5	Feedback
A	<p>Correct</p> $\text{WANS} = 2,000,000 + (500,000/4) = 2,125,000$ $\text{EPS} = 400,000,000/2,125,000 = \text{Rwf } 188$
B	<p>Incorrect</p> $\text{WANS} = 2,000,000 + (500,000/4) = 2,125,000$ $\text{EPS} = 400,000,000/2,125,000 = \text{Rwf } 188$
C	<p>Incorrect</p> $\text{WANS} = 2,000,000 + (500,000/4) = 2,125,000$ $\text{EPS} = 400,000,000/2,125,000 = \text{Rwf } 188$
D	<p>Incorrect</p> $\text{WANS} = 2,000,000 + (500,000/4) = 2,125,000$ $\text{EPS} = 400,000,000/2,125,000 = \text{Rwf } 188$

Unit C: Financial reporting standards

Learning outcomes

- C1. Property, plant and equipment
- C2. Intangible assets
- C3. Impairment of assets
- C4. Investment property
- C5. Inventories and biological assets
- C6. Financial instruments
- C7. Leases
- C8. Provisions, contingencies and events after the reporting period
- C9. Income taxes
- C10. Revenue
- C11. Government grants
- C12. Financial reporting for small and medium-sized entities
- C13. Accounting for transactions in the public sector

Introduction to Unit C

In Unit B, we looked at the format and content of the main financial statements, as required under IAS 1 Presentation of Financial Statements. In this unit, we will develop your understanding of what is included within each section or element of these statements, with more focus on preparing the information to be included in the relevant part of the statements and in related notes.

We will focus on the private sector accounting requirements under IFRS initially, and summarise the IPSAS approach applied in the public sector at the end of this unit.

C.1. Property, plant and equipment (PPE)

The main standards dealing with PPE are IAS 16 and IPSAS 17, which are similar in scope. We will focus on the former in this section. We also look briefly at IFRS 5, which deals with assets held for sale, and IAS 23 Borrowing Costs.

Initial measurement

An item of property, plant and equipment is recognised when:

- it is probable that future economic benefits associated with the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

The asset is initially measured at cost. Cost is made up of:

- Purchase price (less any trade discount)
- Non-refundable purchase tax and import duties
- Directly attributable costs of bringing the asset to its location and condition necessary for its operation. Examples of directly attributable costs are:
 - Site preparation
 - Installation costs
 - Testing
 - Professional fees
- Estimated cost of dismantling and removing asset and restoring the site on which it is located. For example, a company constructed a nuclear power plant which has an expected useful life of 30 years. At that time (30 years), the nuclear power plant will be demolished and the site restored to its original condition. This restoration is a legal obligation that arose on signing the contract to build the nuclear power plant. The expected cost of fulfilling this obligation should be included in the cost of the asset.

Note that staff training is not a directly attributable cost and must be expensed.

Borrowing costs

IAS 23 states that an organisation must capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.

Borrowing costs are interest and other costs that an organisation incurs in connection with the borrowing of funds. For example, loan interest, lease charges and amortisation of discounts or premiums relating to borrowing.

Interest charges are usually shown as an expense in the statement of comprehensive income. IAS 23 states that those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be included in the cost of that asset, i.e. capitalised.

A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. For example; property, plant and equipment or investment property during the construction period; intangible assets during the development period; or 'made to order' inventories.

Borrowing costs that are 'directly attributable' are those that would have been avoided if the expenditure on the qualifying asset had not been incurred.

When an organisation borrows funds specifically for the purpose of obtaining a qualifying asset, then those borrowing costs can be readily identified. The amount of borrowing costs eligible for capitalisation will be the actual borrowing costs incurred on that borrowing during the period less any investment income earned on the temporary investment of these funds. For example, if a company borrows to fund the purchase of an asset for Rwf

100 million, and incurs interest on the loan of Rwf 1 million, the company can capitalise the asset with an initial value of Rwf 101 million.

Where funds are borrowed generally (ie not for a specific project or asset), and part of these funds are applied to a qualifying asset, we need to calculate a weighted average cost of borrowing to determine the amount of borrowing costs to capitalise.

Example

An organisation has the following loans in place:

	1 Jan 20X5	31 Dec 20X5
	Rwf million	Rwf million
10% bank loan	120	120
9.5% bank loan	<u>80</u>	<u>80</u>
	<u>200</u>	<u>200</u>

On 1 January 20X5 the organisation began to build a qualifying asset using existing borrowings. Expenditure incurred on the construction was Rwf 30m on 1 January 20X5 and Rwf 20m on 1 October 20X5.

Solution:

The total interest charge for the year is $(10\% \times \text{Rwf } 120\text{m}) + (9.5\% \times \text{Rwf } 80\text{m}) = \text{Rwf } 19.6\text{m}$

We need to calculate the borrowing costs relating to the qualifying asset – to do this we need to calculate the weighted average borrowing rate and apply it to the borrowing for the qualifying asset.

Weighted average rate: $(10\% \times 120/200) + (9.5\% \times 80/200) = 9.8\%$

Qualifying asset borrowing costs: $(\text{Rwf } 30\text{m} \times 9.8\% \times 12/12) + (\text{Rwf } 20\text{m} \times 9.8\% \times 3/12) = \text{Rwf } 3.43\text{m}$

This means that Rwf 3.43m borrowing costs should be capitalised.

Debit	Non-current asset	3.43m
Debit	Finance costs	16.17m
Credit	Bank	19.6m

Subsequent measurement and revaluation

Subsequently, property, plant and equipment may be measured using either the cost model or the revaluation model.

Cost model	The asset is carried at cost less accumulated depreciation and impairment losses (note – impairment losses are covered later in this unit).
Revaluation model	<p>The asset is carried at fair value less accumulated depreciation and impairment losses.</p> <p>Fair value is the price that would be received to sell an asset in an orderly transaction between market participants.</p> <p>The fair value of the asset is normally determined by a professionally qualified valuer and is usually the market value of the asset.</p> <p>Revaluations should be made with sufficient regularity, depending on the volatility of the fair value of the asset, so that the carrying amount of an asset does not differ materially from its fair value at the reporting date.</p> <p>If one item of property, plant and equipment is revalued then all the items in that particular class of asset should be revalued. For example, if Company A were to revalue one building then all of the buildings would have to be revalued. This is to ensure that an entity does not only revalue assets which have increased in value. Company A would not have to revalue assets from different classes i.e. machinery, land, office equipment.</p> <p>When a company chooses to revalue their non-current assets for the first time this is a change in accounting policy. IAS 16 does not require a retrospective adjustment.</p>

Under IAS 16, a revaluation surplus is credited to the revaluation reserve in the statement of financial position using the following entry:

Debit Property, plant and equipment
Credit Revaluation reserve

You must remember to include this revaluation surplus figure in other comprehensive income.

Any decrease in value on revaluation should be recognised as an expense except where it offsets a previous increase on the same asset had been recognised as a revaluation surplus. Any decrease greater than the revaluation surplus must be taken as an expense to profit or loss:

Debit Revaluation reserve
Debit Expense (excess)
Credit Property, plant and equipment

A negative revaluation reserve cannot be created. The revaluation decrease must be shown in other comprehensive income.

The revaluation surplus should be transferred from the revaluation reserve to retained earnings when the surplus is realised, i.e. when the asset is retired from use or disposed of:

Debit Revaluation reserve

Credit Retained earnings

This transfer is shown in the statement of changes in equity.

Disclosures

IAS 16 contains disclosure requirements for property, plant and equipment.

The key disclosures are as follows:

- Measurement bases used
- Depreciation methods used
- Useful lives
- The gross carrying amount and accumulated depreciation at the beginning and end of the period
- A reconciliation of the carrying amount at the beginning and end of the period showing:
 - revaluations
 - additions
 - disposals
 - depreciation for the period
 - any other changes.

The key disclosures for IAS 16 may be presented in a table as illustrated below:

Rwf million	Land	Buildings	Equipment	Total
Cost/valuation:				
As at January 20X1	650	8,100	500	9,250
Revaluations	250	0	0	250
Additions	0	300	100	400
Disposals	0	(150)	(50)	(200)
As at December 20X1	900	8,250	550	9,700
Accumulated depreciation:				
As at January 20X1	0	730	100	830
Disposals	0	(40)	(22)	(62)
Revaluations	0	0	0	0

Rwf million	Land	Buildings	Equipment	Total
Charge for the year	0	206	118	324
As at December 20X1	0	896	196	1,092
Carrying amount:				
As at January 20X1	650	7,370	400	8,420
As at December 20X1	900	7,354	354	8,608

Depreciation

Depreciation is the measure of the amount of the economic benefits of the non-current asset that have been consumed in the period.

Depreciation matches the cost of using an asset in an accounting period against the benefits derived from it.

It should be allocated on a systematic basis over the useful life of the asset and is recognised in profit or loss as an expense.

The method of depreciation should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the organisation.

The two most common methods of depreciation are the straight-line method and the reducing balance method.

- The straight-line method results in a constant charge over the asset's useful life.
- The reducing balance method results in a decreasing charge over the asset's useful life.

To calculate depreciation, we need to consider an asset's useful life and residual value. The asset's useful life is the period over which an asset is expected to be available for use by an entity. The asset's residual value is the estimated value of the asset at the end of its useful life.

All assets with a finite life must be depreciated. Land has an indefinite life (except land that is mined for minerals, etc) and therefore is not depreciated.

Disposal

Accounting for the disposal of an asset can best be explained through an example.

Company TG purchased an asset for Rwf 80 million. It is sold in year 3 for Rwf 65 million. At the time of its disposal, the asset had been depreciated by Rwf 20 million.

Sale proceeds	65
Carrying value (80 – 20)	(60)
Profit	5

There are several steps to record the profit in the financial statements.

First, the asset is transferred from the non-current asset account to a temporary disposals account.

Debit	Disposals	80
Credit	Non-current asset	80

The accumulated depreciation is then transferred from the accumulated depreciation account to the temporary disposals account.

Debit	Accumulated depreciation	20
Credit	Disposals	20

The proceeds from the sale of the asset are then recorded in the disposals account.

Debit	Bank	65
Credit	Disposals	65

The balance on the disposal account would be a credit of Rwf 5 million ($80 - 20 - 65$). The disposal account can be closed, and the balance transferred to the profit or loss account.

Debit	Disposals	5
Credit	Expenses	5

The profit on disposal would be classified in the same type of expense as the depreciation has been charged through the asset's useful life

Finally, the revaluation reserve is realised and transferred from the revaluation reserve to retained earnings. This means it can now be distributed to shareholders in the form of a dividend.

Debit	Revaluation reserve	20
Credit	Retained earnings	20

IFRS 5 – Non-current assets held for sale

The following conditions must be met for an asset (or disposal group) to be classified as held for sale:

- Management is committed to a plan to sell
- The asset is available for immediate sale
- An active programme to locate a buyer is initiated
- The sale is highly probable, within 12 months of classification as held for sale
- Actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

It is possible that a held for sale asset may remain on an entity's statement of financial position beyond one year, if the prolongation of the selling period is extended by events or circumstances beyond the control of the entity, and the entity remains committed to the sale. An asset that is to be abandoned should not be classified as held for sale. Note that it is not just an asset that can be held for sale, but a 'disposal group' can be too.

A disposal group is a group of assets, possibly with associated liabilities, which an entity intends to dispose of in a single transaction. For example, if a business is selling off a factory that contains equipment, inventory etc.

At the time of classification as held for sale (ie immediately before the initial classification of the asset as held for sale), the carrying amount of the asset will be measured in accordance with applicable IFRSs. For example, property, plant and equipment will be measured in accordance with IAS 16.

After classification as held for sale – assets (or disposal groups) held for sale are measured at the lower of carrying amount and fair value less costs to sell.

Assets (or disposal groups) held for sale are not depreciated. A non-current asset (or disposal group) that is no longer classified as held for sale (for example because the sale has not taken place within one year) is measured at the lower of:

- Its carrying amount before it was classified as held for sale, adjusted for any depreciation that would have been charged had the asset not been held for sale; and
- Its recoverable amount at the date of the decision not to sell.

Assets (or disposal groups) held for sale must be presented separately on the face of the statement of financial position. Note that they are included under 'current assets' because the assets are expected to be realised within 12 months.

An impairment loss should be recognised where fair value less costs to sell is lower than carrying amount.

Note that this is an exception to the normal rule. IAS 36 Impairment of Assets requires an entity to recognise an impairment loss only where an asset's recoverable amount is lower than its carrying value. Recoverable amount is defined as the higher of net realisable value and value in use. IAS 36 does not apply to assets held for sale, and so no value in use calculation is required for assets held for sale. This is because the asset is not going to be used on a continuing basis.

Impairment may be reversed if the fair value of the asset increases, but only to the extent of impairment losses already recognised for the asset.

Note that we will look at IAS 36 Impairment of Assets in more detail in the next part of this unit.

The following disclosures are required by IFRS 5:

- Description of the non-current asset or disposal group
- Description of facts and circumstances of the sale and expected timing
- Impairment losses, if any
- If applicable, the reportable segment in which the asset (or disposal group) is presented in accordance with IFRS 8 Operating Segments.

Example

On 1 December 20X3, a company became committed to a plan to sell a manufacturing facility and has already found a potential buyer. The company does not intend to discontinue the operations currently carried out in the facility.

At 31 December 20X3 there is a backlog of uncompleted customer orders. The company will not be able to transfer the facility to the buyer until after it ceases to operate the facility and has eliminated the backlog of uncompleted customer orders. This is not expected to occur until April 20X4.

Solution

The facility will not be transferred until the backlog of orders is completed; this demonstrates that the facility is **not** available for immediate sale in its present condition.

The facility cannot be classified as 'held for sale' at 31 December 20X3.

It must be treated in the same way as other items of property, plant, and equipment. It should continue to be depreciated and should not be separately disclosed.

C.2. Intangible assets

IAS 38 Intangible Assets specifies the criteria that determine when an intangible asset can be recognised, how to measure its carrying value and explain the disclosure requirements.

Is an identifiable non-monetary asset without physical substance.

An asset is identifiable if it is either:

- Separable i.e. it is capable of being separated or divided from the entity, regardless of whether the entity intends to do so; or
- Arises from contractual or other legal rights.

Intangible assets include

- Development costs – costs of developing a new product, material or system.
- Copyrights
- Patents
- Brands
- Licences
- Franchises
- Purchased goodwill

Research and Development

Research	Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.	<p>Research costs are written off as incurred as an expense.</p> <p>Research costs fail the definition of an asset as probability of future economic benefit cannot be measured.</p>
Development	The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production.	<p>Development costs are capitalised as an intangible asset when specific criteria are met (see below for criteria).</p> <p>Development costs are written off as incurred to the SCI as an expense unless it meets the specific criteria for capitalisation.</p> <p>If the criteria are met then the costs must be capitalised from that point as an intangible asset and amortised over the useful life of the asset once production / commercial benefits commence. Costs incurred prior to the criteria being met are expensed.</p>

The criteria that must be met before development costs can be capitalised are:

- Sellable or useable by the entity
- Technical feasible to complete it such that it can become sellable or usable
- Economic benefits must be expected to flow to the entity from the development of the intangible asset.
- Measurable expenditure. The entity can determine the costs incurred in developing the intangible asset.
- Intention to complete. The entity must be able to demonstrate its intention to complete the development of the intangible asset.
- Completable. The entity can demonstrate it has adequate technical, financial, and other resources to complete the development of the intangible asset.

Example

Uig Company is a manufacturer that has recently significantly increased its investment in research and development in order to produce higher value-added goods.

The Director of Finance is keen to know whether any of the costs included within cost of sales can be treated as capital expenditure and recognised in the statement of financial position.

Explain the accounting treatment for the three scenarios below, and show the proposed accounting entries (excluding disclosures) under IAS 38 Intangible Assets.

1. Rwf 100 million was spent on salary costs of the team that were in the final stages of the development of a new manufacturing technology. The new technology is in its final stages of testing and expected to come into use next financial year. The technology is expected to result in savings in production costs for the company of around Rwf 25 million per year, and will have a useful life of five years.
1. Rwf 150 million was spent on a groundbreaking quality control process. The project is in its early stages, but the project manager is confident it will lead to cost savings. He forecasts that the new process will be ready for implementation in between five and ten years. The Director of Finance, whilst being excited by the cost saving forecasts produced by the project manager, is concerned that the time horizon for the development of the product is too long and believes the organisation should focus its resources on projects that are closer to implementation.
2. The final project under development was a collaboration between three different departments within the company and two of the company's customers who sell Dong Xi PNE's products in the retail market. The aim of the project is to further integrate their logistics management systems. The managers of the project are expecting the integration to take place in two years' time and have the full backing of the Board of all three companies and a commitment to providing the financial and other resources needed to achieve a successful completion. To date it was decided by the project managers not to monitor the costs of the project because the breadth of input from different staff made this too complicated, and would be an unwanted distraction from the main tasks of the project.

Solution

1. From the information available this expenditure appears to meet the criteria for recognition of an asset as per IAS 38 Intangible Assets.

- The proposed technology can be used by the entity.
- The information available suggests it is technically feasible.
- Economic benefit is expected to be received by the entity in the form of cost savings.
- The expenditure is measurable and identified as Rwf100 million.
- The organisation has the intention to bring it into use next year (and hence to complete it).
- Given that the organisation is in the pre-implementation final test stage, and no concerns about feasibility have been raised, it would be reasonable to conclude that the project will be completed by the entity.

Accounting entries:

Dr Non-current asset: Intangible assets	Rwf 100 million
Cr Cost of sales	Rwf 100 million

The assets will be amortised when they come into use, matching the cost to the economic benefits for the entity.

2. In this case, the expenditure does not meet all criteria for recognition and will therefore be written off in the statement of comprehensive income.

Specifically, the entity does not appear to have a clear intention to complete the project, and it seems unlikely that it will receive the resources needed in order to complete it. Furthermore, given the expected time horizon before completion and that the project is in its early stages, uncertainty remains as to whether it is technically feasible or whether it will genuinely result in future economic benefits (cost savings) for the entity. Rwf 150 million should be classified as research, an expense to the profit or loss account.

3. In this case, the expenditure also does not meet all the criteria for recognition and will therefore be written off in the statement of comprehensive income (no adjustments will be made). The expenditure on the project is not measurable and identifiable and therefore cannot be recognised as an intangible asset.

Other Intangibles

Other intangibles include

- Copyrights and patents
- Licenses
- Franchises
- Computer software
- Brands* (see note below)

- Mastheads (of newspapers)*
- Publishing titles*
- Customer lists*

***Note** – These intangibles will only be recognised if they are purchased from a third party.

As with development costs there are criteria which have to be met before an entity can recognise other intangible assets.

Examples	Is this an intangible asset?
Technical knowledge	Technical knowledge can only be recognised if it is protected by a legal right (a patent).
Skills of employees	This does not meet the definition of an assets. The business does not control the future actions of their employees and therefore they cannot capitalise any training costs incurred.
Customer loyalty	This does not meet the definition of an asset. It cannot be measured reliably. The business cannot control the actions of their customers and therefore customer loyalty is not an intangible asset.
Purchase of customer database	This is a separately identifiable asset which is controlled by the entity as a result of a past event and there is an expected future economic benefit. There is a willing buyer and a willing seller and as such the value of the customer database can be measured reliably. Therefore, it is an intangible asset.

Recognition

An intangible asset, when recognised initially, must be measured at cost. It should be recognised if, and only if, both of the following occur:

- It is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- The costs can be measured reliably.

The cost of an internally generated intangible asset is the expenditure incurred from the date when the intangible asset first meets the recognition criteria. Costs prior to this point must be expensed.

Amortisation

IAS 38 requires that intangible assets are amortised over their useful life. Amortisation is the term used for the depreciation of an intangible noncurrent asset.

Example:

Development costs of Rwf 50 million were incurred on a new product which is launched commercially in 20x5. The new product is expected to have a commercial life of 5 years.

Amortisation would start in 20x5. The annual amortisation is

$$50 / 5 = 10.$$

Until the asset is launched commercially, the development cost of Rwf 50 million would be an intangible asset on the balance sheet.

Finite life assets

An intangible asset with a finite useful life should be amortised over its expected useful life.

- Amortisation should start when the asset is available for use.
- Amortisation should cease at the date that the asset is derecognised.
- The amortisation method used should reflect the pattern in which the asset's future economic benefits are consumed. If such a pattern cannot be predicted reliably, the straight-line method should be used.
- The amortisation charge for each period should normally be recognised as an expense.

The residual value of an intangible asset with a finite useful life is assumed to be zero, unless a third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset (so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.

It may be difficult to establish the useful life of an intangible asset, and judgment will be needed.

The amortisation period and the amortisation method used for an intangible asset with a finite useful life should be reviewed at each financial year end.

Indefinite useful life assets

An intangible asset with an indefinite useful life should not be amortised. In accordance with IAS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount:

- annually, and
- whenever there is an indication that the intangible asset may be impaired.

Subsequent Measurement

Consistent with the treatment of tangible non-current assets, there are two methods of valuing intangible assets: the cost and revaluation model.

Applying the cost model, an intangible asset should be carried at its cost, less any accumulated amortisation and less any accumulated impairment losses. This is consistent with the treatment of tangible non-current assets.

The revaluation model allows an intangible asset to be carried at a revalued amount, which is its fair value at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. The revaluation model can only be applied under the following circumstances:

- The fair value must be measurable reliably with reference to an active market in that type of asset
- The entire class of intangible assets of that type must be revalued at the same time
- If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset should be carried at its cost less any accumulated amortisation and impairment losses
- Revaluations should be made with such regularity that the carrying amount does not differ materially from that which would be determined using fair value at the date of the statement of financial position.

An active market is where there are many willing buyers and sellers. As an intangible asset is often unique then there is unlikely to be an active market for such assets except for items such as fishing or taxi licenses.

The accounting treatment for revaluations is consistent with that of revaluations of property, plant and equipment under IAS 16.

Derecognition

An intangible asset should be eliminated from the statement of financial position when it is disposed of, or when there is no further expected economic benefit from its future use or disposal. On disposal, the gain or loss arising from the difference between the net disposal proceeds and the carrying amount of the asset should be taken to the statement of comprehensive income as a gain or loss on disposal. Any remaining balance relating to the asset within the revaluation reserve in the statement of financial position should be transferred to retained earnings.

This treatment is no different from that for property, plant and equipment as specified by IAS 16.

Impairment of assets

The aim of IAS 36 is to ensure that assets are carried at no more than their recoverable amount.

An impairment arises when the current carrying amount is higher than the recoverable amount.

Current carrying amount	Cost or revalued amount less accumulated depreciation
Recoverable amount	Higher of fair value less costs of disposal and value in use
Fair value less costs of disposal	<p>Potential sales proceeds less any costs incurred in selling the asset. Where there is an active market, the fair value is the price of recent sales of similar assets.</p> <p>Where there is no active market, fair value may be determined using best estimates of what the selling price might be in an orderly transaction.</p> <p>Selling costs include incremental costs of sale including advertising, legal costs and transaction taxes.</p>
Value in use	<p>The present value of future cashflows that the asset is expected to generate for the entity.</p> <p>The concept of discounting cash flows to determine their present value is covered in much greater detail in other modules. Essentially it involves applying a discount rate to cash flows in the future to take account of the time value of money.</p>

Value in use

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

The cash flows used in the calculation should be pre-tax cash flows and a pre-tax discount rate should be applied to calculate the present value.

The calculation of value in use must reflect the following:

- An estimate of the future cash flows the entity expects to derive from the asset
- Expectations about possible variations in the amount and timing of future cash flows.
- The time value of money.
- The price for bearing the uncertainty inherent in the asset.
- Other factors that would be reflected in pricing future cash flows from the asset.

Calculating a value in use therefore calls for estimates of future cash flows, and the possibility exists that an entity might come up with over-optimistic estimates of cash flows. The IAS therefore states the following:

- Cash flow projections should be based on 'reasonable and supportable' assumptions.
- Projections of cash flows, normally up to a maximum period of five years, should be based on the most recent budgets or financial forecasts.

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

Testing for impairment

An entity must review its assets to look for indications of impairment at each reporting date. Indicators of impairment include the following:

External sources:

- Market value declines
- Negative changes in technology, markets, economy, or laws
- Increases in market interest rates.

Internal sources:

- Obsolescence or physical damage. For example, inventory being damaged as a result of a flood or fire
- Asset is expected to be disposed of or no longer used
- Plans to discontinue operation in which the asset is used
- Economic performance is lower than expected.

For those assets that show signs of impairment an entity will undertake an impairment test to determine whether the carrying value of the asset exceeds the recoverable amount.

Example

Valta Company has equipment with a current carrying value of Rwf 25 million. Due changes in technology, management believe that the asset may be impaired.

The results of the impairment review show:

- Fair value less costs of disposal are Rwf 15 million
- Value in use is Rwf 17.5 million

Solution

The carrying amount of the asset is Rwf 25 million. This needs to be compared to the recoverable amount.

The recoverable amount is the higher of the fair value less costs of disposal and value in use, which in this case is Rwf 17.5 million.

The recoverable amount of Rwf 17.5 million is lower than the carrying value of Rwf 25 million and therefore an impairment has arisen.

The asset will need to be impaired by $25 - 17.5 = \text{Rwf } 7.5 \text{ million}$

Debit	Expense	7.5	
Credit	Equipment		7.5

Accounting for an impairment

Once an impairment has been calculated it needs to be accounted for. The treatment will depend on whether the asset is carried at historical cost or revalued amount.

Note that the depreciation charge for the year will also need to be adjusted. It is based on the revised carrying amount over its remaining useful life.

When the asset is being held at historical cost less accumulated depreciation, impairment is charged as an expense. Effectively it is just like charging additional depreciation:

Dr Expense

Cr Asset carrying amount

When the asset is held at a revalued amount less accumulated depreciation, the impairment must first be charged to the revaluation reserve. If the impairment loss exceeds the balance on the revaluation reserve for that asset, the excess is charged as an expense.

Dr Revaluation reserve

Dr Expense (for any excess)

Cr Asset carrying amount

Cash Generating Units

It is not always possible to work out the value in use of every asset when determining

impairments. For example, a value in use could not be calculated for an individual piece of machinery in a factory. Therefore, IAS 36 requires the assets of the whole factory to be tested for impairment as a cash generating unit.

A cash generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash flows from other assets or groups of assets.

Example

Royal Restaurants has two CGUs. The restaurant has been impacted by changes in consumer demand and an impairment test has been performed. They have a head office which has not been possible to allocate to the CGUs.

Rwf million	CGU 1	CGU 2	Head office	Total
PPE	800	400	650	1,850
Current assets	<u>200</u>	<u>50</u>	<u>0</u>	<u>250</u>
	1,000	450	650	2,100

The recoverable amount of CGU 1 is Rwf 900 million and for CGU 2 is Rwf 500 million.

The recoverable amount of the whole company is Rwf 1,750 million.

Calculate the impairment loss and allocate it to the correct assets.

Solution

The first step is to test the individual CGUs for impairment. CGU 1 will be impaired by Rwf 100 million. The new carrying value of CGU 1 will be Rwf 900 million. For CGU 2 there is no impairment as the carrying amount is below the recoverable amount.

The second step is to test the company as a whole, using the revised figures for CGU1.

Rwf million	CGU 1 (revised)	CGU 2	Head office	Total (revised)
PPE	700	400	650	1,750
Current assets	<u>200</u>	<u>50</u>	<u>0</u>	<u>250</u>
	900	450	650	2,000

The revised carrying value of the company is Rwf 2,000 million. Comparing this to the recoverable amount of Rwf 1,750 million there is an impairment of Rwf 250 million which will be allocated to the Head Office.

The Rwf 250 million impairment is NOT allocated to CGU 1 or CGU 2 as these have already been tested for impairment

The final carrying figures will be as follows:

Rwf million	CGU 1 (revised)	CGU 2	Head office	Total (revised)
PPE	700	400	400	1,500
Current assets	<u>200</u>	<u>50</u>	<u>0</u>	<u>250</u>
	900	450	400	1,750

Reversing an impairment

If the recoverable amount of an asset that was previously impaired returns above its post-impairment carrying value, the impairment may be reversed.

The new carrying value of the asset can be increased to the lower of the new recoverable amount and the carrying value that would have been if the impairment had never taken place. This ensures that the reversal will never be more than the original impairment.

Accounting for the reversal:

- The reversal is recognised in the statement of profit or loss (up to the extent that the initial impairment was recognised).
- The remainder of the reversal is then recognised in the revaluation reserve (again up to the extent that the initial impairment was recognised in the revaluation reserve).
- Note that an impairment of Goodwill cannot be reversed.

To reverse an impairment the accounting entries are just the opposite of what you posted for the original impairment.

An asset was previously impaired and following an improvement in the market conditions, the directors decide to review whether the impairment could be reversed. The following information is provided:

Solution

Dr Non-current asset – carrying value	Rwf 5 million
Cr Expense	Rwf 5 million

Disclosure

- For each class of assets, the amount of impairment losses recognised, and the amount of any impairment losses recovered (that is, reversals of impairment losses).
- For each individual asset or CGU that has suffered a significant impairment loss, details of the nature of the asset, the amount of the loss, the events that led to recognition of the loss, whether the recoverable amount is fair value less costs of disposal or value in use, and if the recoverable amount is value in use, the basis on which this value was estimated (for example the discount rate applied).

- Use in the production or supply of goods or services or for administrative purposes;
or

- Sale in the ordinary course of business.

IAS 40 lists the following as examples of investment property:

- Land held for long-term capital appreciation rather than short-term sale
- Land held for a currently undetermined future use
- A building owned by the entity (or a right-of use asset relating to a building held by the entity) and leased to a third party under an operating lease
- A building which is vacant but is held to be leased out under an operating lease
- Property being constructed or developed for future use as an investment property.

IAS 40 also provides examples of items that are not investment property;

- Property intended for sale in the ordinary course of business
- Property being constructed on behalf of a third party
- Owner occupied property
- Property leased to another entity under a finance lease.

Investment properties are initially recognised in the statement of financial position at cost.

They are subsequently recognised by one of two methods. The method is an accounting policy and therefore the same model has to be applied to all investment properties.

Cost model

Under the cost model, the entity recognises the investment properties in exactly the same way as under IAS 16 Property, Plant and Equipment (or under IPSAS 17 in the public sector). An additional disclosure of the fair value of the properties must be made. The asset must be depreciated over its useful life.

Example

Tolstac Company uses the cost model to account for investment properties. At the end of the previous reporting period (31.12.X4) an investment property had a carrying value of Rwf 10 million. The remaining useful life of the property is estimated to be 5 years, depreciated on a straight-line basis. At the end of the year (31.12.X5) the fair value of the property is Rwf 11 million

Solution

Note that the company has chosen the cost model to account for investment properties so it will not revalue the investment property. The new fair value of the investment property would nevertheless have to be disclosed in a note to the accounts.

The asset needs to be depreciated:

Debit	Depreciation expense	Rwf 2 million
Credit	Accumulated depreciation	Rwf 2 million

Fair value model

The fair value model involves recognising the investment properties at fair value, this being the amount that would be received to sell an asset in an orderly transaction. Any movement in the fair value of the asset results in a gain or loss being recognised directly in profit or loss as income/expense. The assets are not depreciated.

Example

Lax Company uses the fair value model to account for its investment properties. Lax owns an investment property which is currently held in its accounts at fair value of Rwf 10 million. At the end of year 1 the fair value of the property is Rwf 11 million. At the end of the year 2 the fair value of the property is Rwf 9 million.

Solution

Year 1	Dr Investment Properties	Rwf 1 million
	Cr Other operating income	Rwf 1 million
Year 2	Dr Other operating expense	Rwf 2 million
	Cr Investment properties	Rwf 2 million

Transfers to/from investment property

Transfers to or from investment property should only be made when there is a change in use. For example, owner occupation commences so the investment property will be treated as an owner-occupied property.

The following rules apply for accounting for transfers between categories:

- When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.
- For a transfer from investment property carried at fair value to owner-occupied property or inventories, the fair value at the change of use is the 'cost' of the property under its new classification.
- For a transfer from owner-occupied property to investment property carried at fair value, IAS 16 should be applied up to the date of reclassification. Any difference arising between the carrying amount under IAS 16 at that date and the fair value is dealt with as a revaluation under IAS 16.

Disclosures

IAS 40 requires companies holding investment properties to disclose the following:

- Choice of fair value model or cost model
- Criteria for classification as investment property
- Use of independent professional valuer (encouraged but not required)
- Rental income and expenses

- Any restrictions or obligations.

Additional disclosures relate to the fair value and cost models:

- An entity that adopts the fair value model must also disclose a reconciliation of the carrying amount of the investment property at the beginning and end of the period.
- An entity that adopts the cost model must disclose information on the depreciation method that is applied. In addition, an entity which adopts the cost model must disclose the fair value of the investment property.

Differences between IAS 40 and IPSAS 16

IAS 40 and IPSAS 16 are very similar in scope, definitions, and in the required accounting treatments. As well as some differences in terminology, there are two notable differences:

- IAS 40 requires investment properties to be initially measured at cost. IPSAS 16 requires that investment properties are initially measured at cost, and specifies that where an asset is acquired for no cost (eg as a donation) or for a nominal cost, its cost is its fair value at the date of acquisition.
- IPSAS 16 does not apply to property held to deliver a social service that also generates cash inflows.

Inventories

In order to give a fair presentation of an organisation's profit for an accounting period and the assets held at the end of an accounting period, it is essential that we do not overstate (or understate) inventory.

IAS 2 and IPSAS 12 are similar in scope and in terms of the main accounting requirements for inventories, but the following differences can be noted:

- IPSAS 12 includes guidance on the treatment of inventories that may be distributed at no charge or for nominal charge
- IPSAS 12 includes a definition of current replacement cost
- IPSAS 12 requires the cost of inventories acquired through non-exchange transactions to be based on their fair value at acquisition
- IPSAS 12 requires inventories provided at no charge or for nominal charge are to be value at the lower of cost and current replacement cost.

A central requirement of both IAS 2 and IPSAS 12 is that inventories should be valued at the lower of cost and net realisable value (NRV)

This valuation is in accordance with the accounting concept of prudence.

In addition, an entity is required to apply this valuation to items or groups of similar items separately.

Example

Willow is a company involved in supplying building materials. At 31 May 20X9 its inventory comprised:

(Rwf million)	Cost	NRV
Window frames	100	75
Showers	250	300
Roof tiles	<u>35</u>	<u>50</u>
Total	<u>385</u>	<u>425</u>

Solution

In order to calculate the value of closing inventory at 31 May 20X9, IAS 2 requires that for each group of inventory we take the lower of cost and NRV. Thus, for Willow, window frames originally cost Rwf 100 million, but now have a NRV of just Rwf 75 million. So, we value the window frames at Rwf 75 million. We repeat this for each of the inventory groups, arriving at closing inventory with a value of Rwf 360 million as follows:

(Rwf million)	Cost	NRV	Lower
Window frames	100	75	75
Showers	250	300	250
Roof tiles	<u>35</u>	<u>50</u>	<u>35</u>
Total	<u>385</u>	<u>425</u>	<u>360</u>

Measuring inventory – cost

The cost of inventory comprises:

- Purchase price
- Costs of conversion
- Other costs incurred in bringing inventory to its present location and condition

Costs of conversion include:

- Costs directly related to the units of production, for example direct materials, direct labour.
- Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, for example the cost of factory management and administration.

The standard emphasises that fixed production overheads must be allocated to items of inventory on the basis of the normal capacity of the production facilities. This is an important point, and the standards stipulates the following:

- Normal capacity is the expected achievable production based on the average over several periods/seasons, under normal circumstances.
- The above figure should take account of the capacity lost through planned maintenance.
- If it approximates to the normal level of activity then the actual level of production can be used.
- Low production or idle plant will not result in a higher fixed overhead allocation to each unit.
- Unallocated overheads must be recognised as an expense in the period in which they were incurred.
- When production is abnormally high, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.
- The allocation of variable production overheads to each unit is based on the actual use of production facilities.

Other costs

Any other costs should only be recognised if they are incurred in bringing the inventories to their present location and condition. Other costs include:

- Carriage inwards i.e. the cost of goods being delivered to the company.
- Import duties
- Other handling costs.

The following costs are excluded from inventory valuation:

- Selling costs
- General administrative overheads
- Storage costs (unless necessary before a further production stage)
- Abnormal amounts of wasted materials, labour and other production costs
- Carriage outwards i.e. the cost of delivering goods to the customer.

Measuring inventory – net realisable value

To ensure that the value of inventory is not overstated, where it has fallen below its cost, inventory should instead be valued at net realisable value (NRV).

NRV comprises:

- Actual / estimated proceeds from sale
- Less: Estimated costs to completion
- Less: Estimated costs incurred in marketing / selling.

The principal situations in which NRV is likely to be less than cost are as follows:

- An increase in cost of producing goods
- Fall in selling price / inability to sell product
- New competitor in the market

- Strategic decision to sell products at a loss
- Physical deterioration of the inventory
- Obsolescence of inventory

Cost formulae

The normal basis for valuing inventory is its historical cost but it is sometimes very difficult to derive the historical cost of inventory as a business continually purchases different consignments of the same goods. As consignments are received, the goods are all stored in the same place. When issuing goods, the storekeeper may simply pull out the nearest item, which may not be the oldest in the store. It is therefore typical to have in the same warehouse goods from different consignments. This then makes it very difficult to accurately assess how much each item cost.

The following methods are permitted under IAS 2 and IPSAS 12 for valuing inventory.

- Average weighted cost (AVCO): Inventories are valued at the weighted average price at which items have been purchased during the period.
- First in first out (FIFO): Assumes that the oldest delivery will be issued first.

An entity should use the same cost formula for all inventories having similar nature and use to the entity. For inventories with different nature or use (for example, certain commodities used in one business segment and the same type of commodities used in another business segment), different cost formulas may be justified.

Example

Arnish Company is a manufacturing company which has a year-end of 31 December. The company's inventory at 31 December 20X5 included the following items:

- Raw materials: The company had an inventory on 31 December 20X5 of 1,400 units of material Z.
- The inventory of material Z on 31 December 2014 was nil.
- Purchases and usage of material Z during the year to 31 December 20X5 were as follows:

20X5		No. units	Cost per unit (Rwf 000)
1 September	Bought	1,000	40
11 September	Used	800	
1 November	Bought	1,800	50
13 November	Used	1,000	
1 December	Bought	3,000	60
15 December	Used	2,600	

The selling price of item Y is Rwf 100,000 per unit. The company pays a sales commission equal to 3% of selling price when units of item Y are sold to customers.

We can calculate the value of inventory of raw material Z as at 31 December 20X5, using

- the First-in, first-out (FIFO) method
- the weighted average cost (AVCO) method

Solution

a) FIFO:

	No. of units	Units and Rwf 000 per unit	Balance
Bought 1 September	1,000	1,000 @ 40	
Used 11 September	800	800 @ 40	200 @ 40
Bought 1 November	1,800	1,800 @ 50	200 @ 40 1,800 @ 50
Used 13 November	1,000	200 @ 40 800 @ 50	1,000 @ 50
Bought 1 December	3,000	3,000 @ 60	1,000 @ 50 3,000 @ 60
Used 15 December	2,600	1,000 @ 50 1,600 @ 60	1,400 @ 60

Value of inventory 31 December using FIFO = 1,400 * 60,000 = Rwf 84 million

b) AVCO

	No. of units		Cost (Rwf 000)	Weighted average cost per unit (Rwf 000)
Bought 1 September	1,000	@ 40	40,000	40.00
Used 11 September	800		32,000	
	200		8,000	
Bought 1 November	1,800	@ 50	90,000	

	2,000		98,000	49.00 (98,000 / 2,000)
Used 13 November	1,000		49,000	
	1,000		49,000	
Bought 1 December	3,000	@ 60	180,000	
	4,000		229,000	57.25 (229,000 / 4,000)
Used 15 December	2,600		148,850	

Value of inventory 31 December using AVCO = $1,400 \times 57,250$ = Rwf 80.15 million

Biological assets and agricultural produce

The standards dealing with this type of asset are IAS 41 Agriculture and IPSAS 27 Agriculture. The two standards have similar scope, definitions, and accounting treatments for biological assets and agricultural produce. IPSAS 27 has some additional guidance on accounting for biological assets that are acquired at no charge, for a nominal charge, or through a non-exchange transaction.

Term	Definition
Agricultural activity	The management by an entity of the biological transformation and harvest of biological assets for sale, distribution at no charge, or conversion into agricultural produce or additional biological assets for sale or distribution.
Agricultural produce	The harvested produce of the entity's biological assets.
Bearer plant	A living plant that is used in the production and supply of agricultural produce, is expected to bear produce for more than one period, and has a remote likelihood of being sold.
Biological asset	A living animal or plant.
Biological transformation	The process of growth, degeneration, production, procreation that cause changes in a biological asset.
Harvest	The detachment of produce from a biological asset or the cessation of a biological asset's life processes.

Recognition

The approach to recognition is similar to the general principles set out in the Conceptual Framework, with some additional requirements in relation to control of the asset. The recognition of a biological asset or agricultural produce is only permitted when:

- The entity controls the asset as a result of past events.
- It is probable that future economic benefits or service potential associated with the asset will flow to the entity.
- The fair value or cost of the asset can be measured reliably.

Measurement

Biological assets are initially measured at their fair value less costs to sell, unless fair value can not be measured reliably.

Agricultural produce is measured at fair value less costs to sell at the point of harvest. IAS 2 and IPSAS 12 Inventories are used as a reference for identifying related costs.

In some instances, cost can be used to approximate to fair value: for example, where little biological transformation has taken place since the initial costs were incurred, or the impact of any biological transformation is not expected to be material. If fair value can not be determined reliably, cost may be used as the measure, and this is adjusted for accumulated depreciation and impairment losses.

It may also be necessary to combine assets together to determine fair value for biological assets: for example, by identifying the fair value of land that includes a plantation of trees and deducting the value of undeveloped land (if this is known) to determine the value of the trees.

Gains and losses from biological assets are recognised through profit or loss (or 'surplus or deficit' under IPSAS 27. This can result from either the initial recognition of a biological asset at fair value or from a change in a biological asset's fair value less costs to sell at the reporting date.

Gains and losses arising on initial recognition of agricultural produce at fair value less costs to sell are also recognised through profit or loss in the period in which these arise.

Financial instruments

The IASB has addressed issues relating to financial instruments through the following three accounting standards:

- IFRS 7 Financial instruments: disclosures
- IFRS 9 Financial instruments (replacing IAS 39)
- IAS 32 Financial instruments: presentation

Definitions and examples	
Financial instrument	'Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.' IAS 32
Financial asset	<p>Any of the following are classified as financial assets in IAS 32:</p> <ul style="list-style-type: none"> (a) Cash (b) An equity instrument of another entity (i.e. shares owned in another company, whether a short-term investment in a few shares or a long-term holding in a subsidiary) (c) A contractual right to receive cash or another financial asset from another entity. <p>Trade receivables qualify as financial assets, along with loans made, as both mean that the holder is entitled to receive cash payments from another party. Financial assets do not include physical assets such as inventory.</p>
Financial liability	<p>Any liability that is a contractual obligation to deliver cash or another financial asset to another entity.</p> <p>This definition includes loans, overdrafts, debentures (loan stocks), leases and redeemable preference shares as they all result in a company having a liability to deliver cash in interest and principal payments. Despite the fact that they tend to be short term and non-interest bearing, trade payables are also a financial liability as they result in a contractual obligation to deliver cash (i.e. pay a supplier's invoice).</p>
Equity instrument	<p>Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.</p> <p>Ordinary shares are the main equity instrument in this category.</p>

Presentation of financial instruments

The gearing ratio (we will cover in Unit E) is usually defined as debt / capital employed, and hence shows the percentage of a company that is financed through debt. It is a key performance indicator for companies since a very highly geared company (one with a lot of debt) may be perceived to be a high-risk investment.

It is therefore important that anything meeting the definition of a financial liability is classified as such by companies in order that comparisons of gearing across different companies are meaningful.

IAS 32 requires that financial instruments should be classified on the basis of their substance rather than their legal form. The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer to deliver cash or another financial asset to the other party. If such an obligation exists, that instrument meets the definition of a financial liability.

For example, preference shares have historically been shown as part of share capital. However, if preference shares are redeemable, they meet the definition of a financial liability, as there is a contractual obligation to deliver cash (i.e. to redeem the preference share by giving money back to the shareholder). Therefore, redeemable preference shares are, according to IAS 32, to be classified as liabilities, with distributions to holders (preference dividends) included in the statement of comprehensive income as an expense (within finance costs).

Non-redeemable preference shares will normally continue to be shown as part of share capital, with dividends shown as a debit to equity (i.e. retained earnings as shown in the statement of changes in equity).

Example

The following are extracts from the trial balance of Outend Company as at 31 December X5:

	Rwf 000	Debit	Credit
Preference shares – redeemable on 31 December 20X9		175,000	
Preference dividend paid	5,000		

How should this be presented in the financial statements?

Solution

Statement of profit or loss – extract Rwf 000

Finance cost 5 000

Statement of financial position – extract

Non-current liabilities

Preference shares 175 000

As the preference shares are redeemable, there is a contractual obligation to make a future payment, and they should be classified as a liability.

The corresponding dividend cost must be classified in line with the SFP classification, hence the dividend will be shown as a finance cost.

Compound financial instruments

The situation becomes more complex with financial instruments which combine elements of equity instruments and financial liabilities. Compound financial instruments are a mixture of debt and equity. An example is loan stock if the owner has the option of converting these into ordinary shares or having the loan repaid instead.

The normal method of valuing the components of such an instrument is to calculate the present value of the liability component. The equity component is then the balance of the total value.

Financial assets

There are three categories of financial assets.

Amortised cost	<p>To classify as amortised cost, the financial asset must meet the following conditions:</p> <ul style="list-style-type: none"> • Business model test – The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows. • Cash flow characteristic test – The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
Fair value through profit or loss	Financial assets in this category are ones that do not meet the amortised cost conditions.
Fair value through other comprehensive income	<p>This category can be used for equity instruments when they are not held for trading.</p> <p>This category can also be used for debt instruments (like a bond) that meet the contractual cash flow test, and the entity intends to collect the cash flows and to sell the financial asset.</p>

The following table summarises the classification of financial assets and how this impacts on subsequent measurement:

Classification	Amortised cost	Fair value through profit or loss	Fair value through other comprehensive income
Reason for classification	Meets business test and cash flow test	Held for trading	Equity that is not held for trading Debt that meets the amortised cost criteria but is held for sale
Initial measurement	Cost plus transaction fees	Cost	Cost plus transaction fees
Subsequent measurement	Amortised cost	Fair value	Fair value

Financial liabilities

There are two categories of financial liabilities:

Fair value through profit or loss	This category is used for financial liabilities that are held for trading.
Amortised cost	This is used for all other financial liabilities that can not be classified as fair value through profit or loss

Derecognition

Derecognition refers to the removal of a previously recognised financial asset from an entity's statement of financial position. In essence, the criteria under IFRS 9 for derecognising a financial asset aim to determine whether an asset has effectively been 'sold' and therefore should be derecognised, or if an entity has merely obtained some form of financing against this asset, thus necessitating the recognition of an additional financial liability.

Another scenario requiring the assessment against the derecognition criteria is when a financial instrument is modified or restructured and entities need to determine whether this represents the expiry of the original cash flow rights.

Factoring

Factoring is a financial transaction where a business sells its outstanding accounts receivable to a third party, known as a factor, at a discounted price rather than waiting to be paid based on the original terms. There are two primary types of factoring:

- Recourse factoring: Should the original customer (debtor) fail to settle the invoice, the responsibility remains with the seller. In such cases, the factor can seek 'recourse' from the seller to recover the unpaid amount.
- Non-recourse factoring: Here, the factor takes on the risk of non-payment. If the debtor doesn't pay, the factor absorbs the loss.

IFRS do not mention factoring directly. Application of the principles of IFRS 9 would indicate that in the case of non-recourse factoring, the entity (ie the supplier that is owed money by a customer) should derecognise the receivable and record a loss for the difference between the amount previously owed and the amount received from the factor.

In the case of a recourse factoring arrangement, the nature of the transaction would need to be examined to determine whether a 'sale' had taken place – if not, then a loan between factor and the entity should be recognised, and the receivable retained.

Disclosures

IFRS 7 Financial instruments: Disclosures contains a number of disclosure requirements. These disclosures are intended to inform users of the significance of financial instruments for a company's financial position and performance, as well as the risks the company is taking with regards to these financial instruments.

The two main categories of disclosures required by IFRS 7 are:

1. Information about the significance of financial instruments
 - The carrying amounts of each of the categories financial asset and financial liability discussed above need to be disclosed either in the statement of financial position or in the notes to the financial statements.
2. Information about the nature and extent of risks arising from financial instruments
 - The entity needs to disclose information that enables users to evaluate the nature and extent of risks arising from financial instruments.
 - This is separated into qualitative disclosures and quantitative disclosures
 - Credit risk is the risk that one party to a financial instrument will cause a loss for the other party by failing to pay its obligation.
 - Liquidity risk is the risk that an entity will have difficulty paying its financial liabilities.
 - Market risk is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market price.

Leases

IFRS 16 Leases defines a lease as: 'A contract, or part of a contract, that conveys the right-to-use an asset, the underlying asset, for a period of time in exchange for consideration'.

A right-of-use asset is an asset that represents a lessee's right to use an underlying asset for the lease term. (IFRS 16)

A contract that includes a lease will have two parties: the lessor, who supplies the asset, and the lessee, who uses the asset. In this unit, we focus on the accounting requirements of the lessee.

The first task in accounting for a lease is to determine whether the contract actually contains a lease or not. IFRS states that a contract contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration (usually a regular series of payments to the lessor)

The 'period of time' in the contract may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

Some contracts may involve complex arrangements, requiring the company to separately identify the lease component from any non-lease components, and account for these separately.

Initial Measurement of the right-of-use asset

At commencement of the lease the right-of-use asset is recognised at cost, which includes the following:

- the initial measurement of the lease liability
- lease payments made at or before the commencement dates
- any lease incentives received are deducted
- initial direct costs incurred by the lease

- estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset or restoring the underlying to a condition in line with the lease terms

The recognition of this asset is an example of 'substance over form'. This means that the transactions are recorded according to the economic reality and not just the legal form. For example, with a lease, the lessee does not own the asset legally, but the economic substance is that they have the use of the asset, and will therefore include the asset in their financial statements.

Subsequent measurement of the right-of-use asset

The right-of-use asset should be measured under the cost model of IAS 16. When the right-of-use asset is an investment property or belongs to a class of assets that is held under the revaluation model then it should be revalued.

The asset should be depreciated over the shorter of:

- lease term, or
- the asset's useful life.

If the lease transfers legal ownership at the end of the lease term, or if there is a purchase option that they are expected to exercise, then it should be depreciated over its useful life.

Lease liability

The initial lease liability is measured at the present value of the lease payments that are not paid at that date, which includes any expected payments at the end of the lease. The liability is discounted at the interest rate implicit in the lease.

The lease payments made to the leasing company must be split between the finance element (which is included with finance costs on the statement of comprehensive income) and the principal element (which is the repayment of capital – the repayment reduces the liability within the statement of financial position).

The statement of profit or loss will include amounts within:

- Cost of sales, administration costs, or distribution costs – the depreciation charge for the year
- Finance costs – the interest element of the lease payment

The statement of financial position will include:

- Non-current assets (initial measurement or revalued amount less accumulated depreciation)
- Non-current liabilities (liability to lessor due in more than one year)
- Current liabilities (liability to lessor due in less than one year)

Example

The Micro company leased a piece of plant and machinery from Leases- R-Us on 1 January 20X8 and in return for three years use of the asset, Micro agreed to pay Leases-R-Us Rwf 40.21 million per year on the last day of the year. Micro company incurred direct costs of Rwf 5 million to enter into the lease agreement. The lease does not transfer legal ownership or contain a clause allowing purchase.

The present value of the future lease payments is Rwf 100 million.

The interest rate implicit in the lease is 10%.

Prepare extracts for the statement of profit or loss and statement of financial position for the year-ended 31 December 20X8.

Solution

Step 1: Capitalise asset

IFRS 16 requires that a right-of-use asset is recognised within the lessee's statement of financial position as the lessee controls the asset and the asset has the potential to generate future economic benefits. Therefore, we need to debit non-current assets by Rwf 105,000 which is the present value of the future lease payment and the direct costs.

Dr Right-of-use asset	Rwf 105 million
Cr Cash	Rwf 5 million
Cr Lease liability	Rwf 100 million

Step 2: Complete lease table and calculate closing liability

We will apply the interest rate provided to the liability amount brought forward as follows:

Year	Brought forward	Interest 10%	Principal	Total Payment	Balance
	Rwf 000	Rwf 000	Rwf 000	Rwf 000	Rwf 000
1	100,000	10,000	30,210	40,210	69,790
2	69,790	6,979	33,231	36,559	

Step 3: Depreciate right-of-use asset

As the lease does not transfer legal ownership or there is no purchase option then the right-of-use asset is depreciated over three years.

$$\text{Rwf } 105 \text{ million} / 3 = \text{Rwf } 35 \text{ million}$$

Therefore, the following balances will be taken to the financial statements:

Statement of profit or loss for the year-ended 31 December 20X8 (extract) – Rwf 000

Depreciation 35,000

Finance cost 10,000

Statement of financial position as at 31 December 20X8 (extract) – Rwf 000

Non-current assets (105 000 – 35 000) 70,000

Non-current liabilities 36,559

Current liabilities 33,231

Recognition exemptions

IFRS 16 allows companies an exemption in the following situations:

- Leases that are less than 12 months long
- Leases for assets that are of a low value

If companies take this exemption, they recognise an expense in profit or loss on a straight-line basis. The asset is not recorded on the statement of financial position.

Example

Grims Company entered in to a lease on the 1 January 20X6 for a period of three years for the lease of laptop computers for staff. The terms are to pay Rwf 20 million on the 1 January 20X6 and then three further payments of Rwf 20 million on 31 December each year. Grims have elected to apply the low value exemption.

Solution

The total expense of Rwf 80 million must be spread over the three-year lease.

$$\text{Rwf } 80 \text{ million} / 3 = \text{Rwf } 26.7 \text{ million per year will be the expense for the year.}$$

On the SFP there will be a prepayment of Rwf 13.3 million. This is calculated as follows:

Amount paid	20 + 20	40
Less expense		(26.7)
Prepayment		<u>13.3</u>

Provisions

IAS 37 Provisions, Contingent Liabilities and Contingent Assets defines a provision as: 'a liability of uncertain timing or amount'. IPSAS 19 includes an identical definition of a provision.

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefit. (IAS 37) IAS 37 distinguishes provisions from other liabilities such as trade payable and accruals. This is on the basis that for a provision there is uncertainty about the timing or amount of the future expenditure.

While uncertainty is clearly present in the case of certain accruals, the uncertainty is generally much less than for provisions.

IAS 37 states that a provision should be recognised as a liability in the financial statements when all three of the following criteria have been met:

- An entity has a present obligation as a result of a past obligating event; and
- It is probable that an outflow of economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the obligation.

Present obligation

Obligating event	<p>An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.</p> <p>A constructive obligation arises when the business has created a valid expectation that they will act in a certain way in the future.</p>
------------------	--

Example

Company G operates in a country where it is required by law to clean up any contamination arising from its operations. During the year ended 31 December 20X6 there was an incident that caused environmental damage.

Company H operates in a country where there is no specific legislation requiring a company to clean up after causing contamination. During the year ended 31 December 20X6 there was an incident that caused environmental damage.

Solution

For Company G, the incident is in the past, and as there are laws in place this creates a legal obligation. The first recognition criterion for a provision is met.

For Company H, the answer will depend on the previous actions of H and any published policy. If H had previously cleaned up after any contamination, and had a published policy stating that they would continue to do so, then they have created a constructive obligation.

Probable outflow of economic benefits

Example

Company BB dismissed one of its employees during the year and the employee is now pursuing a claim of unfair dismissal. BB's lawyers have suggested that there is a high probability that the claim will be successful.

Solution

The dismissal of the member of staff is a past event and the claim of unfair dismissal is a present obligation. Therefore, it does meet the first criterion.

As the lawyers indicate that there is a high probability of the claim being successful, an outflow is probable, and the second criterion is met.

Reliable estimate

A provision can only be recognised if a reliable estimate of the amount involved can be made. The accounting entries required for a provision will be to create an expense in profit or loss and a provision on the statement of financial position. As provisions involve a degree of uncertainty, the exact amount paid may differ from the original provision, or the provision may need updating in subsequent years as more information is obtained.

Example

At 31 December 20X8 a provision is created for Rwf 450 million by charging an expense and creating a provision.

Debit Expense	450
Credit Provision	450

In the following financial year, the amount paid is actually Rwf 430 million. No further payment will be required.

The accounting entries in the year ended 31 December 20X9 will be:

Debit Provision	450
Credit Cash	430
Credit Expense	20

This removes the liability and releases the remaining provision back to profit or loss. A release or a further charge is to be expected when the liability is settled as provisions involve a high degree of uncertainty.

The following example illustrates provisions arising from different commercial transactions and events.

Example	Solution
(a) An airline is required by law to overhaul its aircraft once every three years.	<p>There is no present obligation. At the year-end, no obligation exists to overhaul the aircraft independently of the entity's future actions – the entity could avoid the future expenditure by its future actions, for example by selling the aircraft.</p> <p>No provision required.</p>
(b) A car manufacturer gives warranties at the time of sale to purchasers of its cars, the warranties cannot be sold separately. Under the terms of the contract for sale, the manufacturer undertakes to make good any defects that become apparent within three years from the date of sale. On past experience, it is probable that there will be some claims under the warranties.	<p>The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.</p> <p>While the likelihood of outflow for any one car sold may be small, it is probable that an outflow will be required to settle the class of obligations as a whole (i.e. all cars sold during the year).</p> <p>The obligation can be estimated by considering all cars sold in the year, i.e. calculating the likely percentage of cars found to be defective within the three-year period and the average cost to fix each defective car.</p> <p>A provision is recognised for the best estimate of the costs of making good under the warranty all cars sold before the reporting date.</p>
(c) An oil company operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the restoration of damage caused by the extraction of oil. At the reporting date the rig has been constructed but no oil has been extracted.	<p>The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the reporting date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.</p> <p>An outflow of economic benefits in settlement is probable, and a reliable estimate can be made</p> <p>A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig (IAS 16). The 10 per cent of costs that arise through the restoration of damage caused by the extraction of oil are recognised as a liability when the oil is extracted.</p>

Example	Solution
(d) A retail store has a policy of refunding purchases by dissatisfied customers even though it is under no legal obligation to do so. Its policy of making refunds is generally known.	<p>The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund purchases.</p> <p>While the likelihood of outflow to refund any one product may be small, it is probable that an outflow will be required to settle the class of obligations as a whole (i.e. all products sold during the year).</p> <p>The obligation can be estimated by considering all products sold in the year, based on previous returns information.</p> <p>A provision is recognised for the best estimate of the cost of refunds.</p>

Restructuring

Many companies may make plans to alter the way they operate for example closing down a factory or ceasing production of a particular product.

IAS 37 gives the following examples of events that may fall under the definition of restructuring:

- The sale or termination of a line of business.
- The closure of business locations in a country or region, or the relocation of business activities from one country or region to another.
- Changes in management structure, for example, the elimination of a layer of management.
- Fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

The next step is to look carefully at whether a provision can be recognised for restructuring and to do this we need to look at whether the company has created a constructive obligation for the restructuring. For a constructive obligation to be created the standard says that :

1. A detailed formal plan is must exist, and
2. The plan have been communicated to those affected.

Onerous contracts

IAS 37 defines an onerous contract as 'A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it'.

Example

On 1 January 20X5, Company XF entered into a contract to supply clothing over a four-year period. At the end of 20X5 the company identifies that the contract has become loss making, and it is expected to continue to make a loss over the remainder of the contract period. The present value of continuing to supply the order is Rwf 45 million or they could pay a penalty of Rwf 55 million.

Explain, with reasons, how the above should be treated in the financial statements for the year-ended 31 December 20X5.

Solution

The obligating event is the signing of the contract, which gives rise to a legal obligation.

They will either have to fulfil the contract or pay a penalty, so there is a probable outflow of economic benefits, and a reliable estimate can be made.

A provision should be recognised for the lower of the costs of fulfilling the contract and paying the penalty. A provision of Rwf 45 million should be made.

Future operating losses

Provisions should not be recognised for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard.

Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party. For example, an insurance policy may be held to cover negligence claims against the company. If so, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation.

- The reimbursement should be treated as a separate asset, and the amount recognised should not be greater than the provision itself.
- The provision and the amount recognised for reimbursement may be offset in the statement of comprehensive income.

Contingent liabilities

A contingent liability is defined by IAS 37 as:

- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control; or
- a present obligation that arises from past events but is not recognised because:
 - (a) it is not probable that a transfer of economic benefits will be required to settle the obligation; or
 - (b) the amount of the obligation cannot be measured with sufficient reliability.

A contingent liability will not be recognised in the financial statements as there is less certainty that it will occur or be settled than is the case for other liabilities such as trade

payable.

In some circumstances, a contingent liability may need to be disclosed in the notes to the financial statements.

In general, 'probable' means more than 50% likely. If an obligation is probable, it is not a contingent liability; instead, a provision is needed.

Examples of contingent liabilities include loans guaranteed on behalf of third parties, and legal proceedings that are in process against a company where its legal advisors believe that it is unlikely (i.e. less than 50% probable) that any transfer of economic benefits will be required.

Disclosure

The required disclosures for a contingent liability are:

- A brief description of the nature of the contingent liability
- An estimate of its financial effect
- An indication of the uncertainties that exist
- The possibility of any reimbursement.

If the likelihood of settlement is remote, then no disclosure has to be made.

Contingent assets

The IAS 37 definition of a contingent asset is:

- a possible asset that arises from past events
- and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events not wholly within the organisation's control.

Contingent assets are not recognised in the accounts unless virtually certain.

If probable (i.e. more than 50% probability), then they are disclosed by a note to the accounts.

Events after the reporting period

Events that arise between the reporting date (at the end of a financial year) and financial statements being published or issued to shareholders may require adjustments to be made. IAS 10 Events after the Reporting Period provides guidance on when are required.

IAS 10 Definitions	
Events after the reporting period	Events after the reporting period are those events, favourable and unfavourable, that occur between the reporting date and the date when the financial statements are authorised for issue.

IAS 10 Definitions	
Adjusting events	Adjusting events are events that provide evidence of conditions that existed at the reporting date. If going concern is impacted by an event, this would also be an adjusting event
Non-adjusting events	Non-adjusting events are events that are indicative of conditions that arose after the reporting date.

Recognition

An adjusting event must be recognised in the financial statements. This means that accounting entries will be required to reflect the event. The reason for this is that the event is just providing evidence of conditions that were there at the year end.

For a non-adjusting event, the financial statements will not be adjusted, but material events should be disclosed by a note. This means that no accounting entries are required as the event related to conditions that arose after the year end.

The note must state the nature of the event and an estimate of its financial effect (or a statement that such an estimate cannot be made).

Examples of adjusting events

- Settlement of a court case confirming a present obligation at the reporting date.
- Evidence that an asset was impaired at the reporting date but was not reflected in the statement of financial position.
- Customer declared bankrupt soon after reporting date.
- The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.
- The determination of staff bonus or profit-sharing arrangements for which the entity had a legal or constructive obligation to pay at the reporting date.
- Discovery of fraud or error affecting the financial statements.

Examples of non-adjusting events

- Declared ordinary dividends after the reporting date.
- Inventory destroyed in a fire after reporting date.
- Decline in market value of investments after reporting date.
- Major business combination/restructure after reporting date.
- Major ordinary share transactions.
- Changes in tax rates or tax law with a significant effect on current or deferred tax liabilities or assets
- Commencing major litigation arising solely out of events after the reporting date.

Example

Mara Company's closing inventory has been valued at Rwf 65 million. Included within inventory are some goods valued at Rwf 12 million, which were deemed to be obsolete, and so Mara had to discount them to Rwf 2 million to sell them ten days after the year end.

Solution

The sale of the inventory is an event after the reporting date and the issue here is to decide whether it is an adjusting event as per IAS 10. The conditions relating to the value of this inventory existed at the year end and the sale just confirms this i.e. the inventory could not have been sold for Rwf 12 million.

The financial statements should be adjusted, and inventory should be valued at the lower of cost or net realisable value (NRV). NRV is Rwf 2 million therefore inventory is overvalued in the statement of financial position by Rwf 10 million (Rwf 12 million – Rwf 2 million).

This will cause costs of sales to increase by Rwf 10 million and inventory on the statement of financial position to be reduced by the same amount.

Equity dividends

IAS 10 prescribes the following rules for proposed ordinary dividends:

- Ordinary dividends proposed before or after the accounting date are not recognised as liabilities because they do not meet the criteria of a present obligation. Whilst the directors may intend to pay the dividend to shareholders, the company has no obligation to do so until the point at which it is declared to shareholders.
- Ordinary dividends declared/approved after the accounting date are also not recognised as liabilities, because they do not meet the criteria of a present obligation and are a non-adjusting event as per IAS 10.
- Ordinary dividends declared/approved before the accounting date are recognised as liabilities and such dividends are disclosed in the statement of changes in equity (as an adjustment to retained earnings).

Date of authorisation

IAS 10 requires that the date of authorisation for issue of the financial statements must be disclosed, together with the name of the person authorising, usually a director.

This disclosure is important, because this date marks the end of the period in which events after the reporting period are reflected in the financial statements.

Income taxes

Companies usually pay tax several months after the year-end and so may not know the exact liability for tax to include at the year-end. They therefore need to make an estimate of the liability. Any adjustment needed for paying more or less than the estimated amount is accounted for in the following year's statement of profit or loss.

The tax expense in the statement of profit or loss comprises the following three elements:

Rwf	
Current tax	X
Under/(over) provision from previous year	x/(x)
Increase/(decrease) in deferred taxation	x/(x)
Total tax expense	X

The total tax expense is shown on the face of the statement of profit or loss with the detail above in a note.

Current tax is the estimated tax payable for the current year, which is accounted for as:

Debit	Tax expense
Credit	Current tax (current liabilities)

Example – Tash Company

In the accounting year to 31 December 20X6, the Tash Company made a profit before taxation of Rwf 110 million, and current year taxation is estimated as Rwf 45 million.

Solution

The journal entry is:

Debit Tax expense	Rwf 45 million
Credit Payables	Rwf 45 million

Note that the current tax for the year is an estimate. When the tax is actually paid over to the tax authorities, companies will often end up paying more or less than the amount they accrued. The difference must be shown in the accounts for the year in which the payment is made, even though it relates to the previous year.

Example – Tash Company (continued)

In the accounting year to 31 December 20X6, the Tash company paid Rwf 40.5 million in full settlement of the previous year's tax liability, which had been estimated in the 20X5 financial statements as Rwf 38 million.

Solution

The journal entry is:

Debit Payables	Rwf 38 million
Debit Tax expense	Rwf 2.5 million
Credit Cash	Rwf 40.5 million

The previous year's tax liability was under accrued by Rwf 2.5 million (40.5 – 38). This must be accounted for in the current year, 20X6, as it is too late to change the previous year's account.

Tax in the statement of financial position

Tax balances in the statement of financial position comprise the following:

- Non-current liabilities – deferred tax
 - This is the closing deferred tax provision after any increase or decrease required for the year.
- Current liabilities – current tax payable
 - This is the estimated liability for current tax that will be paid over to the tax authorities after the year end.

Example – Tash Company (continued)

In the accounting year to 31 December 20X5, the Tash Company had a deferred tax provision of Rwf 60 million. A provision of Rwf 60 million was required for the year to 31 December 20X6.

Solution

The journal entry is:

Debit Tax expense	Rwf 16 million
Credit Deferred tax	Rwf 16 million

Disclosure and presentation

We can illustrate the effect of the examples above on the financial statements of Tash Company as follows:

Example – Tash Company (continued)

Statement of profit or loss for the year ended 31 December 20X6	Rwf million
Current year	45
Under provision from 20X5	2.5
Transfer to deferred taxation	<u>16</u>
Tax expense	63.5
Statement of financial position as at 31 December 20X6	Rwf million
Non-current liabilities	
Deferred tax	76
Current liabilities	
Current tax payable	45

Deferred taxation

Deferred tax will usually be a credit balance, and each year it may need to increase or decrease.

If an increase to the deferred tax provision is required the adjustment would be:

Debit	Tax expense
Credit	Deferred tax

If a decrease to deferred tax provision is required the adjustment would be:

Dr	Deferred tax
Cr	Tax expense

Deferred tax is not a tax that is paid to the tax authorities, but rather an accruals-based accounting adjustment required by IAS 12 because the accounting treatment of an item differs from its taxation treatment.

For example, the tax system of some countries does not allow companies to claim depreciation as an expense when calculating taxable profit. Instead, the system allows companies to claim 'capital allowances', the tax version of depreciation, on non-current assets, calculated at standard rates.

In general, the total depreciation charge in the statement of profit or loss for a non-current asset should be equal to the total capital allowances claimed over the life of that non-current asset. However, there may be temporary differences between the amount of depreciation charged for an accounting period, and the amount of capital allowances claimed in the tax computation for that period.

A liability for deferred tax arises if a company has claimed more in capital allowances for a non-current asset than it has charged as a depreciation expense in its accounts. This reflects the fact that in the future, the tax allowances given will be less than the accounting charge for depreciation and hence more tax will need to be paid to the tax authorities.

Example

A company buys a wind turbine for Rwf 40 million. The asset will be depreciated on the straight-line basis over four years with no residual value (i.e. Rwf 10 million per year).

For tax purposes the whole Rwf 40 million is allowable as a deduction in the first year as the government is keen to encourage companies to invest in green technology (i.e. the capital allowance is 100% in the first year). The company pays tax at 21%.

The company's pre-tax profit is steady at Rwf 100 million per year for each of the four years concerned.

Solution

The capital allowance in Year 1 reduces the profit for tax purposes by Rwf 40 million, and therefore the profit after tax in Year 1 will be less than in Years 2–4, despite the fact that the profits before tax have remained consistent over the four years. There are no capital allowances in year 2 onwards as the 100% tax allowance was given in year 1.

The deferred tax adjustment required by IAS 12 seeks to rectify this distortion of profits after tax and ensure that the accruals principle is followed.

The first step in calculating the IAS 12 deferred tax adjustment is to calculate the temporary difference. A temporary difference is the difference between accounting value of an asset and the tax value of an asset. IAS 12 requires a net asset approach to calculate this difference.

Rwf million	Year 1	Year 2	Year 3	Year 4
Cost	40	40	40	40
Accumulated depreciation	(10)	(20)	(30)	(40)
Asset's accounting value	<u>30</u>	<u>20</u>	<u>10</u>	<u>0</u>
Cost	40	40	40	40
Accumulated capital allowances	(40)	(40)	(40)	(40)
Asset's tax base	0	0	<u>0</u>	<u>0</u>
Temporary Difference	<u>30</u>	<u>20</u>	<u>10</u>	<u>0</u>

By *temporary*, we mean that the difference eventually disappears, because by the end of the asset's life, its tax base is the same as its accounting value, i.e. nil. The temporary timing difference at the end of each year can be used to calculate the deferred tax provision which is required in the financial statements. Simply take the temporary difference and multiply it by the relevant tax rate (for example 21%) to give you the deferred tax provision which is needed in the accounts.

Rwf million	Year 1	Year 2	Year 3	Year 4
Temporary Difference (above)	30	20	10	0
Deferred tax provision 21%	6.3	4.2	2.1	0
Change in deferred tax	6.3 increase	2.1 decrease	2.1 decrease	2.1 decrease

Therefore, in year 1, a deferred tax provision needs to be set up within the SFP (non-current liabilities) for Rwf 6.3 million. Note that deferred tax should almost always be shown as a non-current liability. This will require the following accounting entry:

Debit Tax expense Rwf 6.3 million
 Credit Deferred taxation Rwf 6.3 million

In years 2-4, we calculated that the deferred tax provision needs to decrease by Rwf 2.1 million each year in order that we are left with nil at the end of the asset's life (the point at which there are no more timing differences). Therefore, the following accounting entry will be required in each of years 2-4:

Debit Deferred taxation Rwf 2.1 million
 Credit Tax expense Rwf 2.1 million

The purpose of the deferred tax adjustment is to eliminate distortions to the tax expense and profits after tax. We can now see that the distortion has been eliminated once we include these adjustments in the accounts.

Rwf million	Year 1	Year 2	Year 3	Year 4
Accounting profit	100	100	100	100
Less tax 21%*	(14.7)	(23.1)	(23.1)	(23.1)
Deferred taxation adjustment	(6.3)	(2.1)	(2.1)	(2.1)
Total tax expense	(21)	(21)	(21)	(21)
Profit after tax	79	79	79	79

* Tax calculated after adding back depreciation 10 million each year and deducting 40 million allowance in Year 1

The total tax expense recognised in the accounts, and hence the profit after tax, is now constant over the four years, which given that pre-tax profits were the same in all four years and the company consumed the asset equally each year would be expected and provides the shareholders with a profit after tax figure which fairly represents the performance.

The financial statements extracts for the four years are therefore as follows:

Statement of profit or loss (extract)				
Rwf million	Year 1	Year 2	Year 3	Year 4
Profit before tax	100	100	100	100
Income tax expense	(21)	(21)	(21)	(21)
Profit after tax	<u>79</u>	<u>79</u>	<u>79</u>	<u>79</u>

Statement of financial position (extract)				
Rwf million	Year 1	Year 2	Year 3	Year 4
Non-current liabilities:				
Deferred taxation	6.3	4.2	2.1	0
Current liabilities				
Current tax payable	14.7	23.1	23.1	23.1

Taxable temporary differences

The main possible causes of timing differences leading to deferred tax liabilities are:

- Accelerated capital allowances (as per example).
- Development costs capitalised and amortised in the financial statements but for tax purposes these costs are deducted from taxable profits as incurred.
- Revaluation gains. Assets are not revalued for tax purposes; this causes a difference between the tax treatment of assets and the accounting treatment of assets as the tax charge on the profit will not arise until the asset is sold but the gain has been recognised.
- Interest received included in financial statements on an accruals basis but not subject to tax until received.

Revenue

The standard we will focus on in this section is IFRS 15 Revenue from Contracts with Customers. Revenue is an important measure of a company's performance. It is used widely by investors and other users for making comparisons and investment decisions.

There are some types of revenue that are specific to the public sector, and we will look at the approach taking by IPSASB later in this unit.

Core principles

The core principles of IFRS are that:

- an entity should recognise revenue when it transfers goods or services to a customer based upon the amount of consideration (payment) to which the entity expects to be entitled from the customer;
- the goods or services are transferred when the customer has control of them; and
- the disclosures are designed to help investors understand the nature, amount, timing and uncertainty of revenue.

Entities most affected by this standard are likely to be those offering complex bundles of goods and services, or those who or provide long-term service contracts such as a mobile phone company offering a handset and the ability to make calls.

Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
Revenue	Income arising in the course of an entity's ordinary activities.
Income	Increases in economic benefits in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity (other than those from equity participants).
Stand-alone selling price	The price at which a good or service would be sold separately to a customer.
Performance obligation	A promise to transfer to the customer either: (i) a distinct (bundle of) goods or services, or (ii) a series of substantially the same distinct goods or services that have the same pattern of transfer to the customer, and the pattern of transfer is both over time and represents the progress towards complete satisfaction of the performance obligation.

Five-Step model

IFRS 15 establishes a five-step model that will apply to revenue earned from a contract with a customer, regardless of the type of revenue transaction or the industry. Every entity must follow this five-step model in order to comply with IFRS 15.

Step 1: Identify the contract(s) with the customer	<p>A contract can be written, oral or implied, but for IFRS 15 to apply the following criteria must be met:</p> <p>Parties have approved the contract and are committed to perform their responsibilities</p> <p>Parties can identify the payment terms</p> <p>The contract has commercial substance</p> <p>It is probable that the consideration will be paid</p>
Step 2: Identify the performance obligations in the contract	<p>It is crucial to identify the performance obligations in the contract. This is because it is only when those performance obligations are satisfied that revenue can be recognised.</p> <p>Remember that the performance obligation is the promise to provide goods or services.</p> <p>A good or service is distinct if it can be sold separately. Key in identifying separate obligations is the distinctiveness of the good or service.</p>

Step 3: Determine the transaction price	A business needs to determine the amount of consideration it expects to receive in order to recognise revenue.
Step 4: Allocate the transaction price	<p>For a contract that has more than one performance obligation, an entity should allocate the transaction price to each performance obligation.</p> <p>This allocation should be based on the relative stand-alone selling price of the goods or services.</p>
Step 5: Recognise revenue when or as a performance obligation is satisfied	<p>A performance obligation is satisfied when control of the goods or services is transferred to the customer.</p> <p>This can be satisfied at a <u>point in time</u>, or <u>over a period of time</u>.</p> <p>For a performance obligation to be satisfied over a period of time it must meet any one of the following criteria:</p> <ol style="list-style-type: none"> 1. The customer simultaneously receives and consumes the benefit provided by the entity's performance as the entity performs it 2. The entity's performance creates or enhances an asset, for example, work in progress, that the customer controls as the asset is created or enhanced 3. The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed. <p>If any of these criteria are met, then revenue should be recognised <u>over a period of time</u>.</p>

Performance obligations satisfied at a point in time

The key is to determine the date that control is transferred. IFRS 15 gives the following as indicators that control has been transferred:

- The entity has a present right to payment
- The entity has transferred physical possession of the asset
- The customer has accepted the asset
- The customer has the significant risk and rewards of the asset
- The customer has legal title to the asset.

Example

A computer manufacturer agrees to supply 50 computers on 1 December 20X6. The price is agreed at Rwf 35 million. An invoice, dated 15 December 20X6, was issued to the customer.

Solution

The contract is for the supply of computers, and the performance obligation is the promise to supply these computers. The transaction price is Rwf 35 million, and there is only one performance obligation.

The final step then is to determine when the performance obligation is satisfied, and control is transferred. The contract does not meet any of the criteria to be recognised over a period of time so should be recognised at a point in time.

They should recognise revenue at the date the computers are supplied, as the indicators are that control is transferred at that date (ie 1 December 20X6), even though the invoice was dated 15 December 20X6.

Example

An airline manufacturer agrees to manufacture a specialised plane for a customer. The plane cannot be used by the manufacturer and the contract specifies that payments are due throughout the period of manufacture.

Solution

Looking at the criteria for recognising over a period of time, the third criterion is met as the asset is being created for the customer and has no alternative use. Also, the contract allows for payments throughout the manufacturing period from the customer to the manufacturer. Revenue should be recognised over a period of time and the manufacturer would then need to decide how to recognise the revenue over that period of time.

Performance obligations recognised over a period of time

When a contract spans more than one accounting period, and it meets one of the criteria for revenue to be recognised over a period of time, the entity will need to determine how to best recognise the revenue over the appropriate period.

IFRS 15 states that this should be done by a method that best depicts the transfer of goods or services.

Example

Glan Company enters into a cleaning contract for an agreed price of Rwf 312,000, to provide cleaning services to a school over a 24-month period.

Solution

There is a clear contract with a single performance obligation and a contract price of Rwf 312,000. The contract meets one of the conditions for the revenue to be recognised over a period of time, as the customer receives and consumes the benefit as it is provided.

Glan would then have to decide how best to spread the revenue over the 24-month period. The most likely method given the service provided is to spread the Rwf 312,000 evenly over the contract, so they would recognise Rwf 13,000 a month as revenue.

Using the output method the contract will be 50% complete at the year end, this is calculated by taking the work certified over the total contract value.

An entity may agree to build an asset for another entity, and that construction of the asset may occur over a number of years.

IFRS 15 requires the entity to choose a method of revenue recognition that best depicts performance. This may be either:

- An input method – for example based on the percentage of cost incurred to date compared to the total costs.
- An output method – for example based on work certified to date.

The following example illustrates these methods:

Example

Spors Company is awarded a contract to build a sports stadium for an agreed price of Rwf 900 million and they expect the costs to be Rwf 600 million. At the end of Year 3 of the project, Spors have spent Rwf 300 million and they estimate that future costs to complete will be Rwf 330 million. A surveyor values the work completed to date as Rwf 450 million

Solution

Using the input method, the contract will be approximately 48% complete at the year end. This is calculated by taking cost incurred to date over total expected costs:

$$300 \text{ million} / 630 \text{ million} = 48\%$$

This percentage would then be used to calculate the amount of revenue and cost to be recognised on the contract.

Using the output method, the contract will be 50% complete at the year end. This is calculated by taking the work certified over the total contract value:

$$450 \text{ million} / 900 \text{ million} = 50\%$$

Presentation in financial statements

Where a contract is in place, and revenue is being recognised over a period of time, there may be assets and/or liabilities associated with the contract, whether the input or output method is applied. These need to be included in the statement of financial position at the end of the year, as well as there being information in the statement of profit or loss on revenue, costs, and profit or loss on the contract in the period.

Statement of profit or loss:

Revenue (total contract revenue x %)	X
Less cost of sales (total contract cost x %)	(X)
Profit	X

Statement of financial position:

Costs incurred	X
Profit recognised (in statement of profit or loss)	X
Less: Progress billings	(X)
Contract asset/(liability)	X/(X)

For contracts where performance obligations are satisfied over a period of time, the stage of completion is required to calculate how much revenue should be recognised to date. However, there is no requirement to calculate the estimated profit/loss on the contract as a whole (except to the extent of determining whether the contract is onerous).

Example

Entity K has two outstanding contracts (Contract A and Contract B) with two customers to design and deliver customer-specific machines.

Entity K has determined that it is appropriate to measure the performance obligations completed to date based on the stage of completion.

Rwf million	Contract A	Contract B
Contract price	15,000	18,000
Costs incurred	6,000	6,000
Estimated further costs to completion	4,000	6,000
Stage of completion	50%	50%
Amount billed to customer	7,500	10,800

Solution

Statement of profit or loss		
Rwf million	Contract A	Contract B
Revenue (50% x contract price)	7,500	9,000
Direct contract expenses (50% x total costs)	(5,000)	(6,000)
Gross profit	<u>2,500</u>	<u>3,000</u>

Statement of financial position		
Rwf million	Contract A	Contract B
Costs incurred	6,000	6,000
Profit recognised in profit or loss	<u>2,500</u>	<u>3,000</u>
	8,500	9,000
Less: progress billings	(7,500)	(10,800)
Contract asset/(liability)	<u>1,000</u>	<u>(1,800)</u>

Sales with a right of return

A consignment arrangement arises when a business delivers goods to another party, such as dealer or retailer, that is for sale to an end customer.

This type of arrangement is often seen in the car industry when the car manufacturer delivers car to a dealership. The car dealership then tries to sell the cars to customers.

IFRS 15 provides the following as indicators that a consignment arrangement exists:

- The product is controlled by the entity until a specific event occurs such as the sale of the product to a customer by the dealer or until a period expires
- The entity is able to require a return of the product or transfer to a third party
- The dealer does not have an unconditional obligation to pay for the product, although a deposit may be required.

Once a consignment arrangement is identified the key is then to determine when control is transferred as it is only at that point that revenue can be recognised. This is illustrated in the following example:

Example

A car dealer has received a delivery of 10 vehicles from a vehicle manufacturer on the following terms:

- Legal title remains with the manufacturer until the dealer is able to agree the sale of a vehicle with a customer.
- The manufacturer is allowed to ask for the return of the cars up to the date of sale to a customer.
- The price which the dealer must pay to the manufacturer is based on the list price of the vehicle on the date on which legal title transfers.
- Payment is due when the dealer sells the cars.

Solution

We need to compare the information in this example with the indicators that control has been transferred from the manufacturer to the dealership.

Indicator that control has been transferred	Application to example
The entity has a present right to payment	The manufacturer has no right to payment
The entity has transferred physical possession of the asset	The asset has been transferred physically to the car dealership, but the manufacturer can ask for it to be returned
The customer has accepted the asset	Yes
The customer has the significant risk and rewards of the asset	No. These remain with the manufacture as the price is based on the date of eventual sale.
The customer has legal title to the asset	No

The car manufacturer did not transferred control of the cars when they were delivered to the dealership, and control will not be transferred until the cars are sold to a customer.

No revenue should be recognised, and the cars will remain as inventory on the manufacturer's financial statements.

Warranties

Some sales may include a warranty. The issue here is whether the warranties are separate performance obligations from the sale of the actual product or not.

IFRS 15 states that, if the customer can purchase the warranty separately, then it is a distinct service, and this should be accounted for as a separate performance obligation. This would be an example of a performance obligation that is satisfied over a period of time. Therefore, the revenue would be recognised over the period of the warranty.

If a warranty cannot be purchased separately then the warranty is accounted for under IAS 37 Provisions. This means the revenue is recognised at the time when the sale of the product is made, and a provision is set up for expected warranty costs.

Sales with a significant financing component

In some instances, a company may make a sale that includes an implicit financing component. If the financing component is 'significant', IFRS requires this to be recognised in the accounting for the sale. This is, in effect, adjusting for the effects of the time value of money.

Examples:

- Cash received in advance from buyer – vendor to recognise the finance cost and the increase in deferred revenue
- Cash received in arrears from buyer – vendor to recognise the finance income and the reduction in revenue

No adjustment for a financing component is needed if the payment is settled within one year of the goods or services being transferred to the buyer.

IFRS does not require an adjustment for the following, as they do not result in a significant financing component:

- The customer has discretion over the timing of the transfer of control of the goods or services.
- The consideration is variable, and the amount or timing depends on factors outside of the control of parties.
- The difference between the consideration and cash selling price arises for other non-financing reasons (ie performance protection).

Bundles of goods and services

Earlier in this unit, we noted that a performance obligation is defined as follows:

Performance obligation	A promise to transfer to the customer either: (i) a distinct (bundle of) goods or services, or (ii) a series of substantially the same distinct goods or services that have the same pattern of transfer to the customer, and the pattern of transfer is both over time and represents the progress towards complete satisfaction of the performance obligation.
------------------------	--

The idea of a 'bundle', is that goods and/or services are supplied together within a single sale transaction.

The following examples illustrate how an entity needs to determine whether goods and/or services are being sold separately or together as a bundle.

Examples	
Callan Company is a manufacturer. Callan enters into a contract with a customer to design and produce a customer-specific machine, together with commissioning and installation of after-sales service.	Callan needs to identify the various components in the arrangement and account for each as a separate performance obligation because the customer can benefit from the good or service on its own.
Broch Builders enters into a contract with a customer to construct a building.	<p>In constructing a building, the customer would also benefit from the supply of bricks and other construction material as well as supply of labour.</p> <p>These items would not be distinct if Broch Builders is providing the material and construction labour to the customer as part of its promise in the contract to construct the building for the customer.</p>
Arnol Company is a software developer. Arnol enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support online and telephone for a specific period.	<p>Arnol would need to assess whether each promised good or service is distinct. It would probably identify four separate performance obligations, ie:</p> <ol style="list-style-type: none"> (1) the software licence (2) an installation service (3) software update (4) technical support.

Government grants

The standard dealing with this topic is IAS 20 Accounting for Government Grants and Disclosure of Government Assistance. We need to distinguish between government grants and government assistance:

Government Grants	<p>Assistance by government in the form of transfer of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.</p> <p>To recognise a government grant, the entity must have reasonable assurance that:</p> <p>it will comply with the conditions attached to the grant; and</p> <p>the grant will be received.</p>
-------------------	---

Government Assistance	<p>Action by government designed to provide economic benefit specific to an entity or range of entities under certain criteria.</p> <p>If a value cannot be reliably placed on the government assistance, or it cannot be distinguished from normal trading activity, then it is not included within the definition of government grants and assistance.</p>
-----------------------	--

Accounting for government grants

IAS 20 requires that grants are recognised as income over the relevant periods, to match them with related costs.

This should be done on a systematic basis. The exact treatment of government grants will depend on whether the grant is a revenue grant or a capital grant.

Grant related to revenue costs	<p>The grant should be credited to profit or loss as income in the period in which the associated expenditure is incurred (normally under 'other operating income').</p> <p>Any government grant received, where the associated expenditure is yet to be incurred, and the terms of the grant do not require the immediate return of the funds to the government, should be credited to the statement of financial position as deferred income (within liabilities). This income is then credited to the profit or loss to <u>match</u> against the associated expenditure in the period that the expenditure is incurred.</p>
--------------------------------	--

Example

Scarist Restaurants has received a Rwf 20 million government grant. The terms of the grant require the funds to be spent on the salary costs of employing a new member of staff for a two-year period, after which any unspent funds must be returned to the government. The staff member commenced work at the beginning of the accounting period with an annual salary of Rwf 10 million.

At the end of year one there is no indication that the employee is to leave their employment.

Solution

Year 1

Debit	Cash	20
Credit	Other operating income	10
Credit	Deferred income	10

Year 2

Debit	Deferred income	10
Credit	Other operating income	10

Grant related to assets (capital expenditure)	<p>Two methods allowed under IAS 20:</p> <ol style="list-style-type: none"> 1. The grant is credited to the statement of financial position as deferred income (a liability). The grant is then credited 'other operating income' over the life of the asset on the same basis as the depreciation is charged on the asset. 2. The grant is credited to the statement of financial position against the carrying value of the non-current asset i.e. reducing the value of the asset and hence resulting in a smaller depreciation charge each year. <p>In the case of grants for non-depreciable assets, certain obligations may need to be fulfilled; in which case the grant should be recognised as income over the periods in which the cost of meeting the obligation is incurred.</p>
---	--

Example

Scarist Restaurants also received a government grant towards the cost of new kitchen equipment. The grant received was Rwf 15 million. The total cost of the new equipment was Rwf 21 million. The useful life of the equipment is five years, it has a residual value of Rwf 1 million, and the business uses the straight line method for depreciating equipment. Scarist uses the deferred income approach to account for capital grants.

Solution

Year 1

Debit	Cash	15
Credit	Deferred income	15
Debit	Non-current asset	21
Credit	Cash	21
Debit	Depreciation expense	4
	$(21 - 1)/5$	
Credit	Non-current asset	4
Debit	Deferred income (15/5)	3
Credit	Other operating income	3

Note: If Scarist was using the reduced asset approach, the initial grant would be credited to Non-current assets (not Deferred income), and depreciation would be calculated on the net amount after the grant:

$$21 - 15 - 1 = \text{Rwf 5 million}$$

$$5/5 = \text{Rwf 1 million per annum.}$$

Conditions attached to a grant

There may be a series of conditions attached to a grant (e.g. certain expenditure has to be made in order to qualify for the grant).

If the conditions for the grant have not been met in the year and part or the entire grant must be repaid, companies need to ensure that the repayable element is recognised as a payable.

Example

A revenue grant of Rwf 150 million has been received by the Buirn Company in 20X0 in order to create jobs in a deprived area. In order to qualify for the full Rwf 150 million, Buirn has to employ an additional 30 local people within its factory by the end of 20X0. If it does not reach the target by the end of 20X0, Buirn will have to pay Rwf 150 million per unfilled job back to the government shortly after the year-end. In the period to 31 December 20X0, Buirn had employed 23 additional local people.

Solution

Buirn will recognise the amount of the grant that it is entitled to keep (i.e. where it has met the conditions) within its other operating income in the statement of comprehensive income. The amount that it will have to repay to the government will have to be shown as a payable within current liabilities as it will have to repay this to the government shortly after the year-end.

Year 1

Debit	Bank	150
Credit	Other operating income	115
	(23 * 5)	
Credit	Payables	35

This will be reported as other operating income in the statement of profit or loss, and a payable under current liabilities in the statement of financial position.

Accounting for government assistance

Some forms of government assistance are excluded from the definition of government grants.

- Some forms of government assistance cannot reasonably have a value placed on them; for example, free technical or marketing advice, provision of guarantees.
- There are transactions with government which cannot be distinguished from the entity's normal trading transactions; for example, government procurement policy resulting in a portion of the entity's sales. Any segregation would be arbitrary.

It may be important to disclose information on such assistance. Where significant, the nature, extent and duration of the assistance should be disclosed.

IAS 20 Disclosures

Disclosure is required for the following:

- The accounting policy adopted by the entity, including the method of presentation.
- The nature and extent of government grants recognised, and other forms of assistance received.
- The unfulfilled conditions and other contingencies that are attached to recognised government assistance.

Financial reporting for small and medium-sized entities

Eligibility criteria

There is no single definition of an SME. There are a number of different dimensions of small and medium-sized business, as well as differences between firms, sectors, or countries at different levels of development.

Most definitions based on size use measures such as number of employees, net assets total, or annual revenues. However, none of these measures apply well across national borders. The SMEs Standard is intended for use by entities that have no public accountability (ie its debt or equity instruments are not publicly traded or holds assets in a fiduciary capacity eg most banks and financial institutions).

Ultimately, the decision regarding which entities should use the SMEs Standard stays with national regulatory authorities and standard setters. These bodies will often specify more detailed eligibility criteria. If an entity opts to use the SMEs Standard, it must follow the standard in its entirety – it cannot select between the requirements of the SMEs Standard and those of full IFRS Standards.

Differences between full IFRS and IFRS for SMEs

It should be clear now that the requirements of IFRS are a significant demand on companies that seek to, or are required to, comply with them. While the IFRS framework as a whole provides a comprehensive and detailed set of requirements, and ensures that users of the financial statements are able to place reliance on the information provided by the financial statements based on IFRS, the resources required to comply fully with them are beyond the ability of many smaller companies. There are also some areas of IFRS that are arguably less relevant to small companies.

As a result of these concerns, the IFRS for Small and Medium-sized Enterprises (SMEs) was issued by the IASB in 2009, and was amended in 2015. While IFRS consists of a set of separate standards on specific accounting topics and issues, the SMEs Standard is a single self-contained document, which is based on the accounting principles found in current IFRSs. The requirements, however, have been simplified to be more appropriate for smaller entities, and there some topics that are not included within the SME standard, as they were deemed to be less relevant, ie:

- earnings per share
- interim financial reporting
- segment reporting
- insurance (because entities that issue insurance contracts are not eligible to use the standard), and
- assets held for sale.

Some IFRS accounting treatments are not allowable under the SMEs Standard. For example, the capitalisation of borrowing and development costs is not permitted under SME Standard, but need to be expensed to profit or loss.

Examples of simplified approach under SMEs Standard	
Borrowing costs	Borrowing costs can not be capitalised, but must be charged as an expense in the statement of profit or loss in the year that they arise
Development costs	Under IFRS 38, development costs are distinguished from research costs and must be capitalised where certain criteria are met. Under the SMEs Standard, development costs are treated the same as research costs, and must be charged as an expense in the statement of profit or loss when they are incurred.
Financial instruments	<p>All basic financial instruments are measured at amortised cost, using the effective interest method, except for investments in non-convertible and non-puttable ordinary and preference shares that are publicly traded or whose fair value can otherwise be measured reliably are measured at fair value through profit or loss.</p> <p>All amortised cost instruments must be tested for impairment.</p> <p>At the same time the standard simplifies the derecognition and disclosure requirements. The SME Standard separates basic and other financial instruments eg hedging instruments, swaps, options.</p> <p>However, the SME Standard still offers significant simplifications even for more complex financial instruments.</p> <p>SMEs can choose to apply the recognition and measurement requirements of IAS 39 if they so wish.</p>
Goodwill and other indefinite-life intangibles	These are amortised over their useful lives, but if useful life cannot be reliably estimated, then 10 years
Investment in associates and joint ventures	The cost model is permitted for investments in associates and joint ventures

The SMEs Standard is a response to international demand from developed and emerging economies for a rigorous and common set of accounting standards for smaller and medium-sized businesses that is much simpler than full IFRS Standards. The SMEs Standard should provide improved comparability for users of financial statements while enhancing the overall confidence in the financial statements of SMEs, and reducing the significant costs involved of maintaining standards on a national basis.

The Board are expected to limit revisions to the SME Standard to once every three years

although the process means in reality the time frames are longer. The IASB are currently (2021) in the process of consulting on whether and how to align the IFRS for SME standard with the full IFRS standards to better serve the users and preparers of financial statements without causing undue cost and effort to SMEs.

There may be some important tax issues arising for SMEs that adopt the SMEs Standard and this has been cited as one of the main reasons why some SMEs have not adopted the SME Standard.

Accounting for transactions in the public sector

Most IPSAS standards are based on an equivalent IFRS standard, with amendments where appropriate to ensure that the standard is relevant to the public sector.

There are some standards, however, that deal with transactions or events that do not have an equivalent IFRS, or where there is a marked difference between the IPSAS and IFRS approaches

The following IPSAS are discussed in more detail below:

- IPSAS 23 Revenue from Non-Exchange Transactions and IPSAS 9 Revenue from Exchange Transactions
- IPSAS 21 Impairment of Non-Cash-Generating Assets
- IPSAS 11 Construction Contracts
- IPSAS 42 Social Benefits

Non-exchange revenue

One of the main characteristics of public sector entities as a whole is that a major part of their revenue is received as taxation or other mandatory payments by citizens or companies, rather than being paid in exchange for good and services. Many public sector bodies also receive donations or grants. A major part of their expenditure involves making payments or providing services for no fee, a nominal amount, or an amount which will not recover costs. These may include payments to relieve poverty, debt forgiveness, and other social expenditures.

These 'non-exchange transactions', in which the parties do not make exchanges of approximately equal value, are a characteristic feature of public sector financial reporting. Non-exchange transactions arise rarely if at all in the private sector, and consequently there is no IFRS covering non-exchange transactions. After considering such transactions, the IPSAS Board developed a standard to prescribe the financial reporting requirements of revenue arising from non-exchange transactions.

'In a non-exchange transaction, an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without receiving approximately equal value in exchange'.

The objective of IPSAS 23 Revenue From Non-Exchange Transactions (Taxes And Transfers) is to set out requirements for the financial reporting of non-exchange revenue. IPSAS 23 applies to revenues from the following transactions and events:

- Taxes, from whatever source.
- Other non-exchange revenue (called 'transfers' in the standard), such as grants,

finances, bequests, gifts, donations, and services-in-kind.

The same principles apply to the recognition of revenue from non-exchange transactions as for other revenue. Revenue collected on behalf of third parties (including other government organisations) is not counted as part of the entity's revenue. Revenue is recognised when:

- It is probable that future economic benefits or service potential will flow to the entity.
- The amount of revenue can be measured reliably.

The principle underlying the recognition of revenue from non-exchange transactions is that if an entity receives an asset in a non-exchange transaction it recognises revenue in the same amount, provided that the asset can be measured reliably.

Assets are defined in IPSAS 1 as 'resources controlled by an entity as a result of past events and from which economic benefits or service potential are expected to flow to the entity'. In the case of a public sector entity, assets arising from non-exchange transactions can take a number of forms including cash, receivables, other assets that provide economic benefits, and assets that have service potential. Under accruals accounting, the public sector entity will recognise revenue when it directly exercises control over these resources, or has reliable information on enforceable claims on these resources.

Non-exchange revenue will typically include:

- Donations.
- Surrenders of taxes.
- Accounts receivable based on invoices, for example for fines levied on offenders, or for settlement of tax balances.
- Accounts receivable from contracts or binding agreements, including grants from another level of government or from international donors.
- Estimates of taxes due based on estimates of the economic activity that gives rise to a requirement to pay tax.

Revenue should only be recognised when control has passed to the receiving entity, on the basis of information which is sufficiently reliable. Pledges, promises or announcements of intention to pay are not generally regarded as sufficient to ensure an enforceable claim and thus control of an asset.

There are three important situations where assets received are not reflected as non-exchange revenue.

1. Contributions from owners: these are disclosed separately and are not part of revenue. These occur when a contributing entity provides and designates funding or other assets as being a permanent contribution, establishing a financial interest in the net assets/equity of the receiving entity.
2. Advance receipts: An entity may receive an asset in advance of the period to which it relates. Such advance receipts generally relate to taxes, but IPSAS 23 also gives an example of annual contributions received in the preceding year. In line with standard accruals principles, these advance receipts are treated as a liability until the taxable or other event triggering recognition occurs, and only at that point is revenue recognised.
3. Assets with linked obligations: The receipt of assets may give rise to a present

obligation, in the form of a duty to act or perform in a certain way. In some cases, this will indicate that the asset has been exchanged for acceptance of an obligation, and normal accounting for exchange transactions should be followed. In other cases, it is more helpful to treat the asset as being received as a non-exchange transaction, but to recognise a balancing liability in respect of the obligation.

Measurement

In line with standard requirements for recognition of revenue, it is necessary that the asset received and controlled by the entity can be measured reliably. Assets acquired through non-exchange transactions are measured at their fair value at the date of acquisition. Revenue is valued at the amount of the increase in assets, less any associated liability attached to the asset. Many such assets are in the form of cash received immediately or within a short period, and establishment of fair values will be straightforward. As with all receivables, questions of collectability due to disputes and delays in payments may need to be addressed. Liabilities relating to present obligations also need to be valued. Where non-performance of the obligation would in principle require the asset to be returned, these are valued at an amount equal to the asset value. The liability will be reduced when the events occur to discharge the obligation, and these will also result in recognition of the revenue.

Revenue from taxes

IPSAS 23 requires a public sector entity to recognise an asset in respect of taxes when the taxable event occurs and the asset recognition criteria (including control, expectation of future economic benefits or service potential, and reliable measurement) are met. Taxes are a major source of revenue for many governments and public sector entities. IPSAS 23 includes a definition of taxes as:

‘Economic benefits or service potential compulsorily paid or payable to public sector entities, in accordance with laws and/or regulations, established to provide revenue to the government. Taxes do not include fines or other penalties imposed for breaches of the law’.

The taxable event will vary according to the type of tax levied and IPSAS 23 provides a list of examples:

- **Income tax** – Earning of assessable income during the taxation period by the taxpayer.
- Value added tax – Undertaking of taxable activity during the taxation period by the taxpayer.
- **Goods and services tax** – Purchase or sale of taxable goods or services during the taxation period.
- **Customs duty** – Movement of dutiable goods or services across the customs boundary.
- **Death duty** – Death of a person owning taxable assets.
- **Property tax** – Passing of the date on which the tax is levied, or the period for which the tax is levied, if the tax is levied on a periodic basis.

IPSAS 23 requires that assets arising from taxation transactions to be measured at their fair value as at the date of acquisition. Assets arising from taxation transactions are measured at the best estimate of the inflow of resources to the entity.

IPSAS 23 describes key features of taxation issues in many jurisdictions that may serve to delay settlement of tax, may make the level of settlement uncertain, and may require the development of statistical models or other estimation approaches. These include the long periods allowed for filing of returns, failures to file returns by the due date, complexities in tax law, and inherent problems in gathering relevant information.

Because of the need for governments to maintain cash flows from tax receipts, it is normal for tax authorities to require payments in advance, particularly from self-employed persons and businesses. IPSAS 23 makes it clear that the significant volume of advance tax receipts encountered in many jurisdictions should not be recognised as revenue until the tax is properly due. Governments applying accruals accounting should recognise tax revenue in line with the taxable events, applying tax rates to taxable income or assets.

The tax area is one where many (perhaps most) governments face significant practical difficulties in producing reliable estimates of total tax due and the likely level of bad debts. In many jurisdictions governments will not be able to estimate these even after collection processes have been completed; they may only be able to measure objectively and reliably the net amount of taxes collected.

Governments will often face additional constraints from limitations in the systems used to collect and account for tax receipts (whether their own or systems used by other entities collecting tax on behalf of government), which may not provide sufficient information on the period to which tax receipts relate.

For these reasons, many governments either do not account for tax revenue on an accruals basis, or provide accruals information which is limited due to difficulties in producing reliable estimates. IPSAS 23 recognises the difficulties and requires disclosure of information on 'missing' tax revenue.

Taxation revenue is determined at a gross amount. It should not be reduced for expenses paid through the tax system, nor should it be grossed up for the amount of tax expenditures.

Transfers	<p>IPSAS 23 applies the same recognition principles to other non-exchange revenue, that is, a public sector entity recognises an asset when the asset recognition criteria (including control, expectation of future economic benefits or service potential and reliable measurement) are met.</p> <p>Revenue is only recognised to the extent that a gain from the asset value is not reduced by an associated liability.</p> <p>Transfers include grants, fines, bequests, gifts, donations, debt forgiveness, and goods and services in kind. All these items have the common attribute that they transfer resources from one entity to another without providing approximately equal value in exchange, and are not taxes as defined in IPSAS 23.</p>
-----------	---

Grants	<p>Grants are often provided with limitations on how money is spent or how the assets are utilised.</p> <p>The standard separates such limitations into <u>conditions</u>, where the money must be spent as specified or returned to the donor (in other words a performance obligation); and <u>restrictions</u>, where there is a more general requirement to spend the money in a specified area, but not to return it if this is not achieved.</p> <p>Where the recipient entity identifies that the donor has imposed conditions, they set up a liability for the obligation for the value of the money received. The liability is reduced as the conditions are satisfied (by spending the money or through other actions) in accordance with the agreement.</p> <p>There is no such requirement for grants with restrictions, and revenue is recognised for those grants immediately.</p>
Fines	Fines are recognised in the period in which the fine is imposed.
Bequests	<p>Bequests are instructions in a deceased person's will to transfer cash or other assets to an entity.</p> <p>Bequests are recognised when the nature of the bequest is known, and it has been established that the estate is sufficient to meet all claims.</p> <p>Bequests may contain directions on how the money is to be spent or assets are to be utilised.</p>
Gifts and donations	<p>Gifts and donations are voluntary transfers of cash or other assets to an entity.</p> <p>Gifts and donations are usually recognised on receipt of the cash or other asset.</p> <p>Pledges to give in the future are not usually recognised as they are not controlled by the entity, but may warrant disclosure as a contingent asset.</p> <p>Gifts and donations may be subject to directions on to how the money is to be spent or assets are to be utilised.</p>
Debt forgiveness	Lenders may waive their right to collect a debt owed by a public sector entity, thus effectively cancelling the debt. In such a case the entity has an increase in net assets/equity and treats the amount forgiven as revenue from a non-exchange transaction.

Services in kind	<p>Such services may include free technical assistance from other governments or international organizations, voluntary work in schools and hospitals or community services performed by convicted offenders.</p> <p>The standard provides that entities may, but are not required to, recognise services in kind as revenue and expenditure where the amount can be measured, is material and its inclusion enhances the presentation of the financial statements.</p> <p>Disclosure of the nature of significant services in kind is encouraged.</p>
------------------	--

Example – services in kind

A hospital employs the following staff: a medical student from university during vacation periods on a voluntary basis, who carries out a variety of jobs in various departments to gain work experience; a trained nurse whose salary is paid by an international agency, who works within standard procedures and whose work is assessed as of equal quantity and quality as that of local nursing staff.

How would this be accounted for in the hospital's financial statements?

Solution

It is unlikely that the services of the medical student would be recognised in the financial statements, as it will normally be difficult to assess the value of this work. There is a better case for recognition of the work of the trained nurse, especially if there are several such staff whose total contribution is material. The valuation of the work might be based on, for example, the salary rate of the local staff who do equivalent work.

IPSAS 9 Revenue from Exchange Transactions

IPSAS 9 is based on IAS 18 Revenue, which has been replaced by IFRS 15 (as discussed above). In broad terms, the approach to recognition of revenue from sales, provision of services, and interest, royalties and dividends is very similar to the IFRS approach to these transactions.

All costs associated with the revenue should be accounted for in the same period as the revenue is recognised. This is commonly referred to as the matching of revenue and expenses.

IPSAS 9 includes two general conditions that must be met before any type of revenue can be recognised, ie:

- It is probable that future economic benefits or service potential will flow to the entity.
- The amount of revenue can be measured reliably.

In addition to these two conditions, there are additional conditions that apply to specific types of revenue, as summarised in the following table:

Sale of goods	<p>Additional conditions:</p> <p>The seller must have transferred to the buyer all of the significant risks and rewards of ownership.</p> <p>The seller no longer has management involvement or effective control of the goods.</p> <p>The costs incurred in relation to the transaction can be measured reliably.</p>
Rendering of services	<p>Additional conditions:</p> <p>The stage of completion can be measured reliably.</p> <p>The costs incurred and the costs to complete in relation to the transaction can be reliably measured.</p> <p>Revenue is recognised by reference to the stage of completion using what is known as the percentage of completion method. The stage of completion can be determined via a number of methods. IPSAS 9 specifically mentions three:</p> <p>Surveys of work performed.</p> <p>Assessing the services performed to date against the total services to be performed under the contract.</p> <p>Assessing the costs incurred to date against the total costs to be incurred under the contract.</p>
Interest, royalties and dividends	<p>Revenue should be recognised on the following basis:</p> <p>Interest revenue is recognised on a time apportion basis.</p> <p>Royalties are recognised on an accrual basis.</p> <p>Dividends are recognised when the shareholder's right to receive the dividend is legally established. This is usually when dividends are declared.</p>

Contracts

IPSAS 11 Construction Contracts provides guidance on how to allocate revenue and costs to the relevant accounting periods, and in doing so enables us to spread the overall profit earned over the life of the contract. The guidance in IPSAS 11 follows the principles of revenue recognition contained in IAS 18 Revenue.

IPSAS 11 requires that the entity matches revenue and expenses over the life of a construction contract. In this way we are recognising profit over the life of the contract.

During the early stages of a contract, it may be too early to recognise any profit on that contract. In this situation, or where it is not possible to estimate the outcome reliably, the entity recognise matching amounts for contract revenue and costs, which results in zero profit in the period.

The following example illustrates how the entity can determine the revenue and expenses to be recognised on a construction contract in the accounting period.

Example

At the end of the year to 31 May 20X9, the Point Company is 10 months into an 18-month contract to build an office block. The total contract price is Rwf 100 million and estimated total costs for the contract are Rwf 60 million. Based on the information at our disposal we can calculate that the total expected profit on this contract as follows:

Profit calculation:	Rwf million
Revenue	100
Expected costs	<u>(60)</u>
Expected profit	<u>40</u>

We now know that the contract is expected to make a profit of Rwf 40 million. It is necessary to calculate how much of this total profit relates to the current accounting period. When calculating how much revenue and costs to include in the financial statements for the current accounting period, we must carefully consider the information that is available. In general, there are four ways in which the information can be used to calculate how much to include in revenue and costs for the current accounting period:

1. Information is available to determine the value of work certified and corresponding costs. This is the ideal information, since we are provided with information on the work completed during the current period and also on the corresponding costs that relate to that work.
4. Information is available to determine value of work certified only. We can use the figure for work certified to estimate the corresponding costs.
5. Information is available on the proportion of the contract that has been completed. We can use this information to estimate the revenues and costs that relate to the current accounting period.
6. Information only available on the costs incurred to date. We can use this information to establish that the contract is X% complete and use this to estimate work completed.

Note that the first of these is the most reliable basis for determining revenues and costs for the period. The other three are acceptable methods for estimating revenues and costs if the 'ideal' information is not readily available.

Example

Returning to Point Company example, if we are told that the costs incurred to date were Rwf 48 million, we could estimate revenues and costs for the current period as follows:

Percentage complete	=	costs incurred to date / total contract costs
	=	480,000/600,000 = <u>80%</u>
Revenue	80% x 1,000,000	800,000
Costs		<u>480,000</u>
Attributable profit		<u>320,000</u>

As soon as the entity becomes aware that a contract is likely to make a loss, it must provide for that loss in full. This is even if the contract is several years away from completion.

Example

At 31 December 20X8, the Tumpan Company provided the following information about a construction contract:

	Rwf million
Total contract price	1,000
Costs incurred to date	600
Value of work certified	800
Corresponding costs	580
Estimated costs to completion	450
Progress payments	850

Solution

Total contract price	1,000
Costs incurred to date	(600)
Estimated costs to completion	<u>(450)</u>
Total costs	<u>(1,050)</u>
Expected loss on contract	<u>—(50)</u>

The contract now shows an expected loss of Rwf 50 million. IPSAS 11 requires that we provide in full for this in the current accounting period, even though the contract is not yet complete.

We must calculate how much to include in revenue and cost of sales in the statement of financial performance and compare these amounts with the amount invoiced to the customer and the costs incurred.

	Statement of financial performance	Amount invoiced	Statement of financial position
Revenue	800 000	850 000	(50 000)
Costs	(580 000)	(600 000)	<u>20 000</u>
Attributable profit	220 000		Payable (30 000)
Provision for loss			
(balancing figure)	(270 000)		Provision <u>(270 000)</u>
Expected loss	<u>(50 000)</u>		<u>(300 000)</u>

Impairment of non-cash generating assets

There are two IPSAS which provide guidance on the impairment of assets:

- IPSAS 21 Impairment of non-cash-generating assets
- IPSAS 26 Impairment of cash-generating assets.

IPSAS 26 is based on IAS 36, and has very similar requirements (with some amendments to terminology).

In the private sector assets are ultimately held to generate a commercial return: i.e. to maximise profit. In the public sector the majority of assets are held for their service potential rather than for generating revenue streams, although there are a number of circumstances in which public sector organisations may hold some assets with the primary objective of generating a commercial return. This distinction between cash-generating and non-cash-generating assets has driven the decision to issue two accounting standards.

IPSAS 21 Impairment of non-cash-generating assets should be applied to non-cash-generating assets. A non-cash-generating asset is an asset that it is not held with the primary objective of generating a commercial return.

When an entity is assessing whether there is an indication that an asset may be impaired, it should consider both external and internal sources of information. Some of the sources of information are relevant to both cash-generating and non-cash-generating assets but in some cases the information is specific to that type of asset.

External sources of information:

- A significant decline in the asset's market value. This may arise, for example, as a result of a new competitor entering the market. (IPSAS 26)

- Significant changes in the technological, market, economic or legal or government policy environment in which the entity operates. This could be as simple as a change in customer tastes. (IPSAS 21 and IPSAS 26)
- Increases in market interest rates which are likely to affect discount rates. (IPSAS 26)
- Cessation, or near cessation, of the demand or need for services provided by the asset. (IPSAS 21)

Internal sources of information:

- Obsolescence or physical damage to the asset. (IPSAS 21 and IPSAS 26)
- Significant changes in how an asset is used or is expected to be used, including the asset becoming idle and plans to discontinue or restructure the division in which an asset is used. (IPSAS 21 and IPSAS 26)
- Performance of the asset being below that planned, for example actual net cash flows generated by the asset being below that budgeted, or the service performance of an asset being significantly worse than expected. (IPSAS 21 and IPSAS 26)
- A decision to halt the construction of the asset before it is complete or in a useable condition. (IPSAS 21 and IPSAS 26)

The general process for impairment of non-current assets is the same under IPSAS as under IAS 36. In both public and private sector, this consists of assessing for an impairment where there is an indication that an asset may be impaired, and this involves comparing the asset's carrying amount with its recoverable amount. The recoverable amount is defined as the higher of:

- The asset's fair value less costs to sell.
- The asset's value in use.

Fair value is the amount obtainable from a sale in an arm's length transaction between a willing buyer and seller, less the costs of disposal.

Note that for a non-cash-generating asset IPSAS 21 uses the term 'recoverable service amount', but we still need to find the higher of fair value less costs to sell and value in use. We will, however, use a different method to calculate value in use.

IPSAS 21 defines value in use of a non-cash-generating asset as the present value of the asset's remaining service potential.

This is determined using the most relevant of the following approaches. The choice of the most appropriate approach to measuring value in use depends on the availability of data and the nature of the impairment.

Depreciated replacement cost approach	The present value of the remaining service potential of the asset is determined as the depreciated replacement cost of the asset. The replacement cost of an asset is the cost to replace the asset's gross service potential. This cost is depreciated to reflect the asset in its used condition.
---------------------------------------	---

Restoration cost approach	This is the cost of restoring the service potential of an asset to its pre-impaired level. Under this approach, the present value of the remaining service potential of the asset is determined by subtracting the estimated restoration cost of the asset from the current cost of replacing the remaining service potential of the asset before impairment.
Service units approach	The current cost of the remaining service potential of the asset before impairment is reduced to conform with the reduced number of service units expected from the asset in its impaired state.

The approaches to calculating value in use for a non-cash-generating asset are illustrated in the following examples:

Example – Depreciated replacement cost approach

In 20X1, the City of Asker purchased a new computer system at a cost of Rwf 100 million. Asker estimated that the useful life of the computer would be seven years, and that on average 80% of the computer's processing capacity would be used by the various departments. The mainframe computer is recognised using the cost model and depreciated straight line over the useful life of seven years.

Within a few months of acquisition, usage reached 80%, but then declined to 20% in 20X5 because of significant long-term changes in technology. A computer is available on the market at a price of **Rwf 5 million** that can provide the remaining service potential of the mainframe computer using the remaining applications.

Solution

The indication of impairment is the significant long-term change in the technological environment resulting in decreased usage of the mainframe computer. Impairment loss is determined using the depreciated replacement cost approach as follows:

Acquisition cost	100
Accumulated depreciation	
(Rwf 100 * 4 ÷ 7)	(57)
Carrying amount	<u>43</u>
Replacement cost	5
Accumulated depreciation (Rwf 5 * 4 ÷ 7)	<u>3</u>
Recoverable service amount	<u>2</u>

Therefore, the impairment loss $43 - 2 = \text{Rwf } 41$ million, which is accounted for as follows:

DR	Expenses – impairment	Rwf 41
CR	Non-current assets – Computer	Rwf 41

The carrying amount of the asset after accounting for the impairment loss is Rwf 2 million

Example – Restoration cost approach

In 20X4, Sollas District Primary School acquired a bus at the cost of Rwf 200 million to help students from a nearby village to travel free of charge. The school uses the cost model and estimated a useful life of 10 years for the bus. In 20X9, the bus sustained damage in a road accident, requiring Rwf 40 million to be restored to a usable condition. The restoration will not affect the useful life of the asset. The cost of a new bus to deliver a similar service is Rwf 250 million in 20X9. Impairment is indicated because the bus has sustained physical damage in the road accident.

Solution

Impairment loss using the restoration cost approach would be determined as follows:

Acquisition cost	200
Accumulated depreciation ($200 \times 5 \div 10$)	<u>100</u>
Carrying amount	<u>100</u>
Replacement cost	250
Accumulated depreciation ($250 \times 5 \div 10$)	<u>125</u>
Depreciated replacement cost (undamaged state)	125
Less: restoration cost	<u>40</u>
Recoverable service amount	<u>85</u>

Impairment loss $100 - 85 = 15$

DR	Statement of financial performance	15
CR	Vehicle non-current asset	15

Carrying amount of asset after impairment loss is Rwf 85 million.

Example – Service units approach

In 20X3, Dalib City Council constructed a 20-story office building for use by the Council in downtown Dalib at the cost of Rwf 80 **billion**. The building is recognised using the cost model and was expected to have a useful life of 40 years. 15 years later in 20Y8, National Safety Regulations required that the top four stories of high-rise buildings should be left unoccupied for the foreseeable future. The building has a fair value less costs to sell of Rwf 45 billion in 20Y8 after the regulations came into force. The current replacement cost of a similar 20-story building is Rwf 85 billion.

Impairment is indicated because the extent of use of the office building has changed from 20 floors to 16 floors as the result of new National Safety Regulations. The reduction in the extent of use is significant and the occupation of the building is expected to remain at the reduced level (16 floors) for the foreseeable future.

Solution

Impairment loss using the service units approach would be determined as follows:

Acquisition cost	80
Accumulated depreciation ($80 \times 15/40$)	<u>30</u>
Carrying amount	<u>50</u>

Replacement cost (20-storey building)	85
Accumulated depreciation ($85 \times 15/40$)	<u>32</u>
Depreciated replacement cost (before adjustment for remaining service units)	<u>53</u>

Value in use of the building after regulation came into effect ($53 \times 16/20$)	42.5
Fair value less costs to sell of building after regulation	45
Recoverable service amount (higher of value in use and Fair value less costs to sell)	45

The impairment loss is therefore $50 - 45 = 5$. This would be accounted for as follows:

DR Expenses – impairment	5
CR Non-current assets – building	5

The carrying amount of asset after recognising the impairment loss is Rwf 45 billion.

Social benefits

IPSAS 42 Social Benefits defines social benefits as cash transfers paid to specific individuals and/or households to mitigate the effect of social risk.

Social risks are events or circumstances that relate to the characteristics of individuals and/or households (eg age, health, poverty, employment status), and may adversely affect the welfare of individuals and/or households either by imposing additional demands on their resources or by reducing their income.

Examples of social benefits that are mentioned in IPSAS 42 include state retirement benefits, disability benefits, income support and unemployment benefits.

The standard requires an entity to recognize an expense and a liability for the next social benefit payment. This will usually be a short-term liability, as only the next payment of social benefit expenditure needs to be accounted for.

IPSAS 42 stems from the need to provide transparency around the nature and financial effects of social benefit schemes, and to better understand how these schemes impact the government's finances as a whole.

There are two approaches to accounting for social benefits that are set out in IPSAS 42, referred to as the general approach and the insurance approach.

General approach:

Under the general approach, the criterion for recognition of a social benefit liability is when the entity has a present obligation for an outflow of resources that results from a past event, and the present obligation can be measured in accordance with the Conceptual Framework. Note that if an obligation can be settled without an outflow of resources by the organisation, it is not recognised as a liability.

In this context, the 'past event' is that an individual or household has met all of the eligibility criteria required to receive a social benefit payment. The satisfaction of eligibility criteria for each social benefit payment is a separate past event. Note that circumstances may change over time (eg employment status), and eligibility criteria will need to be reassessed continually.

IPSAS 42 requires an organisation to recognise an expense for a social benefit scheme at the same point that it recognises a liability (ie a credit to the liability, and a debit to the expense). If a payment is made in advance of the eligibility criteria being met, this is recognised as an asset, not as an expense, unless it is irrecoverable.

A social benefit liability is to be measured initially at the best estimate that the organisation is able to make of the related costs – ie the social benefit payments. This may involve taking account of the effect that subsequent events may have on the related payments.

The liability is reduced as payments are made. If there is a difference between the payments and the carrying amount of the liability, this is recognised in surplus or deficit for the period.

Insurance approach:

The alternative 'insurance approach' is included in IPSAS 42, but requires specific criteria to be met for it to be considered. These criteria include:

- The social benefit scheme is intended to be fully funded from contributions.

- There is evidence that the organisation manages the scheme in the same way as an issuer of insurance contracts, including assessing the financial performance and financial position of the scheme on a regular basis.

Using this approach, the organisation recognises and measures the assets, liabilities, revenue and expenses associated with the social benefit scheme by applying (by analogy) the requirements of the IFRS 17 Insurance Contracts (or the national equivalent).

Summary of Unit C and key learning outcomes

Unit C deals with the key competency 'Apply judgement to complex financial reporting issues for corporate entities and public sector organisations'. In this unit, we looked at the following learning outcomes:

Learning outcome	
Property, plant and equipment	You should now be able to account for the recognition, measurement, depreciation, impairment, revaluation, and disposal of PPE
Intangible assets	You should now be able to account for the recognition, measurement, amortisation, impairment
Impairment of assets	You should now be able to account for impairment losses and reversals
Investment property	You should now be able to account for the recognition, measurement, and disclosure of investment property
Inventories and biological assets	You should now be able to account for the recognition, valuation, and disclosures for inventories and biological assets
Financial instruments	You should now be able to define different classes of financial instrument and discuss their disclosure
Leases	You should now be able to account for the recognition and disclosure of a lease
Provisions, contingencies and events after the reporting period	You should now be able to define and account for provisions, contingent liabilities, and contingent assets
Income taxes	You should now be able to account for current taxation
Revenue	You should now be able to account for the recognition of revenue from contracts
Government grants	You should now be able to account for government grants and government assistance

Financial reporting for small and medium-sized entities	You should now be able to discuss the reporting of SMEs
Accounting for transactions in the public sector	You should now be able to discuss the differences between accounting requirements under IFRS and IPSAS in respect of revenue, impairment, construction contracts, and social benefits.

Quiz questions

1	Learning Outcome: C1		
<p>An organisation's accounting policy is to capitalise all borrowing costs meeting the IAS 23 criteria. It had the following loans in place at the beginning and end of the year-ended 31 December 20X1:</p>			
		1 Jan 20X1	31 Dec 20X1
		(Rwf m)	(Rwf m)
9% bank loan		100	100
7.5% bank loan		<u>150</u>	<u>150</u>
		<u>250</u>	<u>250</u>
<p>On 1 January 20X1 the organisation began to build a qualifying asset using existing borrowings. Expenditure incurred on the construction was Rwf 40 million on 1 February 20X1 and Rwf 25 million on 1 September 20X1.</p> <p>What is the amount of borrowing cost that can be capitalised in accordance with IAS 23?</p>			
A	Rwf 0 million		
B	Rwf 3.645 million		
C	Rwf 20.2 million		
D	Rwf 1.64 million		

1	Feedback
A	<p>Incorrect</p> <p>The total interest charge for the year is $(9\% \times 100) + (7.5\% \times 150) = 20.25$</p> <p>Weighted average rate: $(9\% \times 100/250) + (7.5\% \times 150/250) = 8.1\%$</p> <p>Qualifying asset borrowing costs: $(40 \times 8.1\% \times 11/12) + (25m \times 8.1\% \times 4/12) = 3.645$</p>
B	<p>Correct</p> <p>The total interest charge for the year is $(9\% \times 100) + (7.5\% \times 150) = 20.25$</p> <p>Weighted average rate: $(9\% \times 100/250) + (7.5\% \times 150/250) = 8.1\%$</p> <p>Qualifying asset borrowing costs: $(40 \times 8.1\% \times 11/12) + (25m \times 8.1\% \times 4/12) = 3.645$</p>

1	Feedback
C	<p>Incorrect</p> <p>The total interest charge for the year is $(9\% \times 100) + (7.5\% \times 150) = 20.25$</p> <p>Weighted average rate: $(9\% \times 100/250) + (7.5\% \times 150/250) = 8.1\%$</p> <p>Qualifying asset borrowing costs: $(40 \times 8.1\% \times 11/12) + (25m \times 8.1\% \times 4/12) = 3.645$</p>
D	<p>Incorrect</p> <p>The total interest charge for the year is $(9\% \times 100) + (7.5\% \times 150) = 20.25$</p> <p>Weighted average rate: $(9\% \times 100/250) + (7.5\% \times 150/250) = 8.1\%$</p> <p>Qualifying asset borrowing costs: $(40 \times 8.1\% \times 11/12) + (25m \times 8.1\% \times 4/12) = 3.645$</p>

2	Learning Outcome: C2
<p>A company has developed a new product, which is ready for commercial production. The staff spent one year researching new methods, at a cost of Rwf 100 million, and a further six months developing the product at a cost of Rwf 60 million. How much should be capitalised as an intangible asset according to IAS 38?</p>	
A	Rwf 0 million
B	Rwf 60 million
C	Rwf 160 million
D	Rwf 100 million

2	Feedback
A	<p>Incorrect</p> <p>Rwf 60 million</p>
B	Correct
C	<p>Incorrect</p> <p>Rwf 60 million</p>
D	<p>Incorrect</p> <p>Rwf 60 million</p>

3	Learning Outcome: C3
<p>A company has property with a carrying amount of Rwf 156 million, for which an impairment review is required. A similar property has just been sold for Rwf 60 million net of selling costs of Rwf 5 million. The estimated value in use of the property is Rwf 162 million.</p> <p>At what value should the property be carried following the impairment review?</p>	
A	Rwf 65 million
B	Rwf 156 million
C	Rwf 162 million
D	Rwf 60 million

3	Feedback
A	Incorrect Rwf 156 million
B	Correct
C	Incorrect Rwf 156 million
D	Incorrect Rwf 156 million

4	Learning Outcome: C7
<p>Which if the following is true of the depreciation of a right-of-use asset under IFRS 16 Leases?</p>	
A	The asset should be depreciated over the <i>longer</i> of: the lease term, or the asset's useful life.
B	The asset should be depreciated over the <i>average</i> of: the lease term, and the asset's useful life.

4	Learning Outcome: C7
C	The entity can choose to depreciate the asset over <i>either</i> : the lease term, or the asset's useful life.
D	The asset should be depreciated over the <i>shorter</i> of: the lease term, or the asset's useful life.

4	Feedback
A	Incorrect The asset should be depreciated over the shorter of: lease term, or the asset's useful life.
B	Incorrect The asset should be depreciated over the shorter of: lease term, or the asset's useful life.
C	Incorrect The asset should be depreciated over the shorter of: lease term, or the asset's useful life.
D	Correct

5	Learning Outcome: C11
<p>A company acquires an asset for Rwf 180 million, which has a 20-year useful life. The government provides a government grant for the asset of Rwf 100 million. The company use the reduced asset approach to account for government grants.</p> <p>What will the carrying value of the asset be at the end of year 3?</p>	
A	Rwf 171 million
B	Rwf 153 million

5	Learning Outcome: C11
C	Rwf 76 million
D	Rwf 68 million

5	Feedback
A	Incorrect The government grant is deducted from the cost of the asset. The net amount of Rwf 80 million is depreciated over the useful life. $80 - (3 \times (80/20)) = 68$
B	Incorrect The government grant is deducted from the cost of the asset. The net amount of Rwf 80 million is depreciated over the useful life. $80 - (3 \times (80/20)) = 68$
C	Incorrect The government grant is deducted from the cost of the asset. The net amount of Rwf 80 million is depreciated over the useful life. $80 - (3 \times (80/20)) = 68$
D	Correct The government grant is deducted from the cost of the asset. The net amount of Rwf 80 million is depreciated over the useful life. $80 - (3 \times (80/20)) = 68$

6	Learning Outcome: C	
<p>A company is being sued by a supplier, and the company's legal advisors estimate that there is a 70% likelihood they will have to make a payment Rwf 15 million to the supplier, and 30% chance of paying Rwf 25 million.</p> <p>Prepare journals for the required provision.</p>		
A	Dr Provision	Rwf 40 million
	Cr Expense	Rwf 40 million
B	Dr Expense	Rwf 25 million
	Cr Provision	Rwf 25 million
C	Dr Expense	Rwf 15 million
	Cr Provision	Rwf 15 million
D	Dr Expense	Rwf 40 million
	Cr Provision	Rwf 40 million

6	Feedback
A	<p>Incorrect</p> <p>As this is a single event, the most likely outcome should be taken which is the 70% chance. The accounting entries required are:</p> <p>Dr Expense Rwf 15 million</p> <p>Cr Provision Rwf 15 million</p>
B	<p>Incorrect</p> <p>As this is a single event, the most likely outcome should be taken which is the 70% chance. The accounting entries required are:</p> <p>Dr Expense Rwf 15 million</p> <p>Cr Provision Rwf 15 million</p>
C	<p>Correct</p> <p>As this is a single event, the most likely outcome should be taken which is the 70% chance. The accounting entries required are:</p> <p>Dr Expense Rwf 15 million</p> <p>Cr Provision Rwf 15 million</p>
D	<p>Incorrect</p> <p>As this is a single event, the most likely outcome should be taken which is the 70% chance. The accounting entries required are:</p> <p>Dr Expense Rwf 15 million</p> <p>Cr Provision Rwf 15 million</p>

7	Learning Outcome: C13
Which of the following is not a method of determining value in use for non-cash-generating assets under IPSAS 21 Impairment of Non-Cash-Generating Assets?	
A	Fair value approach
B	Service units approach
C	Restoration cost approach
D	Depreciated replacement cost approach

7	Feedback
A	Correct Fair value approach is not a method of determining value in use for non-cash-generating assets
B	Incorrect Fair value approach is not a method of determining value in use for non-cash-generating assets
C	Incorrect Fair value approach is not a method of determining value in use for non-cash-generating assets
D	Incorrect Fair value approach is not a method of determining value in use for non-cash-generating assets

8	Learning Outcome: C13
Which of the following would be classed as revenue from a non-exchange transaction under IPSAS 23 Revenue from Non-Exchange Transactions?	
A	Sales
B	Interest received
C	Fines
D	Royalties

8	Feedback
A	Incorrect Fines are an example of non-exchange revenue
B	Incorrect Fines are an example of non-exchange revenue
C	Correct
D	Incorrect Fines are an example of non-exchange revenue

9	Learning Outcome: C6
Which of the following is not a category of financial asset according to IAS 32 Financial Instruments: Presentation?	
A	Fair value through other comprehensive income
B	Fair value through profit or loss
C	Amortised cost
D	Replacement cost

9	Feedback
A	Incorrect Replacement cost is not a category of financial asset according to IAS 32
B	Incorrect Replacement cost is not a category of financial asset according to IAS 32
C	Incorrect Replacement cost is not a category of financial asset according to IAS 32
D	Correct

10	Learning Outcome: C10
A company sells goods to a customer for Rwf 95 million on one year's interest free credit. Assuming the applicable discount rate is 10% how much revenue should be recognised immediately?	
A	Rwf 95 million
B	Rwf 86.3 million
C	Rwf 0 million
D	Rwf 85.5 million

10	Feedback
A	Incorrect $95 \times (1/1.1) = 86.3$
B	Correct $95 \times (1/1.1) = 86.3$
C	Incorrect $95 \times (1/1.1) = 86.3$
D	Incorrect $95 \times (1/1.1) = 86.3$

Exercises

Exercise C1

Berner Company has three assets which the directors believe may have become impaired because of changes in the market for their products.

Asset	Carrying amount	FV less selling cost	Value in use
1	Rwf 1 million	Rwf 1.2 million	Rwf 1.5 million
2	Rwf 3.5 million	Rwf 2.8 million	Rwf 3.3 million
3	Rwf 5 million	Rwf 4.8 million	Rwf 4.5 million

Calculate the carrying amount of each asset after any impairments that need to be accounted for.

Exercise C1 solution

The carrying amount after the impairments are highlighted in bold below. Where this is different to the previous carrying amount, an impairment expense will need to be recorded and the asset value reduced.

Asset	Carrying amount	FV less selling cost	Value in use
1	Rwf 1 million	Rwf 1.2 million	Rwf 1.5 million
2	Rwf 3.5 million	Rwf 2.8 million	Rwf 3.3 million
3	Rwf 5 million	Rwf 4.8 million	Rwf 4.5 million

Exercise C2

Stein Company are valuing their inventory, and the following information is available:

(Rwf 000)	Cost	Selling price	Costs to complete
Material P	400	500	50
Material Q	345	400	95
Material R	700	850	25

Exercise C2 solution

(Rwf 000)	Cost	NRV	Lower
Material P	400	450	400
Material Q	345	305	305
Material R	700	825	<u>700</u>
			<u>1,405</u>

The NRV is calculated as the anticipated selling price *less* the cost to complete. The inventory is then valued on a line-by-line basis taking the lower of cost and NRV.

Exercise C3

How should the following financial instruments be presented in the financial statements?

- a) Company D acquires a bond, the terms of which are that they will receive a fixed amount of interest and will be repaid on a set date
- b) Company D acquires shares in another company
- c) Company X issues a bond

Exercise C3 Solution

- a) Company D acquired the bond to receive these cash flows.

The bond is a financial asset and should be classified at amortised cost.

This is because Company D bought it for its cash flow (the business model test) and it has specific cash flows for the interest and the principal (cash flow test).

- b) The purchase of shares is a financial asset.

Shares have no contractual cash flows attached to them and there is no legal requirement for a company to pay a dividend.

Therefore, the shares cannot be classified at amortised cost.

The acquisition of the shares will be classified as fair value through profit and loss. This means that the changes in the value of the shares will be shown as income or an expense in profit or loss.

- c) This is a financial liability.

The company has issued a bond, and has a contractual right to repay.

The bond is not held for trading, so should be classified as amortised cost.

Exercise C4

The New Valley company leased a piece of plant and machinery from the Bakers company on 1 January 20X8. The present value of the future lease payments is Rwf 82 million, and in return for five years use of the asset, New Valley agreed to pay Bakers Rwf 20 million per year on the last day of the year. New Valley were given a Rwf 3 million cash incentive to enter into the lease, and legal transfer of the plant and machinery occurs at the end of the lease. The useful life of the item is six years. The interest rate implicit in the lease is 7%.

Prepare extracts for the statement of profit or loss and statement of financial position for the year-ended 31 December 20X8.

Exercise C4 solution

Step 1. Capitalise asset

The present value of the future lease payments of Rwf 82 million less the incentives of Rwf 3 million gives Rwf 79 million.

Dr Asset	Rwf 79 million
Dr Cash	Rwf 3 million
Cr Lease Liability	Rwf 82 million

Step 2. Complete lease table and calculate closing liability

Year	Brought forward	Interest 7%	Principal	Total Payment	Balance
	Rwf 000	Rwf 000	Rwf 000	Rwf 000	Rwf 000
1	82,000	5,740	14,260	20,000	67,740
2	67,740	4,742	15,258	20,000	52,482

Step 3. Depreciate asset

Depreciation charge over 6 years is $79 \text{ million} / 6 = \text{Rwf } 13.167 \text{ million}$. As there is transfer of ownership at the end of the lease the right-of-use asset is depreciated over the six-year useful life. Therefore, the following balances will be taken to the financial statements:

Statement of profit or loss for the year-ended 31 December 20X8 (extract) – Rwf 000

Cost of sales – Depreciation	13,167
Finance cost	5,740

Statement of financial position as at 31 December 20X8 (extract) – Rwf 000

Non-current assets (79,000 – 13,167)	65,833
Non-current liabilities	52,482
Current liabilities	15,258

Exercise C5

During the year ended 31 December 20X4, Shaw Company was sued by a former employee for unfair dismissal. Fab's legal advisors expect that Shaw will lose the case and have advised Fab that in similar recent cases the courts have decided on compensation of around Rwf 100 million.

- Explain how the above claim should be treated in the financial statements for the year ended 31 December 20X4.
- Prepare the accounting entries for the year ended 31 December 20X4.
- In the year ended 31 December 20X5 the case goes to court and the judge determines that compensation of Rwf 125 million should be paid. Prepare the accounting entries for the year ended 31 December 20X5.

Exercise C5 solution

Treatment

The accounting issue here is to establish whether a provision should be created. To do this we need to establish whether it meets the recognition criteria, and we will look at each criterion.

1. Present obligation (legal or constructive) as a result of a past event – the past event was the dismissal of the employee, and the present obligation is the expected legal obligation to pay compensation following the court case.
2. It is probable that a transfer of economic benefits will be required to settle the obligation – to meet this it must be more likely than not, i.e. more than 50% probable that we will have to pay compensation. If our legal advisors believe we will lose the case, then this second criterion has been met.
3. A reliable estimate can be made of the obligation – the third criterion has also been met as our legal advisors have been able to estimate likely compensation based on similar cases.

This will mean that an expense and corresponding provision will be created in the financial statements for the year ended 31 December 20X4.

Accounting entry 20X4

The accounting entry for making a provision will be:

Dr Operating expenses	Rwf 100 million
Cr Provisions (liabilities)	Rwf 100 million

If it is likely that settlement will have to be paid within one year then the provision will be categorised as a current liability.

Accounting entry 20X5

In the following year Shaw, pays out compensation of Rwf 125 million, rather than the Rwf 100 million previously estimated by its legal advisors, in accordance with IAS 8 Accounting Policies this change to an accounting estimate must be recognised within the current year and not treated as a prior year adjustment. Therefore, the accounting entry is:

Dr Operating expenses	Rwf 25 million
Dr Provisions (liabilities)	Rwf 100 million
Cr Cash	Rwf 125 million

Exercise C6

- (a) Three weeks after the reporting date there was a fire at a company's store that destroyed a large amount of inventory. The inventory destroyed had been included in the closing inventory at Rwf 80 million.
- (b) A company's closing trade receivables are Rwf 64 million. Shortly after the year end a major customer was declared bankrupt. It is now anticipated that although the customer owed Rwf 25 million as at the year end, only 10% of the debt will be collected.
- (c) A fire shortly after the reporting date destroyed a company's inventory valued at Rwf 3 million. The value of inventory at the reporting date was Rwf 600 million.

Explain how the above should be treated in the financial statements.

Exercise C6 solution

- (a) This is a non-adjusting event per IAS 10, as conditions were not in place at the reporting date. The amount is material, so the event information should be disclosed in a note to the accounts.
- (b) This is an adjusting event, as conditions were in place at the reporting date. The reporting entity needs to write off the debt to the extent that it will not be collected. This will mean that there will be an additional expense of Rwf 22.5 million, and trade receivables will reduce by Rwf 22.5 million.
- (c) This is a non-adjusting event per IAS 10, as the conditions were not in place at the reporting date.

The amount in this case is not material (ie only 0.5% of closing inventory), so there is no need for a disclosure note.

The reduction in the value of inventory will be accounted for in the following year (in which the fire occurred).

Exercise C7

The Avan company made a profit before tax of Rwf 375 million for the year ended 31 December 20X3.

Current tax was estimated at Rwf 59 million. In the previous year, 20X2, tax on profits was estimated to be Rwf 38 million. It was subsequently agreed with the tax authorities that the tax to be paid for 20X2 was Rwf 39 million.

The deferred tax balance at the start of the year was Rwf 50 million. At the end of the year a liability of Rwf 68 million is required.

Show the balances related to taxation that will be recognised in the financial statements for the year ending 31 December 20X3.

Exercise C7 solution

Statement of profit or loss for the year ended 31 December 20X6	Rwf million
Profit before tax	375
Tax expense (W1 below)	<u>(78)</u>
Profit after tax	<u>297</u>
W1:	
Current year charge	59
Under provision (39–38)	1
Transfer to deferred taxation (68 – 50)	<u>18</u>
Tax expense	<u>78</u>
Statement of financial position as at 31 December 20X6	Rwf million
Non-current liabilities	
Deferred tax	68
Current liabilities	
Current tax payable	59

Unit D: Preparation of the financial statements of group entities

Learning outcomes

D.1. Preparation of consolidated financial statements

Introduction to Unit D

In this unit, we will look at the concepts underlying the preparation of consolidated financial statements. We then prepare a consolidated statement of financial position (SFP) and a consolidated statement of profit and loss (SPL).

The following standards are relevant to group accounting:

- IAS 27 (revised) Separate Financial Statements
- IAS 28 (revised) Investments in Associates and Joint Ventures
- IFRS 3 Business Combinations
- IFRS 10 Consolidated Financial Statements
- IFRS 11 Joint Arrangements (not examinable)
- IFRS 12 Disclosure of Interests in Other Entities

The IPSAS framework also has a similar range of standards dealing with group accounting, but we will focus on the IFRS framework in this unit.

So far in this module, we have looked at the preparation of single entity accounts. In reality many companies grow their business by acquiring other companies and becoming a group of companies. The power they have over that other company (or companies) will determine how they account for this investment, and they may be required to prepare an additional set of financial statements – ie consolidated financial statements.

We will look carefully at the concepts involved and some key definitions that are relevant for an understanding of this topic. Then we show you how to prepare group financial statements, with related calculations and accounting adjustments.

Subsidiary v associate

We will consider two distinct types of investment, which require different accounting treatment under IFRS – ie a subsidiary and an associate.

Subsidiary	An entity that is <u>controlled</u> by another entity. (IFRS 10) The subsidiary is the investee, i.e. the company that is being controlled by the parent.	An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. (IFRS 10)
Associate	An associate is an entity over which the investor has <u>significant influence</u> , but does not control. (IAS28)	Significant influence is 'the power to participate in the financial and operating policy decisions of the investee but is not control of those policies' (IAS 28). Owning 20% or more of a company's ordinary shares usually means that there is significant influence.

D.1. Preparation of financial statements – parent and subsidiary

Key points to note in relation to financial statements where there is a parent with one subsidiary:

- Preparation of consolidated financial statements reflects the control the parent has over its subsidiary.
- Consolidated financial statements are prepared as if the group is a single entity.
- These additional set of financial statements are sent to the shareholders of the parent company, and enable them to make more informed decisions in the context of the group as a whole.

Goodwill

Goodwill is defined by IFRS 3 as 'an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised'.

Goodwill is included as an intangible non-current asset in the consolidated statement of financial position. Goodwill is not amortised, but is tested annually for impairment. Any impairment loss is recognised as an expense.

If consideration is less than the fair value of the identifiable net assets acquired, the difference is negative goodwill. If negative goodwill arises, IFRS 3 requires the acquirer to:

- review the fair values of the net assets acquired to ensure that there is no error, and
- recognise any negative goodwill which remains as 'other income'

It is unusual for a business to be sold for less than the fair value of their net assets which is why the standard requires the fair values to be checked.

The following approach should be used to calculate goodwill on acquisition:

	Rwf
Cost of shares acquired	X
Less: share of fair value of net assets at acquisition	(X)
Goodwill (before any impairment)	X
Less: Impairment to date	(X)
Goodwill	X

Note also:

- Goodwill must be calculated on the basis of the fair values of the assets acquired and consideration paid.
- Once calculated, it is not necessary to calculate the goodwill on acquisition at a future year end date as the value determined will not alter (other than impairment).
- Goodwill calculated will be shown as an intangible asset in the consolidated statement of financial position, unless it is impaired to nil.
- When goodwill is impaired, the goodwill will be reduced, and retained earnings will also be reduced.
- The investment in the subsidiary is eliminated on consolidation. In its place, the consolidated statement of financial position will include the assets and liabilities of the subsidiary.

Fair value adjustment

You may have noted above that the calculation of goodwill involves deducting the relevant share of the fair value of net assets at acquisition from the cost of shares acquired.

Example

The Cloud Company acquired 75% of the ordinary shares of the Rain Company on 1 September 20X5 for Rwf 51 million. At that date, the fair value of Rain's non-current assets was Rwf 23 million greater than their net book value, the balance of retained earnings was Rwf 21 million, and share capital was Rwf 20 million.

Solution

Net assets at date of acquisition:	Rwf
Share capital	20
Retained earnings	21
Fair value adjustment	<u>23</u>
Total	<u>64</u>
Calculation of goodwill:	Rwf
Cost of shares acquired	51
Less: share of fair value of net assets at acquisition ($75\% \times 64$)	<u>(48)</u>
Goodwill (before any impairment)	3
Less: Impairment to date	<u>(0)</u>
Goodwill	<u>3</u>

Consolidated statement of financial position

We will look at the preparation of the statement of financial position and the statement of profit or loss separately, as there are some specific aspects that are best looked at in the context of each statement.

In both cases, we will use a methodical process, involving a series of 'steps'. Although this process is not essential for simple examples, it is important to use it consistently so that you make sure you deal with all aspects of the process.

In dealing with examples of consolidated statements of financial position, we will use the following six steps. Additional adjustments will need to be included within the relevant step(s), which we will add later in this unit.

Step 1	Establish the group structure
Step 2	Set out the net assets of the subsidiary
Step 3	Calculate goodwill on acquisition
Step 4	Calculate the non-controlling interest
Step 5	Calculate group retained earnings
Step 6	Prepare consolidated statement of financial position

Example

Ach Company acquired 100% of the share capital in Bar Company on 31 December 20X1. At that date the retained earnings of Bar amounted to M5m.

Statements of financial position at 31 December 20X7:

Rwf million	Ach	Bar
Tangible non-current assets	200	30
Investment – shares in D	50	0
Current assets	45	15
Total assets	295	45
Share capital (Rwf 1,000 per share)	100	25
Retained earnings	170	15
Current liabilities	25	5
Total equity and liabilities	295	45

Prepare the consolidated statement of financial position as at 31 December 20X7.

Solution

Step 1 – Group structure is Ach owns 100% Bar, with 0% non-controlling interest (NCI)

Step 2 – Net assets of Bar

	20X1	20X7
Share capital	25	25
Retained earnings	<u>5</u>	<u>15</u>
Total	<u>30</u>	<u>40</u>

Step 3 – Goodwill

	Rwf million
Consideration transferred	50
Less share of net assets at acquisition (100 % x 30)	<u>(30)</u>
Goodwill (before impairment)	20
Less impairment to date	<u>0</u>
Goodwill	<u>20</u>

Step 4 – NCI

$$\text{NCI} = 0\% \times 40 = 0$$

Step 5 – Retained earnings

	Rwf million	
Parent's retained earnings (100%)		170
Subsidiary – group share of post-acquisition retained earnings:		
Retained earnings at date of reporting	15	
Less: retained earnings at date of acquisition	(5)	
Post-acquisition retained earnings	10	
Group share = 100% x 10		10
Goodwill impairment		0
Group retained earnings		180

Step 6 – Consolidated statement of financial position

		Rwf million
Tangible non-current assets	$P + S = 200 + 30 =$	230
Goodwill	Step 3	20
Current assets	$P + S = 45 + 15 =$	60
Total assets		310
Share capital (Rwf 1,000 per share)	P only, S's cancelled on consolidation	100
Retained earnings	See step 5	180
Non-controlling interest	See step 4	0

Fair value adjustment – inventory

Another type of fair value adjustment relates to Inventories. Inventories are normally valued at the lower of cost and net realisable value but when calculating goodwill they must be valued at fair value.

The five-step approach will be impacted as follows:

Step 1: No impact

Step 2: Include the fair value adjustment at acquisition and in the reporting date column – this will always be the same amount. If any inventory has been sold by the year end show the fair value relating to this as a negative figure in the reporting date column. If all of the inventory has been sold by the reporting date the reporting date column will have an equal positive and negative.

Step 3 and Step 4: By adjusting net assets to fair value in Step 2 you will have calculated the net assets figures to use in these steps.

Step 5: Reduce subsidiary's post-acquisition retained earnings by the change in the inventory calculated in Step 2.

Step 6: If the inventory is unsold at the reporting date the adjustment should be reflected in the consolidated SFP when calculating inventory.

Example

Light Company acquired 80% of the ordinary shares of the Hill Company on 1 October 20X5. At that date the fair value of hill's inventory was Rwf 10 million higher than the carrying value, and the balance of retained earnings was Rwf 50 million. By the 31 December half of the inventory had been sold by Hill. The statement of financial position of both companies at 31 December 20X5 is given below.

Rwf million	Light	Hill
Assets		
Property, plant and equipment	94,500	42,000
Investment in S at cost	76,500	0
Current assets	<u>123,000</u>	<u>64,500</u>
Total assets	<u>294,000</u>	<u>106,500</u>
Equity and liabilities		
Ordinary shares of Rwf 1,000 each	120,000	30,000
Retained earnings	144,000	61,500
Current liabilities	<u>30,000</u>	<u>15,000</u>
Total equity and liabilities	<u>294,000</u>	<u>106,500</u>

Prepare the consolidated statement of financial position for P as at 31 December 20X5.

Solution

Step 1: Establish the group structure

Light owns 80% of Hill

Step 2: Set out the net assets of the subsidiary

Net assets:	Acquisition	Reporting
Share capital	30,000	30,000
Retained earnings	50,000	61,500
Fair value adjustment	10,000	10,000
Inventory adjustment	<u>0</u>	<u>(5,000)</u>
Total	<u>90,000</u>	<u>96,500</u>

At the year end, the inventory adjustment only needs to be Rwf 5 million as half of the inventory has now been sold outside the group.

Step 3: Calculate goodwill on acquisition

	Rwf million
Cost of shares acquired	76,500
Less: share of net assets at acquisition (80% × 90,000)	<u>(72,000)</u>
Goodwill (before any impairment)	4,500
Less: Impairment to date	<u>(0)</u>
Goodwill	<u>4,500</u>

Step 4: Calculate the non-controlling interest

Non-controlling interest = 20% × 96 500 = 19,300

Step 5: Calculate group retained earnings

	Rwf million
Parent's retained earnings (100%)	144,000
Subsidiary – group share of post-acquisition retained earnings:	
Retained earnings at date of reporting date	61,500
Inventory adjustment	(5,000)
Less: retained earnings at date of acquisition.	<u>(50,000)</u>
Post-acquisition retained earnings	6,500
Group share = 80% × 6,500	5,200
Less: Goodwill impairment (see step 3)	<u>(0)</u>
Group retained earnings	<u>149,200</u>

Step 6: Consolidated statement of financial position at 31 December 20X5:

	Workings	Rwf million
Assets		
Property, plant and equipment	(94,500 + 42,000)	136,500
Goodwill	Step 3	4,500
Current assets	(123,000 + 64,500 + 10,000 – 5,000)	<u>192,500</u>
Total assets		<u>333,500</u>
Equity and liabilities		
Ordinary shares	Light only	120,000
Retained earnings	Step 5	149,200
Non-controlling interest	Step 4	19,300
Current liabilities	(30,000 + 15,000)	<u>45,000</u>
Total equity and liabilities		<u>333,500</u>

Note how the fair value adjustments are followed through to the statement of financial position in the current asset calculations as they impact on inventory.

Deferred consideration

Deferred consideration is an obligation to pay a certain amount at a specified date after the date of acquisition. In this case there is no uncertainty regarding whether the amount needs to be paid or the total amount to be paid.

Deferred consideration is included in the consideration transferred and is recognised and measured at fair value at the date of the business combination.

Contingent consideration

Many business combinations include contingent consideration, often referred to as an 'earn-out clause' and defined as an obligation of the acquirer to transfer additional assets or equity interests to the acquiree's former owners if specified future events occur or conditions are met.

A contingent consideration arrangement is inherently part of the economic considerations in the negotiations between the buyer and seller.

It is important to note that:

- Goodwill is not adjusted after the acquisition date to reflect changes in the fair value or settlement of contingent consideration except for adjustments qualifying as measurement period adjustments or arising from correction of errors.
- Some contingent consideration arrangements may include transactions that are accounted for separately from the business combination; eg where the additional payment is contingent on the seller remaining as an employee of the acquiree for a certain period after the combination.

The classification of a contingent consideration obligation that meets the definition of a financial instrument as either a financial liability or equity is to be based on the relevant definitions in IAS 32. It should be noted that IAS 32 includes in the definition of a financial liability a contract that will or may be settled in the entity's own equity instruments and is:

- a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments, or
- a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Identifiable assets and liabilities subject to specific IFRS 3 guidance (exceptions)

Under IFRS 3, the general recognition principle is that the identifiable assets acquired and liabilities assumed should meet the definition of assets and liabilities in accordance with the Conceptual Framework at the acquisition date. However, some recognition and measurement exceptions have been included for particular types of assets and liabilities.

Contingent liability	<p>For a provision or contingent liability that would be within the scope of IAS 37, the acquirer applies IAS 37 to determine whether <u>at the acquisition date</u> a present obligation exists as a result of past events.</p> <p>A contingent liability assumed in a business combination is recognised at the acquisition date:</p> <ul style="list-style-type: none">• <i>only if</i> it is a present obligation that arises from past events and its fair value can be measured reliably, and• <i>even if</i> an outflow of economic benefits is not probable (uncertainty is considered in the determination of fair value).• Other contingent liabilities are not recognised.
----------------------	---

Contingent asset	Contingent assets at acquisition are not recognised
Intangible assets	The acquirer may recognise identifiable intangible assets that are acquired in a business combination (eg a brand name, a patent or a customer relationship), that the acquiree did not recognise as assets in its financial statements because it developed them <u>internally</u> and charged the related costs to expense.

Share exchange

In all our examples so far, the parent has acquired the shares in its subsidiary for cash. Another way to acquire a subsidiary is through a share exchange.

When calculating goodwill, always use the market value of shares given to gain control (not the nominal value of the shares) The question will have to tell you the fair value of the shares (ie the market value), and these are introduced into the parent's statement of financial position with a share premium account for the difference between the nominal value of the shares issued and their fair value as given.

Intra-group trading

There are some situations in the consolidation process where we need to cancel out items that are assets in one group company and liabilities in another. These can arise through intra-group trading, and are known as intra-group or inter-company balances.

Where group companies trade with each other, there are several ways in which balances with each other can arise. The most common of these are listed below:

Debentures/Loan stock	<p>Where one company in the group has made a loan to another – in one company there is a payable and in the other there is a receivable (normally shown as investment). These are cancelled on consolidation.</p> <p>The cancellation process is very simple: the credit balance of one company is offset against the debit balance of the other company, eliminating both balances from the consolidated statement of financial position.</p> <p>We only include debentures/loan stock held by third parties in the consolidated statement of financial position.</p>
Inter-company accounts	<p>These are intra-group trading balances, e.g. current assets of subsidiary might include amounts owing from parent. These amounts will be included as current liabilities by the parent. The treatment of inter-company account balances is the same as for debentures/loan stock.</p> <p>Inter-company accounts may not agree due to goods in transit or cash in transit. If the difference is cash in transit, increase the consolidated cash balance by that amount. If the difference is goods in transit, increase the consolidated inventory by that amount.</p>

Bank balances	Bank overdrafts (liability) and cash at bank (asset) must be shown separately. It is not permissible to offset bank overdrafts against cash at bank.
Unrealised profit in inventory	Group companies often sell goods (or any other assets) to one another. Transfers may include an element of profit. If goods or assets are subsequently sold, the group has realised the profit and no further adjustment is necessary. If goods or assets are still held within the group at the year end, we need to remove any unrealised profit. In consolidated accounts, we want to reflect only profits made by group companies trading with third parties. The exact adjustments depend on whether Parent (P) sold to Subsidiary (S) or Subsidiary (S) sold to Parent (P).
Parent sells to Subsidiary	<p>Profit in inventory arising when P sells to S is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from P's retained earnings at the reporting date.</p> <p>Debit P's retained earnings (in Step 5)</p> <p>Credit Closing inventory (in consolidated statement of financial position)</p>
Subsidiary sells to Parent	<p>Profit in inventory arising when S sells to P is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from S's retained earnings at the reporting date.</p> <p>Debit S's retained earnings (in Step 2 – reporting date column)</p> <p>Credit Closing inventory (in consolidated statement of financial position)</p> <p>Unrealised profit is calculated using one of the three methods below; depending on the information you are given in the question:</p>

a) Gross profit margin given:

Example: P sold goods to S for Rwf 10 million. The profit margin was 40%. At the year end, S had sold half of these goods on to third party.

Unrealised profit = Inventory value X % margin/100%

Inventory = half of 10 million

= 5 million

Unrealised profits = 5 million x 40%/100%

= 2 million

b) Mark up given

Example: P makes sales of M10,000 to S. This figure comprises cost plus 25% mark up. S had sold half of these goods on to third party

Unrealised profit = Inventory value X % mark-up/(100% + % mark-up)

Inventory = half of 10 million

= 5 million

Unrealised profits = 5 million x 25/(100%+25%)

= 1 million

c) Profit given

Unrealised profit = profit figure given X % of goods unsold.

Examples – Intra-group sales

1. During the accounting period, P sold goods to S for Rwf 8 million, which gave P a profit of Rwf 2 million. One half of these goods were included in the closing inventory of S at the end of the reporting period.

Solution

Unrealised profit = $0.5 \times \text{Rwf } 2 \text{ million} = \text{Rwf } 1 \text{ million}$.

The adjustment in the consolidated statement of financial position would be as follows:

Debit P retained earnings Rwf 1 million

Credit Closing inventory Rwf 1 million

The inventory still held by S, valued at Rwf 4 million in S's inventory, is being reduced to its cost to the group of Rwf 3 million.

2. During the year S sold goods to P for Rwf 30 million at a mark-up of 50%. Half of these goods were unsold at the year end.

Inventory = $0.5 \times \text{Rwf } 30 \text{ million} = \text{Rwf } 15 \text{ million}$

Unrealised profit = $\text{Rwf } 15 \text{ million} \times 1/3 = \text{Rwf } 5 \text{ million}$

Dr Retained earnings of S Rwf 5 million

Cr Inventory Rwf 5 million

Impairment of goodwill

Statement of financial position as at 31 March 20X9:

	Ally	Wedge
Rwf million		
Tangible non-current assets	450	470
Investment – 60m shares in Wedge	300	0
Current assets	<u>50</u>	<u>95</u>
Total assets	<u>800</u>	<u>565</u>
Share capital	200	100
Retained earnings	560	400
Current liabilities	<u>40</u>	<u>65</u>
Total equity and liabilities	<u>800</u>	<u>565</u>

Ally acquired share capital in Wedge on 30 June 20X7. At that date the retained earnings of Wedge amounted to Rwf 300 million.

Since the acquisition impairment of goodwill totalling Rwf 10 million has been recognised.

Prepare a consolidated statement of financial position at 31 March 20X9.

Solution

Step 1. Establish the group structure

Ally owns 60% of Wedge

Non-controlling interest = 40%

Step 2 Set out the net assets of the subsidiary

	At date of acquisition	At date of reporting
	Rwf million	Rwf million
Share capital	100	100
Retained earnings	<u>300</u>	<u>400</u>
Total	<u>400</u>	<u>500</u>

Step 3. Calculate goodwill on acquisition

	Rwf million
Cost of shares acquired	300
Less: share of net assets at acquisition	
(60% × 400)	<u>(240)</u>
Goodwill (before any impairment)	60
Less: Impairment to date	<u>(10)</u>
Goodwill	<u>50</u>

Step 4 Calculate the non-controlling interest

Non-controlling interest = $40\% \times 500 = 200$

Step 5 Calculate group retained earnings

	Rwf million	Rwf million
Parent's retained earnings (100%)		560
Subsidiary – group share of post-acquisition retained earnings:		
Retained earnings at date of reporting	400	
Less: retained earnings at date of acquisition	(300)	
Post-acquisition retained earnings	<u>100</u>	
Group share = $60\% \times 100$		60
Goodwill impairment		<u>(10)</u>
Group retained earnings		<u>610</u>

Step 6

Ally – Consolidated statement of financial position at 31 March 20X9:

		Rwf million
Tangible non-current assets	P + S = $450 + 470$	920
Goodwill	Step 3	50
Current assets	P + S = $50 + 95 =$	<u>145</u>
Total assets		<u>1,115</u>
Share capital	P only	200
Retained earnings	See step 5	610
Non-controlling interest	See step 4 200	
Current liabilities	P + S = $40 + 65$	<u>105</u>
Total equity and liabilities		<u>1,115</u>

Consolidated statement of profit or loss

The financial statements of the parent show their share of the dividend receivable from the subsidiary.

From the parents' shareholders point of view this does not reflect the income and expenses that are under the control of the parent. The consolidated statement of profit or loss shows the income generated from the group's resources.

The concepts underlying group accounts apply to the statement of profit or loss and income and expenses are consolidated 100% line by line.

This concept would also apply to other comprehensive income when the parents and the subsidiaries are consolidated by adding 100% line by line.

When preparing the consolidation, it is important to remember the concept of single entity and transactions between the parent and the subsidiary must be cancelled out.

The following adjustments may arise:

- Intra-group sales must be eliminated from both the revenue of the selling company and the cost of sales of the buying company.
- DR Revenue CR Cost of sales.
- Unrealised profit included in year-end inventory must be eliminated.
- DR Cost of sales (DR Retained Earnings in SFP) CR Closing inventory.
- Any intra-group interest must be eliminated from finance income and finance costs.
- DR Finance Income CR Finance Costs
- Dividends from subsidiaries must be eliminated since the whole of the profits of those subsidiaries are being consolidated and it would be double counting to include the dividends as well.

When preparing the consolidation, we will add in 100% of the income and expenses of the subsidiary to reflect control but then we need to show ownership by calculating the non-controlling interest. NCI is calculated as the NCI % \times Subsidiary's profit after tax.

The allocation of the profit after tax is shown at the end of the consolidated statement of profit or loss. This shows who owns the profits that have been earned under group control.

Profit for the year	XX
----------------------------	-----------

Attributable to:

Equity shareholders in parent (balancing Figure)	X
--	---

Non-controlling interest (NCI% \times Profit after tax)	X
---	---

Profit for the year	XX
----------------------------	-----------

In dealing with examples of consolidated statements of profit or loss, we will use the following six steps. Additional adjustments will need to be included within the relevant step(s).

- | | |
|--------|--|
| Step 1 | Establish the group structure |
| Step 2 | Adjust for unrealised profits |
| Step 3 | Calculate revenue and cost of sales |
| Step 4 | Calculate intra-group investment income and interest payable |
| Step 5 | Calculate non-controlling interest |

Step 6 Prepare consolidated statement of profit or loss

Example – revenue

Inner Company controls 80% of Outer Company's ordinary share capital. During 20X8, Inner reported

revenue of Rwf 120 million while Outer reported revenue of Rwf 90 million. There were no intragroup sales.

Solution

The consolidated statement of profit or loss shows all income generated by the group's resources. This is the case even if the equity share in subsidiary is less than 100%.

Consolidated statement of profit or loss:

Revenue 120 + 90 = Rwf 210 million

Example – statement of profit or loss

The following statements of profit or loss are for Upper company and Lower company for the year ended 31 December 20X7:

Rwf million	Upper	Lower
Revenue	1,000	750
Cost of sales	<u>(350)</u>	<u>(400)</u>
Gross profit	650	350
Distribution costs	(50)	(120)
Administrative expenses	(150)	(110)
Investment income (dividend from Lower)	<u>48</u>	<u>0</u>
Profit before tax	498	120
Tax	<u>(150)</u>	<u>(35)</u>
Profit for the year	<u>348</u>	<u>85</u>

- Upper controls 80% of the ordinary share capital of Lower.
- During the year, Lower had sold goods to Upper for Rwf 40 million. These had cost Lower Rwf 20 million. At 31 December 20X7, Upper still had half of these goods in inventory.

Prepare a consolidated statement of profit or loss for the year ending 31 December 20X7.

Solution

Step 1 Establish the group structure

Upper owns 80% of Lower

Non-controlling interest = 20%

Step 2 Unrealised profits

Goods transferred from Lower to Upper	40
Cost of goods transferred	<u>(20)</u>
Profit	<u>20</u>
Unrealised profit (50% × 20)	10

Step 3 Revenue and cost of sales

Revenue – Upper	1 000
– Lower	<u>750</u>
Total	1,750
Less: Intra-group sale	<u>(40)</u>
Consolidated revenue	1,710
 Cost of sales– Upper	350
– Lower	<u>400</u>
Total	750
Less: Intra-group purchase	<u>(40)</u>
Add: Unrealised profit (step 2)	<u>10</u>
Consolidated cost of sales	<u>720</u>

Step 4

Eliminate investment income from Lower

Step 5 – Non-controlling interest

$$\text{NCI} = 20\% \times 85 - 10 = 15$$

Step 6 – Consolidated statement

Upper Company – Consolidated Statement of profit or loss for the year ended 31 Dec 20X7

	Workings	Rwf million
Revenue	Step 3	1,710
Cost of sales	Step 3	(720)
Gross profit		990
Distribution costs	(50 + 120)	(170)
Admin expenses	(150 + 110)	(260)
Profit before tax		560
Taxation	(150 + 35)	(185)
Profit for the year		375
Attributable to:		
Equity shareholders in Upper	Balancing figure	360
Non-controlling interest	Step 5	15
Profit for the year		375

Acquisition of subsidiary part-way through year

As the statement of profit or loss reports on income and expenditure that has occurred over a twelve-month period (rather than being balances at the end of the year as in the statement of financial position), we need to note whether the parent has held the investment in the subsidiary for the whole of the period or not. If, the acquisition took place during the year, we need to make adjustments to the statement of profit or loss figures for the subsidiary, as profits earned prior to the investment by the parent are not relevant to the consolidated statement. We will assume in the following examples that profit is earned equally across the year; in other words, if the investment takes place half way through the period, then we consolidate half the subsidiary's figures (with adjustments where necessary).

The following example illustrates the process.

Example – acquisition of subsidiary part-way through the year

The following statements of comprehensive income for the year ended 31 December 20X7 have been prepared for Sta Company and its subsidiary Bost Company.

Rwf million	Sta	Bost
Revenue	750	283
Cost of sales	(250)	(150)
Gross profit	500	133
Distribution costs	(150)	(60)
Administrative expenses	(200)	(30)
Investment income (dividend from Bost)	20	0
Profit before tax	170	43
Tax	(50)	(3)
Profit for the year	120	40

1. Sta acquired 80% of the share capital in Bost **on 1 July 20X7**
2. During the year Sta had sold goods to Bost for Rwf 50 million. These had cost Sta Rwf 25 million. One quarter of these goods remained in inventory at 31 December 20X7.

Prepare the consolidated statement of profit or loss for the year to 31 December 20X7.

Solution

Note that the

Step 1 – Establish the group structure

Sta owns 80% of Bost

Non-controlling interest = 20%

Step 2 – Unrealised profits

Calculation	
Goods transferred from Sta to Bost	50
Cost of goods transferred	(25)
Profit	25
Unrealised profit (25% x 25)	6.25

Step 3 – Revenue and cost of sales

Calculation		
Revenue – Sta	750	
– Bost (283 x 6/12)	141.5	
Total	891.5	
Less: Intra-group sale	(50)	
Consolidated revenue	841.5	

Calculation		
Cost of sales – Sta	250	
– Bost (150 x 1/12)	75	
Total	325	
Less: Intra-group purchase	(50)	
Add: Unrealised profit (step 2)	6.25	
Consolidated cost of sales	281.25	

Step 4– Investment income and interest payable

The Rwf 20 million received from Bost must be excluded on consolidation. This is because we are consolidating the profits of Bost from which this dividend will have been paid. To include would be double counting.

Step 5 - Non-controlling interest

Bost profit = 40, so assuming an even spread over the year, the profit for Jul-December is:

$$40 \times 6/12 = 20.$$

Unrealised profit needs to be deducted:

$$20 - 6.25 = 13.75$$

NCI share is 20%:

$$13.75 \times 20\% = 2.75$$

Step 6: Consolidated statement of profit or loss

Sta Company - Consolidated Statement of comprehensive income for the year ended 31 Dec 20X7

	Workings	Rwf million	
Revenue	Step 3	841.5	
Cost of sales	Step 3	(281.25)	
Gross profit		560.25	
Distribution costs	P+S= 150 + (60 x 6/12)	(180)	
Admin expenses	P+S= 200 + (30 x 6/12)	(215)	
Profit before tax		165.25	
Taxation	P+S= 50 + (3 x 6/12)	(51.5)	
Profit for the year		113.75	
Attributable to:			
Equity shareholders in A	Balancing figure	111	
Non-controlling interest	Step 4	2.75	
Profit for the year		113.75	

Fair value depreciation adjustment

In preparing the consolidated statement of financial position, we saw that the net assets of the subsidiary must be adjusted to fair value and then additional depreciation may be required. In the consolidated SFP this impacted on the groups retained earnings.

This additional depreciation must also be reflected as an additional expense by adding the additional amount to cost of sales or expenses.

You must ensure that the subsidiary's profit used to calculate the noncontrolling interest is reduced by the same amount.

Inter-company asset disposal

If a non-current asset has been transferred within the group, adjustments must be made to eliminate any profit / loss on disposal and for any difference in depreciation. We saw the impact of this on the consolidated statement of financial position. In the consolidated statement of profit or loss, you will need to:

- Increase cost of sales (eliminate any profit on transfer)/ Decrease cost of sales (eliminate any loss on transfer). If the subsidiary was the selling company, you will need to ensure that the subsidiary's profit used to calculate the non-controlling interest is reduced by the profit on disposal (or increased by the loss on disposal).
- Decrease cost of sales to remove excess depreciation charged as a result of transferring an asset within the group at a profit / increase cost of sales to account for additional depreciation required as a result of transferring an asset within the group at a loss.

If the subsidiary was the purchasing company, you will need to ensure that the profit used for the non-controlling interest calculation is increased to eliminate any additional depreciation charged after transfer (or decreased if the depreciation charge is less after the transfer).

Associate

According to IAS 28 Investments in Associates and Joint Ventures, an associate is an entity over which the investor has significant influence, but does not control.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control of those policies.

We can assume that significant influence exists if the percentage holding is greater than or equal to 20% of the ordinary shares.

The standard also says that the existence of significant influence by an entity is usually evidenced in one or more of the following ways:

- Representation on the board of directors;
- Participation in the policy-making process;
- Material transactions between the entity and investee;
- Interchange of managerial personnel;
- Provision of essential technical information.

The reason that this is so important is that the accounting for an associate is different than for a subsidiary because the investor does not have control. The method for accounting for associates in consolidated financial statements is the equity method.

The equity method is a method of accounting whereby an investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. This means that the change in an associate's net assets to be included in the consolidated financial statements is equivalent to the parents share of the associate's profit or loss for that period.

In the separate financial statements of the investor the investment will be shown at cost, but in the consolidated statement of financial position an extra line will be added in under non-current assets as shown below.

The amount to be shown under Non-current assets is calculated as follows:

Cost of investment	X	
Plus: Investor's % (step 1) of associate's post-acquisition retained earnings		X
Less: Impairment loss	(X)	
Investment in associate	X	

An associate is not controlled by the investor and therefore we do not consolidate the assets and liabilities as this would be misleading to the user.

For the investment in associate, we show the original investment that has been made, plus their share of post-acquisition profits.

Example

The Donald Group has prepared its consolidated SFP but has not yet equity accounted for its 35% investment in Eoin Company. Donald paid Rwf 150 million for its share in Eoin when the retained earnings of Eoin were Rwf 100 million.

The group retained earnings prior to equity accounting were Rwf 955 million and the retained earnings of Eoin at the reporting date were Rwf 290 million.

Calculate the investment in associate line that will shown in the consolidated statement of financial position and calculate the group retained earnings.

Calculate group retained earnings

	Rwf million
Group retained earnings	955
Associate – group share of post-acquisition retained earnings:	
Retained earnings at date of reporting	290
Less: retained earnings at date of acquisition	(100)
Post-acquisition reserves	190
Group share $190 \times 35\%$	66.5
Retained earnings	1,021.5

Calculate 'investment in associate'

	Rwf million
Cost of investment	150
Plus: group share of associate's post-acquisition profits	66.5
Investment in associate	216.5

Measurement of investments in separate financial statements

IAS 27 Separate Financial Statements is a fairly short standard which prescribes how a parent presents its investment in a subsidiary (or associate or joint venture) in its separate financial statements.

Separate financial statements are the financial statements presented in addition to the consolidated financial statements. These are not required by IFRSs, but they may be required by local regulation.

Statement of financial position:	When an entity prepares separate financial statements, it accounts for investments in subsidiaries or associates (or joint ventures or associates) using one of the following: (a) at cost (b) as a financial asset in accordance with IFRS 9 Financial Instruments (c) using the equity method
Statement of profit or loss	The treatment should follow the option chosen above. For a) or b) the dividend will be shown in profit or loss. For c), the entity should apply equity accounting.

Summary of Unit D and key learning outcomes

Unit D deals with the key competency 'Preparation of the financial statements of group entities'. In this unit, we looked at the following learning outcome:

Learning outcome	
Preparation of consolidated financial statements	You should now be able to prepare the consolidated statement of financial position and the consolidated statement of profit or loss for a parent and subsidiary. You should also now be able to prepare the consolidated statement of financial position and the consolidated statement of profit or loss for a parent an associate using equity accounting.

Quiz questions

1	Learning Outcome: D1
Which of the following is 'a method of accounting whereby an investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets'?	
A	Equity accounting
B	Subsidiary accounting
C	Group accounting
D	Consolidated accounting

1	Feedback	
A	Correct	
B	Incorrect Equity accounting	
C	Incorrect Equity accounting	
D	Incorrect Equity accounting	

2	Learning Outcome: D1
If Company X purchase 75% of the shares in Company Q at the start of month 10 of their financial year, how should they account for the revenue of Company Q in the consolidated statement of profit or loss for the year?	
A	They should include 75% of the revenue of Company Q in the consolidated revenue figure
B	They should include none of the revenue of Company Q in the consolidated revenue figure

C	They should include 100% of the revenue of Company Q in the consolidated revenue figure
D	They should include 25% of the revenue of Company Q in the consolidated revenue figure

2	Feedback
A	Incorrect They should include 25% of the revenue of Company Q in the consolidated revenue figure
B	Incorrect They should include 25% of the revenue of Company Q in the consolidated revenue figure
C	Incorrect They should include 25% of the revenue of Company Q in the consolidated revenue figure
D	Correct

3	Learning Outcome: D1
<p>Baker Company has sold equipment to its subsidiary Cono Company during the year, recording a profit of Rwf 10 million on the transaction as 'other income'. Cono charges depreciation of equipment to cost of sales over five years using the straight-line method.</p> <p>When preparing the consolidated statement of profit or loss, which of the following actions is correct in order to adjust for adjusting for excess depreciation from the sale of the equipment?</p>	
A	Increase 'other income' by Rwf 2 million Reduce 'cost of sales' by Rwf 2 million
B	Reduce 'other income' by Rwf 10 million Reduce 'cost of sales' by Rwf 2 million
C	Increase 'other income' by Rwf 10 million Increase 'cost of sales' by Rwf 2 million
D	Reduce 'other income' by Rwf 10 million Increase 'cost of sales' by Rwf 10 million

3	Feedback
A	Incorrect Reduce 'other income' by Rwf 10 million Reduce 'cost of sales' by Rwf 2 million
B	Correct
C	Incorrect Reduce 'other income' by Rwf 10 million Reduce 'cost of sales' by Rwf 2 million
D	Incorrect Reduce 'other income' by Rwf 10 million Reduce 'cost of sales' by Rwf 2 million

4	Learning Outcome: D1
Which of the following is the correct journal entry for preparing consolidated financial statements when the Parent company (P) has sold goods at a profit to its Subsidiary (S)?	
A	Debit Non-controlling interest Credit P's retained earnings
B	Debit P's retained earnings Credit Closing inventory
C	Debit P's retained earnings Credit Closing inventory
D	Debit S's retained earnings Credit Closing inventory

4	Feedback
A	Incorrect Debit P's retained earnings Credit Closing inventory
B	Correct

4	Feedback
C	Incorrect Debit P's retained earnings Credit Closing inventory
D	Incorrect Debit P's retained earnings Credit Closing inventory

Exercises

Exercise D1

Pint Company acquired 60% of the ordinary share company of Scone Company on 1 January 20X1, when Scone's retained earnings were nil. Immediately after being acquired by Pint, Scone sold plant with a net book value of Rwf 100 million to Pint for Rwf 125 million.

The companies prepare both accounts to 31 December 20X1 and the balances of their retained earnings at that date were:

Pint (after charging depreciation of 10% on plant) Rwf 270 million

Scone (including profit on sale of plant) Rwf 180 million

Show the working for group retained earnings.

Exercise D1 solution

Parent's retained earnings (100%)	270
'Extra' depreciation to be added back:	
$(125 \times 10\%) - (100 \times 10\%) =$	2.5
Subsidiary - group share of post-acquisition retained earnings:	
Retained earnings at date of reporting	180
Unrealised profit on disposal	(25)
Less: retained earnings at date of acquisition	<u>0</u>
Post-acquisition retained earnings	155
Group share = $60\% \times 155$	93
Less: Goodwill impairment	<u>(0)</u>
Group retained earnings	<u>365.5</u>

Unit E: Analysis and interpretation of financial reports

Learning outcomes

- E1. Analysis of financial statements to meet the needs of different stakeholders
- E2. Limitations of financial statements and financial analysis techniques

Introduction to Unit E

Financial statements do not tell us very much about how an organisation has performed. For example, if a company has made a profit of Rwf 15 million, does this mean the company has performed well? What if that company has Rwf 10 billion worth of assets? Financial performance must always be put in context to be meaningful.

Certain tools are available to contribute to this analysis, such as ratio analysis, trend analysis, performance indicators, benchmarking, etc. However, it's also important to be aware of the limitations of these techniques.

E1. Analysis of financial statements to meet the needs of different stakeholders

Ratio analysis

Financial ratios are calculated using information from a company's financial statements. These ratios can be defined in different ways (as there are no standards dealing with these, other than for Earnings Per Share), and can be grouped in different ways, but they can be considered in the context of the following five categories:

- Profitability
- Efficiency
- Liquidity
- Solvency
- Shareholder investment

Accounting ratios can help to summarise and present financial information in a more easily understood form. They can assist in assessing the performance of an organisation by identifying significant relationships between different figures. The term 'ratios' is used as a general reference for all items that might be used in this way; we will therefore look at some that are indeed expressed as a ratio (ie one amount is compared in relation to another and stated in the form 2:1 or 3:2, etc) and also at other figures that are measured as a percentage or as a frequency (eg '3 times per year') or as a period of time (eg 30 days).

Profitability ratios

The usefulness of the figures shown in the statement of profit or loss will be greatly enhanced by expressing profit as a percentage of revenue or capital employed, thereby allowing comparison with previous years and other organisations. In addition, these ratios will provide an indication of how well an organisation controls its costs.

The most commonly used profitability ratios are:

Ratio	Formula
Return on capital employed (%) (ROCE)	$(\text{Profit from operating activities} / \text{capital employed}) \times 100$
Return on equity (ROE) (%)	$(\text{Profit from operating activities} / \text{shareholders' funds}) \times 100$
Net profit margin (%)	$(\text{Profit from operating activities} / \text{revenue}) \times 100$
Gross profit margin (%)	$(\text{Gross profit} / \text{revenue}) \times 100$

Efficiency (or working capital) ratios

To be successful it is essential that a business makes good use of its assets. We can get an indication of this through calculating the following ratios:

Ratio	Formula
Turnover of capital employed or Asset turnover (times)	$\text{Revenue} / \text{capital employed}$
Non-current asset turnover (times)	$\text{Revenue} / \text{non-current assets}$
Current asset turnover (times)	$\text{Revenue} / \text{current assets}$
Average inventory days	$(\text{Average inventory} / \text{cost of sales}) \times 365$
Average trade payables days	$(\text{Average trade payables} / \text{credit purchases}) \times 365$

Liquidity ratios

Of crucial importance to any organisation is its ability to generate cash and be able to meet day-to-day debts as they fall due. To help assess an organisation's liquidity we use the following ratios:

Ratio	Formula
Current ratio	$\text{Current assets} / \text{current liabilities}$

Ratio	Formula
Quick ratio (or acid test)	$(\text{Current assets} - \text{inventory}) / \text{current liabilities}$
Both these ratios are expressed as x:y, (eg 2:1, 1.5:1)	

Care must be taken when interpreting the current ratio and in particular it is important to consider the makeup of current assets. If current assets predominately comprise inventory and receivables, then a business with a healthy current ratio might still experience liquidity problems since it is not always easy to turn these assets into cash at short notice. For this reason, the acid test ratio should be used in conjunction with the current ratio.

Long term solvency and debt ratios

Investors and lenders will be interested in an organisation's long-term funding arrangements and in particular its dependence on borrowed funds. The greater an organisation's dependence on borrowed funds, the higher the risk that it will be unable to meet interest and capital repayments when they become due. The following ratios assist our understanding of this area.

Ratio	Formula
Gearing (%)	$(\text{Non-equity finance} / \text{capital employed}) \times 100$
Interest cover (times)	$\text{Profit from operating activities} / \text{finance costs}$

Shareholder investment ratios

Of prime concern to investors are the likely return from and the level of risk attached to an investment. We will consider the following ratios to assess the return to investors:

Ratio	Formula
Ordinary dividend cover (times)	$\text{Profit attributable to ordinary shareholders} / \text{ordinary dividends}$
Earnings per share (Basic) (EPS)	$\text{Profit attributable to ordinary shareholders} / \text{number of ordinary shares}$

Interpretation of the statement of profit or loss and statement of financial position

We will look at the interpretation of the statement of cash flows separately later in this unit, but we can first note that virtually all of the ratios listed above are based on the information to be found in a company's statement of profit or loss and statement of financial position.

The example below illustrates both how these are calculated, and also how the information can be interpreted.

Example – interpretation of statement of profit or loss and statement of financial position

You are the management accountant of the Field Company. The Plaster Company is a competitor in the same industry, and it has been operating for 20 years.

Summaries of Plaster's statement of statement of profit or loss and statement of financial position for the previous 2 years are given below:

Plaster Company – summarised statement of profit or loss account for the year ended 31 December:

	20X9	20X8
	(Rwf million)	(Rwf million)
Revenue	913	981
Cost of sales	<u>(590)</u>	<u>(645)</u>
Gross profit	323	336
Distribution and admin expenses	<u>(219)</u>	<u>(214)</u>
Profit before interest	104	122
Finance costs	<u>(19)</u>	<u>(15)</u>
Profit before tax	85	107
Income tax	<u>(45)</u>	<u>(52)</u>
Profit for the year	<u>40</u>	<u>55</u>

Plaster Company summarised statement of financial position as at 31 December:

	20X9	20X8
	(Rwf million)	(Rwf million)
Non-current assets:		
Intangible assets	48	40
Property, plant & equipment	216	206
Current assets:		
Inventory	294	303
Receivables	160	141
Bank	<u>52</u>	<u>58</u>
Total assets	<u>770</u>	<u>748</u>
Equity and reserves:		
Ordinary share capital	100	100
Retained earnings	346	380
Non-current liabilities:		
Long term loans	138	88
Current liabilities:		
Trade payables	75	75
Other payables	<u>111</u>	<u>105</u>
Total equity and liabilities	<u>770</u>	<u>748</u>

Solution

The following comments can be made on the financial statements of Plaster Company.

Profitability

ROCE	$104 / 584 * 100$	18%
	$122 / 568 * 100$	21.5%

The company has seen a reduction in return on capital employed.

Gross profit	$323 / 913 * 100$	35%
	$336 / 981 * 100$	34%

Gross profit margin has increased slightly, suggesting that the company is controlling their direct cost of sales.

Net profit	$104 / 913 * 100$	11.4%
	$122 / 981 * 100$	12.4%

Sales revenue has fallen by Rwf 68 million in 20X9 compared to 20X8 (ie from Rwf 981 million to Rwf 913 million), but costs have not declined in line with this fall, meaning net profit margins have suffered.

ROCE has been impacted by declining net profit.

Efficiency

Non-current asset turnover

$913 / 264$	3.5 times
$981 / 246$	4.0 times

Non-current asset turnover has declined between 20X9 and 20X8. Given the increase in non-current assets this could suggest that the new assets acquired during the year are not yet operating at full efficiency. This would also contribute to the decline in ROCE.

Current asset turnover

$913 / 506$	1.8 times
$981 / 502$	1.95 times

Current asset turnover has also declined. By looking at the current asset breakdown this appears to be a result of the increase in receivables.

Inventory days	$394 / 590 * 365$	182 days
	$303 / 645 * 365$	171 days
Receivables days	$160 / 913 * 365$	64 days
	$141 / 981 * 365$	52 days
Payables days	$75 / 590 * 365$	46 days
	$75 / 645 * 365$	42 days

Both the inventory period and receivables period have risen, offset to some extent by payables days increasing.

This suggests that management of working capital might have deteriorated: for example, credit control procedures may have weakened, and obsolete inventory may be being held.

Solvency

Gearing	$138 / 584$	24%
	$88 / 568$	15%

Gearing has risen from 15% to 24% in 20X9.

This increasing reliance on debt has resulted in subsequent increases in finance costs, and has therefore impacted profitability.

Although the company is not over-reliant on debt (non-equity finance is still well below 50%), the rise in gearing will have increased its perceived riskiness to investors and lenders.

Interpretation of the statement of cash flows

The statement of cash flows, as prepared in accordance with IAS 7, provides the users of accounts with information which is not found elsewhere in the accounts. In particular, the relationship between profit and cash can be seen clearly and analysed accordingly. As explained in Units A to C of this module, the cash flow statement analyses cash flows into:

- cash flows from operating activities;
- cash flows from investing activities; and
- cash flows from financing activities.

This classification assists users in making informed predictions about a company's future cash flows.

Cash generated from operating activities

Profit is not the same as cash; one reason for this is the accruals concept: the profit and loss account records sales when they happen, even if the customer has not paid yet.

Companies may generate a lot of profits but if these profits are not capable of being converted into cash (for example if cash is not being collected from receivables), then companies may still face liquidity problems. It is beneficial to have profits that are matched by corresponding inflows of cash from operations.

Cash generated from operating activities must also be available to meet unavoidable costs such as interest charges and taxation. This is also a measure of the safety margin; i.e. how long a company could continue to pay unavoidable costs.

The amount of cash generated from operating activities is a key indicator of the extent to which the operations of the business have generated sufficient cash flows to repay loans, maintain the operating capability of the business, pay dividends, and make new investments without recourse to external sources of financing.

Cash generated from investing activities

These are cash flows arising from the acquisition and disposal of non-current assets and investments. It is useful to consider how much of the expenditure is to replace existing non-current assets and how much is to increase capacity.

If the investing cash flows relate to increasing existing activities, then there is potential for an increase in turnover and profits. If the company has merely replaced non-current assets that were worn out, then the company is not expanding.

Cash generated from financing activities

Cash generated from financing activities includes receipts from or payments to the external providers of finance.

Cash flows from financing activities help to predict the claims on future cash flows by providers of capital to the company. New issues of shares (ordinary or preference) mean more dividends need to be paid in the future.

A new long-term loan brings with it additional costs and benefits. The company can use the loan to acquire non-current assets, to grow and expand the business, but it must also make allowance for increased loan interest payments.

The relationship between the three activities: operating, investing and financing activities must be examined when analysing a statement of cash flows. Also, the statement of cash flows should be used in conjunction with the statement of comprehensive income and statement of financial position.

This should provide information that enable users to evaluate changes in:

- the net assets of an entity
- its financial structure
- its liquidity and solvency
- its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.

Example

Statement of cash flows for Milking Company	20X8	20X7
	Rwf million	Rwf million
Cash flows from operating activities		
Profit before tax	10.0	6.0
Depreciation	1.5	1.1
Finance cost	0.8	0.5
Increase in inventories	(2.0)	(0.5)
Increase in receivables	(3.0)	(0.7)
Decrease in payables	(1.5)	(0.1)
Taxation paid	(1.8)	(1.7)
Finance costs paid	<u>(0.8)</u>	<u>(0.5)</u>
Net cash generated from operating activities	<u>3.2</u>	<u>4.1</u>
Cash flows from investing activities		
Purchase of property, plant and equipment	(20.0)	(1.0)
Proceeds from sale of property, plant and equipment	<u>0.5</u>	<u>0</u>
Net cash used in investing activities	<u>(19.5)</u>	<u>(1.0)</u>
Cash flows from financing activities		
Cash proceeds from loans	18.0	-
Dividends payment	<u>(3.0)</u>	<u>(2.5)</u>
Net cash generated from financing activities	<u>15.0</u>	<u>(2.5)</u>
(Decrease)/Increase in cash and cash equivalents	(1.3)	0.6
Net cash and cash equivalents at beginning of period	<u>4.0</u>	<u>3.4</u>
Net cash and cash equivalents at end of period	<u>2.7</u>	<u>4.0</u>

Solution

- Overall, in 20X8 there has been a cash outflow of Rwf 1.3 million in Milking's business.
- Whilst the profit before tax has increased by Rwf 4 million from the previous year, this has not been matched by an increase in operating cashflows. The reasons for this are:
 - They have had a significant cash outflow from the management of working capital
 - The business is holding more inventory
 - There has been an increase in receivables
 - The business is also paying its suppliers sooner.
- Whilst their operating cash flows is lower than the previous year, the business is still generating a positive cash flow from trading.
- Compared to the previous year, Milking has made a significant investment in acquiring PPE this year. This would suggest a significant expansion, and this would fit with the changes in working capital. A possible explanation could be that they have won a new contract or expanded into a new business area.
- A large cash outflow isn't always a problem; it depends what the business is spending on. In this example, the purchase of non-current assets suggests that Milking is investing in the future capacity of the business.
- Similarly, a large cash inflow isn't always good news; if cash has been generated by selling assets this may help the cash position this year, but this approach isn't sustainable as next year Milking may have no similar assets to sell.
- To finance this expansion, Milking have taken on new borrowings, and this has resulted in a small increase in finance costs. It is likely that finance cost will increase further in the future as the new borrowings may have been taken out towards the end of the year. However, the profits and their operating cash flows may also increase as the benefits of expansion flow to the business.
- Despite the decrease in operating cash flows, Milking have increased the dividend paid to shareholders. A key area of concern with this business is that they paid out a significant dividend at a time when they are going through a significant expansion. If the expansion does not translate to increased cash flows, this may lead to cash problems.

Interpretation of public sector financial statements

Most of the ratios discussed above have some application in the public sector, but the following points need to be taken into account:

- Some definitions may need to be modified to reflect the terminology and structure of IPSAS statement: eg use of 'operating surplus' rather than 'profit before interest and tax'.
- Some public sector organisations have limited control over some aspects of their finances; organisations may be largely funded by a grant from an external body, rather than being able to generate their own income from sales.

- Public sector organisations may have different objectives, with little or no emphasis on profit as an objective.
- Public sector organisations tend to have a wide range of stakeholders, so it is not always straightforward to identify ratios or other performance measures that are relevant to all potential stakeholders.
- Some organisations are given targets to achieve in the year, and performance should be assessed against these targets rather than against past performance or the performance of other organisations.
- Organisations may have to operate in the context of statutory targets; eg an education authority may not be legally permitted to have classes above a certain number of students.
- Competition is less of an issue in the public sector, so comparisons with other organisations may be carried out for different reasons, eg benchmarking, continuous improvement, rather than to become more competitive.

Where statutory targets exist, these form a framework which can help the users of the financial statements draw conclusions about financial performance. Organisations often have locally determined financial targets that are used to help assess their financial performance.

Where there are no targets to use as a reference point, it may be necessary to use standard financial ratios to assess performance. Not all the ratios listed above will be relevant or useful when analysing the financial performance of a particular public service organisation. It is important to consider the following in the selection of ratios:

- Are the ratios relevant to the entity you are assessing? For example, interest cover and gearing ratios will not be relevant to organisations which have limited or no loan capital.
- Do the ratios address the issues that impact on that entity? Don't focus on profitability margins if you know that the key concern of the entity is its cash flow.

Some of the other considerations of applying ratios to public service entities are considered below.

Return on capital employed (ROCE)

ROCE has been widely used by governments to evaluate the performance of a wide range of public sector bodies. For example, UK hospitals have to report their annual performance against a ROCE-based target to ensure that the money invested in setting up the hospital by central government is generating a sufficient return for the government.

ROCE provides an indicator of what, in financial terms, has been achieved through investing in public services. Of course, calculating ROCE by itself will not give an understanding of the organisation's achievement in delivering good quality services.

Meeting a required rate of return is a statutory target for some organisations, and performance against this target needs to be reported in a note to the financial statements. Failure to achieve the target could result in a ministerial review or, where an organisation is judged on its financial performance as part of a wider assessment regime, a poor rating being given.

Entity-style reporting arrangements

A more general application of ratio analysis is advantageous where organisations are subject to entity-style reporting requirements. This might be relevant for organisations such as housing associations, universities, further education colleges and government trading funds.

In these cases, as well as ROCE, many other ratios could be relevant in the assessment of the financial statements. These could include measures of liquidity and the efficient use of working capital, growth and long-term stability.

Similarly, for charities administered by a public body, a review of ROCE, working capital, liquidity and long-term stability would be important issues for the trustees to consider and monitor. There would also be interest expressed in the returns gained on investments, asset utilisation and so on.

Trading organisations and companies

Many parts of the public sector also have trading organisations and companies. These entities would be interested in all of the above, plus return on sales, gross and net profit (or surplus) percentages, various cost subdivisions as a proportion of sales, etc.

The parent organisation can use these measures to determine whether the trading organisation has operated effectively and met required organisational objectives.

Looking beyond the results of ratios

It is important not to regard the figures resulting from use of ratios as being the definitive or complete answer. It is important to consider the context, look behind the results, and refer to other information (such as changes in the services provided) in order to provide a full analysis of the organisation's performance.

Key issues you may need to consider in assessing the results of ratios could include:

- Whether meeting a target around breaking even is in itself enough. Issues such as: the extent to which financial performance is recurrent; financial risks attached to both the statement of financial performance and the statement of financial position; and cash flow versus break even, may all need to be considered.
- The impact of accounting policies. This will be particularly important if you are comparing organisations. For example, IPSAS 17 Property, Plant and Equipment allows a choice of holding property at either historic or current cost. Choosing the current cost option (i.e. revaluing property) will result in a lower ROCE than a comparable organisation which chooses not to revalue property, since the surplus will be lower (higher depreciation cost) and capital employed will be higher (inclusion of a revaluation reserve).
- Non-financial performance is usually considered to be as important as financial performance in the public sector. Some reference to non-financial factors might be appropriate to supplement the financial analysis.

Understanding breakeven

Public sector organisations often have a requirement to break even (i.e. income equals expenses) or to return a certain level of surplus. It is important that we consider not only if the target has been achieved, but also the extent to which it has been achieved through non-recurring sources. We will look at this using the example of Castle University below, which has a financial target of breaking even each year.

Castle University – summarised information from accounts for the year ending 31 July 20X2

	Rwf million
Total operating income	275,900
Total operating expenditure	(277,300)
Operating deficit	(1,400)
Investment income	1,000
Interest payable	(300)
Gain on disposal of non-current assets	705
Surplus for the year	5

It appears that Castle University has met its financial target of breaking even in year. The surplus of Rwf 5 million is minimal and would not be likely to attract criticism from its stakeholders for under-investing in services.

Looking behind how performance has been achieved, we should recognise that the break-even position has only been achieved through the generation of a significant gain on disposal of non-current assets. This means that achieving the target in future years may become harder as we may not have any other fixed assets to sell, and by reducing the number of fixed assets we hold, we may impair our ability to generate income and provide services and thus fail to meet the target in future years.

In addition to the gain on disposal of non-current assets, we may need to think about whether break-even has been achieved from non-recurring sources of income. These could include one-off grants or income that will not be received in the future from discontinuing or declining services.

Revenue risk

Another important factor to consider with regard to financial performance is the extent to which any income earned is subject to risk. In other words, we may have managed to break even this year, but what about future years when our revenue levels may fall? We can consider this question by referring to the information on Castle University.

Analysis of a break-even or target surplus needs to consider if the performance has been achieved only because of income whose level is subject to risk. For example, investment income will be subject to risk as the levels achieved will depend upon:

The level of returns that can be generated. These will change given investment strategy (do we invest in equities or bonds?) and market rates.

The amount that the organisation can invest. This will depend on our liquidity overall and how much cash we can tie up in both current and long-term investments.

Other income streams

In addition to the investment income that we have identified as being subject to risk, we may also have to consider other income streams. For example, income that is subject to a specified level of activity or even a specified level of output may threaten the achievement of financial performance in the future. Of course, in some cases income may be matched with variable costs which will reduce with corresponding falls in activity, but this is unlikely to be the case in most public service organisations given the high level of fixed costs. For example, the university may have received significant amounts of funding for research in the current year, but if this income is unavailable in the next year and the salaries of academics still need to be paid, then the university may find it difficult break even in future years

In conclusion, Castle University can claim to have met its break-even target this year. But it may find that in future years this is challenging if a substantial element of its income is subject to significant risks.

Limitations of financial statements analysis

In this section, we will consider a number of different aspects of financial statement analysis, looking at the extent to which we can rely on such information, and where there are important limitations that we need to keep in mind.

Financial ratios can be very helpful in gaining a deeper understanding of an organisation's financial situation. However, it is important to be aware of their limitations and to be careful in how they are actually used. Some of the main limitations are listed below.

- Financial statements are historic in nature, thus any ratios calculated are based on past rather than future performance
- Comparison of results may be difficult due to:
 - Use of different accounting policies
 - One-off items that distort results (e.g. a large bad debt)
 - Definition of ratio used (e.g. ROCE and gearing both have several definitions. In order to make meaningful comparison it is important to apply each definition consistently)
 - Judgements (e.g. useful life of NCA, allowance for receivables)
 - Economic conditions (e.g. high inflation)
 - Seasonal variations (e.g. impact on inventory).
- Ratios indicate problems but do not necessarily recommend solutions.

Fair value measurement

We sometimes refer to the 'fair value' of an asset as though it is a definitive figure with only one possible value.

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

When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or the liability under current market conditions, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

Within the definition provided by IFRS 13, you can see that there is some room for different interpretations of the appropriate figure for a particular asset. If an asset is one of a number of identical assets (eg offices in a large block of offices, all of equal size), and there is a regular market showing the price being paid for an equivalent asset, it should be possible to identify a market price and from that a fair value. If, however, a company has an asset that is fairly unique, and for which there are no recent comparators in terms of sales in recent times, the fair value may be difficult to determine, except to provide a wide range of potential values.

In the public sector, there are additional considerations, for example:

- Some assets are held for their cultural or historical significance, rather than for economic reasons (eg parliament building, palace, museum, national monument, work of art). IPSASB have identified a separate class of such assets, termed 'heritage assets', and have provided guidance on how these might be valued. As there is no intention to sell (and this may be legally impossible for some assets), and there is no discernible market, these may be held at 'nil' value.
- Some assets have no alternative application. Military assets, for example, may for both legal and practical reasons have no clear usage outside the public sector organisation (eg Ministry of Defence).
- Some assets are held for service potential rather than economic reasons; eg schools, hospitals, law courts. If these were sold, they would need to be replaced in order to continue providing the service, so a replacement cost may be more relevant to users than a market or fair value.

Historical financial statements

One of the main problems with financial statements is that they are backward looking. We have seen how the preparation of the main financial statements is carried out after the financial period has ended, and this process may take several months to complete. The historic financial information is important for accountability to shareholders and other stakeholders, but it is of very limited use in terms of predicting future financial performance:

- The fact that Company X has made a profit in the past year does not tell us whether they will continue to be profitable in future years.
- The assets and liabilities that were reported at the year end may not be in place at later periods. Some, such as property may not change much in the short term, but other balances (eg a bank loan or a payables amount) may be very different within days of the reporting date (eg if a loan is paid off, or a large payable incurred).

- The use of the historic cost basis of accounting may mean that even at the reporting date some figures may not be very meaningful. For example, a building bought for Rwf 10 billion in Year 1, and shown at a carrying amount of Rwf 6 billion in Year 10, may have a market value of Rwf 50 billion, but this may not be evident from the financial statements.

Other limitations

One of the most important points to note in the interpretation of financial statements is that a professional accountant should apply their knowledge of financial reporting concepts, principles, and standards, as well as any other technical knowledge such as in relation to tax accounting, company law, etc. In other words, an understanding of how financial statements are prepared is essential for reliable interpretation and analysis of these statements.

It is also crucial to note the circumstances of the business or organisation being assessed – which industry does it operate in, is it large or small, is it a new business or well established, what type of assets does it make use of, what are the characteristics of its inventory, etc? The context of the business is essential for valid conclusions to be made from any financial information.

Summary of Unit E and key learning outcomes

Unit E deals with the key competency 'Analysis and interpretation of financial reports'. In this unit, we looked at the following learning outcomes:

Learning outcome	
Analysis of financial statements to meet the needs of different stakeholders	<p>You should now be able to apply a range of relevant financial ratios to financial statements and prepare analysis for a range of potential users in the private sector and in the public sector.</p> <p>You should be aware of the importance of combining financial and non-financial information to inform the analysis of organisational performance and to enhance management reporting.</p> <p>You should be able to apply ratio analysis and other techniques to the comparison of organisational performance over time, and also between different organisations.</p>

Limitations of financial statements and financial analysis techniques

You should now be aware of the main limitations of the use of ratio analysis in the interpretation of financial statements.

You should be able apply knowledge of accounting standards in understanding the significance of information in the financial statements and using that knowledge to inform the use of ratios in performance appraisal.

You should be aware of the differences between private and public sector entities in terms of financial standards, objectives, stakeholders, etc, and apply that awareness in the interpretation of financial statements.

Quiz questions

1	Learning Outcome: E1
<p>Company F has a current ratio of 2:1 and a quick ratio of 0.5:1 in 20X4. The average in the industry is current ratio 2:1 and quick ratio 1.5:1. Company F has been close to the industry average each year for these ratios over the past 5 years.</p> <p>Which of the following is a potential conclusion in analysing the performance of Company F in 20X4?</p>	
A	Company F is holding less inventory than normal, and should take action to reduce inventory levels in future
B	Company F is holding more cash than normal, and should take action to reduce its cash balances by making investments
C	Company F is holding less cash than normal, and should take action to increase its cash balances by borrowing
D	Company F is holding more inventory than normal, and should take action to reduce inventory levels in future

1	Feedback
A	<p>Incorrect</p> <p>Company F is holding more inventory than normal, and should take action to reduce inventory levels in future</p>
B	<p>Incorrect</p> <p>Company F is holding more inventory than normal, and should take action to reduce inventory levels in future</p>
C	<p>Incorrect</p> <p>Company F is holding more inventory than normal, and should take action to reduce inventory levels in future</p>
D	<p>Correct</p>

2	Learning Outcome: E1												
<p>The following balances are taken from the financial statements of Company Y:</p> <table> <tr> <th></th><th>Rwf million</th></tr> <tr> <td>Profit from operations</td><td>945</td></tr> <tr> <td>Profit for the year after tax</td><td>673</td></tr> <tr> <td>Shareholders' funds</td><td>2,400</td></tr> <tr> <td>Long-term debentures</td><td>1,200</td></tr> <tr> <td>Total shareholders' funds plus liabilities</td><td>4,250</td></tr> </table> <p>What is Company Y's ROCE?</p>			Rwf million	Profit from operations	945	Profit for the year after tax	673	Shareholders' funds	2,400	Long-term debentures	1,200	Total shareholders' funds plus liabilities	4,250
	Rwf million												
Profit from operations	945												
Profit for the year after tax	673												
Shareholders' funds	2,400												
Long-term debentures	1,200												
Total shareholders' funds plus liabilities	4,250												
A	26%												
B	19%												
C	16%												
D	22%												

2	Feedback
A	Correct $945 / (2,400 + 1,200) = 26\%$
B	Incorrect $945 / (2,400 + 1,200) = 26\%$
C	Incorrect $945 / (2,400 + 1,200) = 26\%$
D	Incorrect $945 / (2,400 + 1,200) = 26\%$

3	Learning Outcome: E1
<p>Company B revalues property each year.</p> <p>Which of the following effects would the revaluation have on ROCE and gearing?</p>	

3	Learning Outcome: E1
A	The revaluation will cause both and gearing ROCE to increase
B	The revaluation will cause both and gearing ROCE to reduce
C	The revaluation will cause gearing to reduce and ROCE to increase
D	The revaluation will cause gearing to increase and ROCE to reduce

3	Feedback
A	Incorrect The revaluation will cause both and gearing ROCE to reduce
B	Correct
C	Incorrect The revaluation will cause both and gearing ROCE to reduce
D	Incorrect The revaluation will cause both and gearing ROCE to reduce

4	Learning Outcome: E1
Which of the following is the formula for calculating non-current asset turnover?	
A	Revenue / non-current assets
B	Non-current assets / revenue
C	Non-current assets / cost of sales
D	Cost of sales / non-current assets

	Feedback
A	Correct
B	Incorrect Revenue / non-current assets

	Feedback
C	Incorrect Revenue / non-current assets
D	Incorrect Revenue / non-current assets

5	Learning Outcome: E1
Which of the following ratios is defined as 'profit from operating activities / finance costs'?	
A	Gearing ratio
B	Interest cover ratio
C	Ordinary dividend cover ratio
D	Quick ratio

5	Feedback
A	Incorrect Interest cover ratio
B	Correct
C	Incorrect Interest cover ratio
D	Incorrect Interest cover ratio

6	Learning Outcome: E2
Which of the following is a limitation of interpretation of public sector financial statements?	
A	IPSAS standards do not recognise non-current assets
B	Public sector financial statements are not audited

C	Some public sector organisations have limited control over their revenue as it is provided through a grant
D	Public sector organisations do not use the accruals method of accounting

6	Feedback
A	<p>Incorrect</p> <p>Correct answer is C: Some public sector organisations have limited control over their revenue as it is provided through a grant.</p> <p>Note: public sector organisations that use the cash basis of accounting may not include non-current assets in their financial reporting, but IPSASB encourages accruals accounting and IPSAS 17 Property, Plant and Equipment and other standards require recognition of non-current assets.</p>
B	<p>Incorrect</p> <p>Correct answer is C: Some public sector organisations have limited control over their revenue as it is provided through a grant.</p>
C	Correct
D	<p>Incorrect</p> <p>Correct answer is C: Some public sector organisations have limited control over their revenue as it is provided through a grant.</p> <p>Note – some public sector organisations use the cash basis of accounting, but it is not correct to say that no public sector organisation uses accruals.</p>

7	Learning Outcome: E1
<p>DEF Agency is a public sector organisation that is required to break even each year (ie expenditure must be less than or equal to its income for the year).</p> <p>DEF made a surplus of Rwf 500 million in 20X5, which was achieved after selling non-current assets in December at a profit of Rwf 3,000 million.</p> <p>Which of the following might be a concern for DEF?</p>	
A	They should have retained the non-current assets in order to achieve a higher profit by selling at a later date
B	The auditors may query the recognition of the profit of Rwf 3,000 million in the current year, as this should be spread over the economic life of the assets
C	The profit from the sale of non-current assets is a non-recurring form of income, so there may be concern that it will not be able to break even in future years

D	The large profit on the sale of the non-current assets suggests that DEF had been charging the wrong depreciation amount in the preceding periods
---	---

7	Feedback
A	Incorrect The profit from the sale of non-current assets is a non-recurring form of income, so there may be concern that it will not be able to break even in future years
B	Incorrect The profit from the sale of non-current assets is a non-recurring form of income, so there may be concern that it will not be able to break even in future years
C	Correct
D	Incorrect The profit from the sale of non-current assets is a non-recurring form of income, so there may be concern that it will not be able to break even in future years

8	Learning Outcome: E2
<p>Company MNO have prepared draft financial statements which show Rwf 3,600 million of shareholders' funds.</p> <p>The external auditors have identified Rwf 400 million which relate to long-term loans, but have been included within shareholders' funds.</p> <p>Which of the following statements is true?</p>	
A	Company MNO may have deliberately classified the Rwf 400 million in order to manipulate the financial statements and provide a lower gearing ratio
B	Company MNO may have used professional judgement appropriately
C	Company MNO should add a note to the statement of financial position to explain the treatment of the Rwf 400 million
D	The inclusion of the Rwf 400 million within shareholders' funds has no impact on the gearing ratio

8	Feedback
A	Correct

B	<p>Incorrect</p> <p>Company MNO may have deliberately classified the Rwf 400 million in order to manipulate the financial statements and provide a lower gearing ratio</p>
C	<p>Incorrect</p> <p>Company MNO may have deliberately classified the Rwf 400 million in order to manipulate the financial statements and provide a lower gearing ratio</p>
D	<p>Incorrect</p> <p>Company MNO may have deliberately classified the Rwf 400 million in order to manipulate the financial statements and provide a lower gearing ratio</p>

Exercises

Exercise E1

You are the financial controller of Moody University. In recent years the management board of the university has become increasingly concerned about the future of Porterhouse as a centre of higher education.

A principal concern is the fact that student enrolments have fallen for the last five years, including a 10 per cent fall in the last year alone. The main problem with enrolments seems to lie in the university's over-reliance on courses which are no longer perceived as relevant by prospective students, such as ancient history and classics.

The head of the university has asked you to put together some information for the next meeting of the university's board of management focusing on recent financial performance and the key factors lying behind that performance. She also wants you to put forward some suggestions on how financial performance might be improved.

The University has three internally set financial targets which are:

- Surplus for the year to be at least 2.5% of total income
- Staff costs not to exceed 80% of total costs (excluding depreciation)
- Amounts owed by students in tuition fees and room rental not to exceed 1.5% of total assets.

You have several items of information available to help your analysis, including the following taken from the last two years' financial statements:

Moody University: Statement of financial performance

Year ending 31 July	20X2	20X1
	Rwf million	Rwf million
Revenue:		
Funding council grants	19,157	20,133
Tuition fees and education contracts	8,119	8,572
Research grants and contracts	6,044	6,224
Other income	<u>3,403</u>	<u>2,611</u>
Total revenue	36,723	37,540
Expenses		
Staff costs	(27,061)	(29,806)
Other operating expenses	(7,815)	(5,406)
Depreciation	<u>(2,252)</u>	<u>(2,351)</u>
Total expenses	<u>(37,128)</u>	<u>(37,563)</u>
Operating surplus/(deficit)	(405)	(23)
Investment income	4,239	3,338
Finance expenses	<u>(20)</u>	<u>(4)</u>
Surplus for year	<u>3,814</u>	<u>3,311</u>

Income from research grants and contracts has been stable over the last few years.

Other income consists primarily of receipts from catering and conferences Rwf 1,411 million in 20X0/X1; Rwf 1,635 million in 20X1/X2) and rents from university-owned student accommodation.

Last year, in a bid to raise income, the university increased rents by 25%. Student opposition to this rise led to a rent strike by approximately half the students in university-owned accommodation.

The increase in other operating expenses was due almost entirely to expenditure on a backlog of repairs to buildings and student accommodation.

Moody University: Statement of financial position

At 31 July	20X2	20X1
Non-current assets (at valuation)	Rwf million	Rwf million
Tangible fixed assets	55,679	54,417
Investment properties	14,224	<u>14,218</u>
	69,903	68,635
Current assets		
Inventory	15	16
Receivables	1,598	732
Current asset investments	2,079	–
Cash in hand	–	<u>2</u>
	3,692	<u>750</u>
	3,692	<u>750</u>
Total assets	73,595	<u>69,385</u>
Equity		
Revaluation reserve	19,227	18,991
Retained surplus	53,270	<u>49,686</u>
	72,497	68,677

Non-current liabilities:		
Provisions for liabilities and charges	20	20
Current liabilities		
Trade creditors	672	598
Bank overdraft	406	<u>90</u>
	1,078	<u>688</u>
Total equity and liabilities	73,595	<u>69,385</u>

- Investment properties in the statement of financial position relate exclusively to university-owned student accommodation.
- Receivables relate exclusively to amounts owed by students for tuition fees and room rental.

Prepare a report to the management board of the university which covers the following points:

- Whether or not the university has achieved its targets for the two financial years and factors which may have affected this year's performance.
- Any other matters emerging from the information above relating to the financial performance of the university which you consider should be mentioned.
- Recommendations for improving the university's financial performance.

Exercise E1 solution

a) Achievement of financial targets and factors affecting this year's performance

Target 1: Retained surplus for the year to equal at least 2.5 % of total income

	20X2 Rwf million	20X1 Rwf million
Surplus	3,814	3,311
Total income	40,962	40,878
Achievement	9.3%	8.1%
Target met?	Yes	Yes

Comment:

The target was met in the current year despite a fall in funding and tuition fees (down by about 5 per cent). This trend likely to continue unless student numbers increase.

The fall in funding and tuition fee income was partly offset by increases in other income and endowment income.

Costs were held broadly in line with last year overall, but a large repairs bill helped contribute to the fall in surplus.

Although a surplus is shown in both years, this is due to large amounts from investment income. Operating activities are actually operating at a deficit. Target may not be meaningful or helpful in this format.

Target 2: Staff costs not to exceed 80 per cent of total costs (excluding depreciation)

	20X2 Rwf million	20X1 Rwf million
Staff costs	27,061	29,806
Total cost less depreciation	34,876	35,212
Achievement	77.5%	84.6%
Target met?	Yes	No

Comment:

The target has been met for this year (it was not met last year) partly owing to a fall in staff costs of 9 per cent. This may represent a reduction in staff commensurate with declining student numbers.

Another factor in achieving this year's target was a rise in other expenditure following one-off repairs expenditure. If this is excluded, staff costs would be 83 per cent – above the required target.

Target 3: Amounts owed by students not to exceed 1.5% of total assets

	20X2 Rwf million	20X1 Rwf million
Owed by students (receivables)	1,598	732
Total assets	73,595	69,385
Achievement	2.2%	1.1%
Target met?	No	Yes

Comment

The target was met in the prior year but not in the current year. This is unsurprising; the rent strike protest by students means that the amount owed in rent arrears has increased considerably since the prior year.

b) Other significant matters

Whilst income from research and teaching grants has stayed steady recently, this might be expected to fall as student and staff numbers decline.

In 20X2, interest of Rwf 20 million was paid on the overdraft of Rwf 405 million at the same time that the University had over Rwf 2,000 million in short term investments. Since it is unlikely that we are getting a better return on these than we are paying the bank, this could be an indication of poor treasury management at the University.

Receivables, probably owing to the amounts of rent withheld as part of the rent strike. Some consideration should be given as to whether or not all of this is likely to be recovered.

c) Recommendations for improving the University's financial performance:

The key to improving the financial performance of the University is to increase student enrolments and thus boost the main sources of income; i.e. funding council grants and tuition fees.

A wider review of the courses offered should be undertaken to make the University more attractive.

Whilst pursuing an improvement in financial performance the University should not ignore non-financial factors such as the quality of teaching and other issues which might affect student recruitment, e.g. the rent strike caused by the rise in student rents last year.

Exercise E2

Guirm Company has prepared its financial statements for the year to 31 December 20X8. The company's cash flow statement, together with comparative figures for 20X7 is shown below.

Rwf million	20X8	20X7
Profit before taxation	2,000	16,000
Depreciation	200	1,600
Finance costs	200	1,200
(Increase) / decrease in inventory	2,000	500
(Increase) / decrease in receivables	5,000	(700)
Increase / (decrease) in payables	(2,200)	(100)
Taxation paid	(1,900)	(3,200)
Finance costs paid	<u>(800)</u>	<u>(500)</u>
Net cash flows from operating activities	<u>4,500</u>	<u>14,800</u>
Cash flows from investing activities:		
Purchase of property, plant and equipment	0	(3,000)
Proceeds from sale of property, plant and equipment	<u>10,200</u>	<u>0</u>
Net cash flows from investing activities	<u>10,200</u>	<u>(3,000)</u>
Cash flows from financing activities:		
Repayment of loan	(4,000)	0
Dividends payment	<u>(8,000)</u>	<u>(8,000)</u>
Net cash flows from financing activities	<u>(12,000)</u>	<u>(8,000)</u>
Net increase / (decrease) in cash and cash equivalents	2,700	3,800
Net cash and cash equivalents at beginning	<u>5,800</u>	<u>2,000</u>
Net cash and cash equivalents at end	<u>8,500</u>	<u>5,800</u>

Prepare an analysis of Guirm's statement of cash flows for 20X8

Exercise E2 – solution

The business has seen an increase in cash of Rwf 2,700 million.

- The profit before tax has decreased significantly. There has been a decrease in cash generated from operating activities, but this remains a positive figure. This has been achieved due to the significant reduction in trade receivables and inventories. This suggests that the company is slowing operations down.
- The business has made significant disposals of property, plant and equipment during the year, with no further investments in assets. This would again suggest a significant reduction in operations, which would fit with the changes in working capital that have been seen, along with the decrease in depreciation expense.
- The sale of assets has been used partly to finance the repayment of loans, which will have led to the reduction in finance costs during the period.
- Despite the reduction in cash generated from operating activities, the dividend payment has remained the same. Given the level of profits for the year, part of this dividend is being funded from retained earnings. Again, this would highlight that the business is in decline and profits are not being used for investment purposes.
- Although the business has a strong cash position, this is due to the reduction in working capital and the sale of non-current assets, rather than from the company's trading performance in the year.

Unit F: Developments in financial reporting regulations and practices

Learning outcomes

F.1. Current issues affecting financial reporting

Introduction to Unit F

In this unit, we will look briefly at the developments taking place in international accounting standards in both the public and private sectors.

As this situation is evolving continually, the summary in this unit will only be up to date for a limited period of time, and new pronouncements are made by the IASB regarding IFRS, and the IPSASB regarding IPSAS each year.

F.1. Current issues affecting financial reporting

IASB

As discussed in Unit A of this module, the standard-setting process involves several steps and therefore takes place over a period of time. Information is available in the IASB work plan, which can be accessed through the IFRS web site www.ifrs.org. This provides details, including dates, on activities related to standards and other IASB documents.

The projects in the IASB work plan are divided into the following areas:

Research projects	Gathering information and evidence related to an issue, such as a problem that may require a standard or a change to a standard to address the problem and identify a feasible solution.
Standard-setting projects	After completing the research, work takes place to develop a new standard or amend an existing standard
Maintenance projects	Maintenance projects focus on application questions about IFRSs, and the IASB develops narrow-scope amendments to these standards when necessary.

Application questions	The IFRS Interpretations Committee (IFRIC) considers questions regarding the use of IFRSs. This may lead to a need for a change to an existing standard, so may require a Maintenance project to take forward.
Small and medium-sized (SME) Q and A	The SME Implementation Group considers implementation and applications questions about the IFRS for SMEs.
Taxonomy projects (see also Unit G of this module)	These reflect new or amended IFRSs that affect presentation or disclosure requirements, and may lead to updating of the IFRS Accounting Taxonomy (see Unit G).

For example following are the Research and Standards projects in the work plan in 2024:

Research projects	
Intangible assets	Comprehensive review of the accounting requirements for intangibles
Post-implementation review of IFRS 15 Revenue from contracts with customers	Seeking stakeholders' views on requirements of IFRS 15 and follow up as necessary
Post implementation review of IFRS 9 Financial instruments	Review of IFRS 9 requirements on impairment, seeking stakeholders' views on requirements and disclosures and following up as necessary
Standards-setting projects	
Business Combinations	Exposure Draft Business Combinations – Disclosures, Goodwill, and Impairment. Seeks amendments to IFRS 3 Business Combinations and IAS 36 Impairment of Assets
Dynamic Risk Management	Development of model to assist investors' understanding of a company's dynamic risk management and develop Exposure Draft – relates to IFRS 9 Financial Instruments

Equity Method	Review use of equity method of accounting and develop answers to application questions about the method. Develop Exposure Draft – relates to IAS 28
Financial Instruments with Characteristics of Equity	To improve information from companies about financial instruments and address challenges with IAS 32 Financial Instruments – Presentation. Impacts on Conceptual Framework, IAS 32 and IFRS 9.

IPSASB

The IPSASB work programme is available for review at the web site www.ipsasb.org.

The following are the main projects included in the work programme in 2024:

Standard-setting projects	
Sustainability: Climate-Related Disclosures	To develop a standard that provides public sector specific guidance on climate-related disclosures
Measurement – Application Phase	To issue amended IPSASs with revised requirements for measurement at initial recognition, subsequent measurement, and measurement-related disclosures.
Other Lease-Type Arrangements	To issue a new IPSAS on leases that will be convergent with IFRS 16 Leases to the extent appropriate, with an initial Exposure Draft.
Natural Resources, and Natural Resources – IFRS 6 and IFRIC 20 Alignment	To develop a Consultation Paper and Exposure Draft(s) to address issues relating to the recognition, measurement, presentation, and disclosure of natural resources.
Presentation of Financial Statements	To enhance the communication effectiveness of financial information by developing a new IPSAS to replace IPSAS 1 Presentation of Financial Statements, focusing on improvements to support accountability and decision-making in the public sector.
IPSAS 33 – Limited Scope Update	To enhance IPSAS 33, First-Time Adoption of Accrual Basis IPSAS, to make this more effective and user-friendly.

Other comments

Note that for both IASB and IPSASB work programmes, there can be several steps in the process, depending on the nature of the project:

- Research
- Consultation
- Exposure Draft (ie a draft of the proposed new/amended standard)
- New/amended standard published

The information provided on the IFRS and IPSASB web sites is dynamic, and it alters continually. It therefore provides not only an outline of each project, but also information on work completed to date, the next step in the process, standards or other pronouncements that are impacted by the changes, other related projects that are under way, and detailed timelines, and the expected completion date.

Summary of Unit F and key learning outcomes

Unit F deals with the key competency 'Developments in financial reporting regulations and practices. In this unit, we looked at the following learning outcome:

Learning outcome	
Current issues affecting financial reporting	<p>You should now be able to discuss the types of project carried out by the IASB and IPSASB to maintain and develop standards for both the private and public sectors.</p> <p>You should also now be aware of examples of key projects that are underway in 2024, and the IFRS or IPSAS standards that are affected by these projects.</p>

Quiz questions

1	Learning Outcome: F1
Which one of the following statements is true?	
A	The IASB and IPSASB have a joint work programme to ensure that they develop standards that are interchangeable.
B	The IASB work programme includes Maintenance projects and SME projects
C	The IPSASB does not issue Exposure Drafts
D	The IASB Conceptual Framework is revised and re-issued on an annual basis

1	Feedback
A	Incorrect The IASB work programme includes Maintenance projects and SME projects
B	Correct
C	Incorrect The IASB work programme includes Maintenance projects and SME projects
D	Incorrect The IASB work programme includes Maintenance projects and SME projects

2	Learning Outcome: F1
Which one of the following is the objective of the IPSASB project 'Measurement – Application Phase'?	

A	To research and develop new ways of measuring the value of investments and other assets.
B	To remove the option of carrying assets at revalued amount from relevant standards
C	To issue amended IPSASs with revised requirements for measurement at initial recognition, subsequent measurement, and measurement-related disclosures.
D	To encourage entities to show all property, plant and equipment at market values.

2	Feedback
A	Incorrect To issue amended IPSASs with revised requirements for measurement at initial recognition, subsequent measurement, and measurement-related disclosures
B	Incorrect To issue amended IPSASs with revised requirements for measurement at initial recognition, subsequent measurement, and measurement-related disclosures
C	Correct
D	Incorrect To issue amended IPSASs with revised requirements for measurement at initial recognition, subsequent measurement, and measurement-related disclosures

3	Learning Outcome: F1
Which standards does the IASB project on Business Combinations seek to amend?	
A	IFRS 3 Business Combinations and IAS 32 Financial Instruments – Presentation.
B	IFRS 3 Business Combinations and IFRS 15 Revenue from contracts with customers

C	IFRS 3 Business Combinations and IASB Conceptual Framework
D	IFRS 3 Business Combinations and IAS 36 Impairment of Assets

3	Feedback
A	Incorrect IFRS 3 Business Combinations and IAS 36 Impairment of Assets
B	Incorrect IFRS 3 Business Combinations and IAS 36 Impairment of Assets
C	Incorrect IFRS 3 Business Combinations and IAS 36 Impairment of Assets
D	Correct

Unit G: Use of digital technologies

Learning outcomes

G.1. Use of digital technologies in financial reporting

Introduction to Unit G

In recent years, as technology, and in particular digital technology, has increased in terms of its sophistication, availability, speed, etc, there has been a vast change in the opportunities available within accounting and finance for exploiting this technology. This can range from a company making their web-site more interactive, thus enabling customers to search products, make purchases, apply payments, etc, to governments creating 'gateways' and 'portals' through which service users and tax payers can interact with government information and government services.

The whole area of digital technology, and the related topics within digital finance, are complex and varied areas that we cannot deal with in detail in this module. However, it is important that you are aware of the trends in how financial reporting is being impacted by digital technology, and the opportunities for exploiting digital technologies in ways that are of benefit to reporting entities, accounting professionals, and the users of financial statements.

Benefits of digital technology

Digital technology provides a variety of potential benefits in the context of financial reporting, for example:

Automation	Where financial reporting involves repeated actions, these may be automated rather than requiring human intervention.
Speed	As technology becomes more sophisticated and more automated, there is potential for preparing financial statements and delivering them to users more quickly.
Accuracy	Less human intervention, may lead to more accuracy, especially in repeated actions.

Volume	<p>'Big data' is becoming a more necessary part of modern commercial activity, and this can impact on financial reporting. Big data is extremely large and diverse collections of data that continue to grow over time and are too large or complex to be dealt with by traditional data-processing application software.</p> <p>Also, large companies with complex structures require large volumes of transactions and adjustments in preparing financial statements.</p>
Flexibility	<p>At the one end of the spectrum, delivering financial statements on paper or in a 'fixed' format such as a pdf document, do not enable users to adapt the information easily, whereas a more interactive form of financial statement may provide more opportunities (see XBRL below).</p>
Comparability	<p>Use of the same technology over time and across different organisations may enhance the consistency of information (in terms of content and presentation) and thus increase the ease of making comparisons.</p> <p>See also the use of 'tags' in XBRL below.</p>
Interrogation	<p>Where financial statements are provided in a flexible format (eg via spreadsheet, or with XBRL), the user is more able to carry out detailed analysis of the information.</p>

G.1. Use of digital technologies in financial reporting

When we refer to 'preparing financial statements' we do not usually specify what form these statements need to be in. It does not usually matter if these statements are presented on paper, in the form of a pdf electronic document, or in some other format. In this module so far, we have focused on the content of the statements, discussing how they need to meet the requirements of relevant IFRSs in terms of the figures included, the terms used to describe balances, the level of detail, etc.

From a user's perspective, the format of the statements and the method of delivery of the statements can be important.

If we consider various characteristics of statements that may be of importance to the user, we can see how these can be enhanced by use of technology. As a reminder, the IASB Conceptual Framework notes the following characteristics of useful information:

- Relevance
- Faithful representation
- Timeliness
- Understandability
- Verifiability
- Comparability

These largely relate to the preparation of the financial statements, stressing how important it is that the preparers of financial statements consider each of these in the way that data is collected, and the way in which the content of the financial statements is compiled. These characteristics are also identified by the IASB as essential in ensuring that the standards and related guidance are prepared in a consistent manner, and that the resulting accounting treatments lead to financial statements that contain useful information.

Production of financial statements

When preparing financial statements, we need to consider certain requirements, for example:

- Compliance with IFRS and legislation
- Timely finalisation of statements
- Reliable transfer of data from the accounting system to statements (including check for completeness, reconciliations, etc)
- User-friendly presentation
- etc

Over time, organisations have changed their practices so that the amounts in the financial statements are either automated or prepared with assistance from various technological tools. For example, for several years it has been common for organisations to have a set of blank statements set up using Excel or a similar system, so that the preparer of the statements can insert the relevant figures into the appropriate location. More sophisticated arrangements can use a financial management system to collect the balances from relevant accounts (eg by having links in the spreadsheet that relate to specific codes in the financial system) and include them in the relevant places in the financial statements.

The main advantage of using technology in this way is that the preparer can focus on checking the results to ensure that there are no errors or other issues, rather than their time being taken up with the laborious process of collecting all the financial data and transferring it manually into the statements.

This also means that training for accountants needs to emphasise the activities involved in applying a technological tool and checking results before statements are finalised. This will involve 'professional scepticism': accountants (and auditors) need to approach their work with the attitude that there may be issues that need to be identified and resolved, rather than assuming that any previous work (either via human action or from a computerised process) will be correct. Sample checking of output, and checking for reasonableness of specific figures, are necessary aspects of professional scepticism.

The recent trend in financial reporting has been to move towards reports that are machine readable. This means producing statements in a form that can be used in different and active ways by the user, rather than simply read by the user. For example, providing financial statements in Excel format would enable a user to make quick comparisons with other financial statements that are also in Excel (such as the same entity from previous periods, or similar organisations).

Distribution of financial statements

Over time, there have been a number of changes in the way that a company, or another

entity, issues its financial statements to make them available to users. At its simplest, this would have involved sending printed copies of the statements to users such as shareholders. This may have been speeded up in some cases by using an electronic transmission, such as email, but may still have involved a 'fixed' format such as a pdf, rather than a machine-readable format.

Users that the entity is not required to provide financial statements to may in the past have had to request that a set of statements is sent to them, either in hard copy by post, or electronically via email. Many organisations now provide access to financial statements through their web site, so interested parties can access them instantly once the statements have been uploaded to the web site. Again, however, these have tended to be in pdf or similar format.

Consumption of financial statements by users

The way in which financial statements are prepared and distributed will to a large extent dictate how users then consume that information. If a user receives a hard copy of the annual financial statements, for example, they can make use of the information by performing their own detailed analysis, calculations, comparisons, etc, if they have the time, knowledge, and resources to carry this out (but not all users will have these resources).

Financial statements that are machine readable create enhanced opportunities for users to interrogate and analyse the information contained in them.

This is partly enabled by providing statements in electronic format, such as using Excel. However, the user will still need to be careful when carrying out their analysis as statements may not be presented with similar levels of detail, consistent descriptors, etc. For example, two companies may show the following entries in their statement of financial position:

Company A	Rwf million
Bank	500
Company B	Rwf 000
Cash and bank	5,000

The use of different monetary details (Rwf millions and thousands) and different descriptors of balances (are 'Bank' and 'Cash and bank' comparable accounts?) can be misleading and make automated comparisons difficult.

Use of 'tags' can reduce this problem. The tags are embedded in the statements and need to be machine readable, so that they can be utilised by the user in performing further analysis or comparisons. Tags can also be linked to IFRS disclosure requirements – eg provisions as defined by IAS 37 can be tagged so that the equivalent item in another statement (eg from another company) can be easily identified as it will have the same tag embedded in that part of the statement (even if it is called something slightly different in the description).

Therefore, by digitising financial reports, information in those reports becomes machine-readable, allowing users to extract, compare and analyse information efficiently.

For digitalised financial statements to be effective, there needs to be a classification system to make the financial statements machine-readable. As standard setters (such as the IASB) are responsible for preparing and issuing standards which set out the requirements for company disclosures in financial statements, there also needs to be guidance on how

tags are derived from these standards to make the disclosures machine-readable in a systematic way. This indicates a need for a 'digital taxonomy':

Digital taxonomy	A system for classifying and structuring data points in a manner that: makes the data machine-readable aids users in finding, understanding and comparing large amounts of information to facilitate efficient financial analysis
	By using a common taxonomy to tag quantitative and qualitative disclosures, computers have the content needed to determine whether disclosures with different descriptors are comparable disclosures or not.
	The IFRS Accounting Taxonomy lists the globally agreed computer codes (elements) that preparers can use to identify (tag) disclosure in IFRS financial statements The Taxonomy describes the accounting meaning of each element and provides references to the IFRS standards. The Taxonomy organises elements into groups and defines relationships between them to help preparers and users of tagged financial statements to find elements more easily.
	The Taxonomy reflects disclosure requirements in IFRSs: It does not introduce new requirements It is not a disclosure checklist It does not dictate how prepares should present their reports

The extension of the use of digitalised financial statements and application of the IFRS Accounting Taxonomy to machine-readable financial statements can potentially provide additional benefits to users, particularly for investors, eg:

- The ability for investors to tailor the presentation of financial reports to meet their decision-making needs.
- Interactive financial reports that allow investors to 'toggle' between different measurement bases.
- Enhanced ability to reflect relationships between items / disclosures.

However, the use of the IFRS Accounting Taxonomy is currently fragmented, so these benefits are not fully available to investors yet

Technologies

The following are aspects of digital technology that have relevance in financial reporting:

XBRL	eXtensible Business Reporting Language is a language for tagging financial data.
	XBRL enables businesses to process and share data efficiently and accurately.
	Preparers of financial statements can use software to tag all items in the financial statements to the elements within a taxonomy (such as the IFRS Accounting Taxonomy)
Blockchain	Blockchain technology is an advanced database mechanism that maintains a growing list of ordered records (or 'blocks') and allows transparent information sharing within a business network. The database stores blocks that are linked together in a chain.
	The technology is used in recording transactions of cryptocurrencies. Other uses are found in smart contracts, supply chains, etc. A smart contract is used to automate the execution of an agreement, so that all participants can be certain of the outcome immediately.
	Banks and other financial institutions are developing uses in financial services, where the technology is thought to provide opportunities in increased efficiency and cost reduction.
	In financial accounting and financial reporting, there may be more impact from blockchain in the future, eg: Use in record keeping, transaction processing, authorisation. Settling liabilities through the use of digital assets. Relying on data exchange on a blockchain to support an accounting estimate. Automation of transactions and control through a smart contract.
Artificial intelligence (AI)	AI is the simulation of human intelligence processes by computer systems
	It has been used in accounts payable and invoicing to extract data and perform quality checks.
	It can also source information from an entity's public statements and facilitate activities such as fraud analytics, balance sheet analysis, etc.

	AI-powered software has been used to categorise expenses automatically, reconcile accounts, and generate financial reports.
	<p>Benefits include:</p> <p>Speed and efficiency.</p> <p>Continuous improvement, through machine learning.</p> <p>Time savings.</p> <p>Processing, structuring, and analysing of large amounts of data.</p>

Summary of Unit G and key learning outcomes

Unit G deals with the key competency 'Use of digital technologies'. In this unit, we looked at the following learning outcome:

Learning outcome	
Use of digital technologies in financial reporting	<p>You should now be able to discuss the benefits of the use of various forms of digital technology in financial reporting.</p> <p>You should now be able to describe the characteristics of digital technologies for use in each part of the financial reporting process, and how these technologies can be applied effectively in financial reporting.</p>

Quiz questions

1	Learning Outcome: GI
Which of the following is described as 'an advanced database mechanism that maintains a growing list of ordered records'?	
A	XBRL
B	Blockchain
C	Artificial intelligence
D	Accounting Taxonomy

1	Feedback
A	Incorrect Blockchain
B	Correct
C	Incorrect Blockchain
D	Incorrect Blockchain

2	Learning Outcome: GI
Which one of the following is a description of 'big data'?	
A	Large and diverse collections of data that are predictable over time and are too varied to be dealt with by traditional data-processing application software
B	Large and diverse collections of data that are derived from published financial statements and can be analysed using traditional data-processing application software such as Excel
C	Large and diverse collections of data published by the IASB and that can be compared using traditional data-processing application software

D	Large and diverse collections of data that continue to grow over time and are too large or complex to be dealt with by traditional data-processing application software
---	---

2	Feedback
A	Incorrect Large and diverse collections of data that continue to grow over time and are too large or complex to be dealt with by traditional data-processing application software
B	Incorrect Large and diverse collections of data that continue to grow over time and are too large or complex to be dealt with by traditional data-processing application software
C	Incorrect Large and diverse collections of data that continue to grow over time and are too large or complex to be dealt with by traditional data-processing application software
D	Correct

3	Learning Outcome: GI
Which one of the following lists the globally agreed computer codes (elements) that preparers can use to identify (tag) disclosure in IFRS financial statements?	
A	The IFRS Accounting Taxonomy
B	The IASB Accounts Codes
C	The IFRIC Accounting Manual
D	The IASB Finance Tags

3	Feedback
A	Correct
B	Incorrect The IFRS Accounting Taxonomy

C	Incorrect The IFRS Accounting Taxonomy
D	Incorrect The IFRS Accounting Taxonomy

4	Learning Outcome: G1
Which one of the following is a characteristic of useful information according to the IASB Conceptual Framework?	
A	Accuracy
B	Comparability
C	Brevity
D	Faithful characterisation

4	Feedback
A	Incorrect Comparability
B	Correct
C	Incorrect Comparability
D	Incorrect Comparability

5	Learning Outcome: G1
Which one of the following is true?	
A	Artificial intelligence is used to generate random text and has no applications in financial accounting or financial reporting
B	The use of artificial intelligence in financial reporting is illegal and would render financial statement unreliable

C	Artificial intelligence has been used in accounts payable and invoicing to extract data and to perform quality checks
D	Artificial intelligence has been used by the IASB to draft new accounting standards

5	Feedback
A	Incorrect Artificial intelligence has been used in accounts payable and invoicing to extract data and to perform quality checks
B	Incorrect Artificial intelligence has been used in accounts payable and invoicing to extract data and to perform quality checks
C	Correct
D	Incorrect Artificial intelligence has been used in accounts payable and invoicing to extract data and to perform quality checks

Summary of Module and key learning

The introduction to the Financial Reporting module identified a number of key areas of financial accounting that are covered in the 10 units:

- Preparation of financial statements for a single entity
- Preparation of consolidated financial statements
- Interpretation and analysis of financial statements
- The financial accounting context:
 - Regulatory framework – IFRS and IPSAS
 - Developments in financial reporting regulations
 - Digital finance

The following table provides an overview how Units A to G covered these areas, including a reminder of the key competency for each unit.

Unit A – Regulatory frameworks for financial reporting

This unit serves as an introduction to the module as a whole, and sets the context for the preparation of financial statements.

The unit describes the regulatory framework of both the private sector and public sector, focusing on the role of IFRS and IPSAS respectively, but also touching on the relevance of legislation and other regulations.

The Conceptual Framework is also discussed, covering key topics including recognition, measurement, characteristics of useful information, and disclosures.

Unit B – Development and presentation of financial and non-financial information for a single entity

This unit is in three sections. The first section deals with the preparation of financial statements for private and public sectors, the structure and content of the main statements, and the requirements of IAS 1 and IPSAS 1.

The second section looks at disclosure requirements for discontinued operations, earnings per share.

The final part of the unit covers non-financial reporting, including the role of the management commentary and the use of sustainability reporting.

Unit C – Financial reporting issues

This unit is the longest and most detailed of the units in the Financial Reporting module.

The structure and content of the unit reflects the main IFRSs (and IPSASs, where these are significantly different) that are included in the Financial Reporting syllabus.

Each section of the unit deals with a specific standard or group of standards, outlining the main financial reporting and disclosure requirements of the standard, and providing illustrative and practice examples.

Unit D – Preparation of the financial statements of group entities

This unit requires an understanding of most of the content from the preceding units, particularly in terms of the structure of the main statements and the application of key standards. However, the context in Unit D is for a group of companies, rather than a single entity.

The first part of the unit discusses the main processes involved in preparing the statement of financial position and the statement of profit or loss for a group involving a parent company with one subsidiary.

Subsequent sections deal with more complex adjustments, such as for intra-group trading, accounting for the fair value of assets, changes to the group structure during the year.

Accounting for an associate and for joint ventures are also discussed.

Unit E – Analysis and interpretation of financial reports

Unit E discusses the main types of ratio used in financial statement analysis, using practical examples to develop skills in applying this technique to assess the financial performance of a company.

The unit also looked at the use of ratios to draw conclusions and identify appropriate courses of action to restore or maintain effective financial performance. This includes analysis of cash flow information, and application of these techniques to public sector financial statements.

Unit F – Developments in financial reporting

This brief unit looks at the way in which the IASB and IPSASB work on the development of new or revised standards.

The unit includes a summary of the main projects underway at the time of writing to develop both IFRS and IPSAS standards.

Unit G – Use of digital technologies

Digital technology plays an ever increasing part in all aspects of organisations in the private and public sectors, including financial accounting systems and the preparation of financial statements.

Unit G considers how some of these different technologies are impacting directly on financial reporting and the potential for using these to increase the efficiency and usefulness of financial statements.

Quiz answers

Unit A Quiz answers

1	C
2	B
3	A
4	A
5	C
6	D
7	C
8	D
9	A
10	B

Unit B Quiz answers

1	D
2	B
3	A
4	C
5	A

Unit C Quiz answers

1	B
2	B
3	B
4	D
5	D
6	C
7	A
8	C
9	D
10	B

Unit D Quiz answers

1	A
2	D
3	B
4	B

Unit E Quiz answers

1	D
2	A
3	B
4	A
5	B
6	C
7	C
8	A

Unit F Quiz answers

1	B
2	C
3	D

Unit G Quiz answers

1	B
2	D
3	A
4	B
5	C



Contact Us
 Institute of Certified Public Accountants of Rwanda (ICPAR)
 KG 686 ST, House #10, Kamutwa, Kacyiru
 P.O. Box: 3213 Kigali
 Tel: +250 784103930
 Email: info@icparwanda.com
www.icparwanda.com